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Special Issue on the ZEDEs


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# Journal of Special Jurisdictions

## Special Issue on the ZEDEs

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## Letter from the Publisher

**Joseph McKinney**  
**Startup Societies Foundation**

A meteor hit the world in 2020. There were no billowing flames, darkened skies, nor flattened cities, but the results were equally traumatic. Covid-19 demolished everyone's way of life. Governments responded in ways unprecedented in human history. On top of the staggering toll on life and health, societies' core foundations have staggered. Politics, economics, finance, and culture have oscillated, desperate to find a new equilibrium.

This type of stress forces us to look at the world through new lenses. Because of the sheer magnitude of today's problems, decision-makers are more open to different approaches. As a result, many in government, businesses, academia, and

the media are looking towards Special Jurisdictions for the first time.

In 2019, while Special Jurisdictions were widespread, many still viewed them as strange and "out-there". In 2021, when traditional solutions have failed, "strange" has become "innovative" and inevitable.

This renewed Special Jurisdictions interest coincided with the launch of the most advanced example of a special jurisdiction to date: the Honduran ZEDEs. The ZEDE framework has progressed in different forms over the last ten years. Last year, it finally came to fruition with the launch of the first ZEDE, Próspera. It was quickly followed by the second, Ciudad Morazán. ZEDEs embody the next generation of Special Jurisdictions with

their own legal, administrative, and regulatory systems.

As institutions reflect on how to recover and thrive in a Post-Covid World, we have an advantage. At the Startup Societies Foundation, we have been studying special jurisdictions for the last 5 years. Now more than ever, I can say with great confidence: it is crucial to look at special jurisdictions. Today, this means looking at the ZEDEs. Their success, or failure, could shape the future of Special Jurisdictions, and the course of governance in the 21st century.

In 2020, we released a call for papers on the ZEDEs to fulfill that need. Because of our extraordinary authors, that the second issue of the Journal is *the* ultimate academic guide on the ZEDEs. We expect that stakeholders in government, academic, business, and media take our authors' work to heart. Ultimately, we hope that they take action, based on the best practices tested in the ZEDEs, and let more special jurisdictions thrive.



## Letter from the Editor

**Dr. Nathalie Mezza-Garcia, PhD**  
**Startup Societies Foundation**

The second issue of the Journal of Special Jurisdictions focuses on the Honduran Zones for Employment and Economic Development–Zonas de Empleo y Desarrollo Económico, ZEDEs. This time, we introduce five papers about the ZEDEs, one about pandemics and medical zones, and another one about China’s foreign SEZ policy and Brazil. I am proud to say that all our ZEDE papers contribute to the body of scholarship of common law special jurisdictions, and in particular the ZEDEs, using various methods and approaches. However, this issue has several comparative analyses. Some papers compare ZEDEs, ZEDEs and other zones around the world, ZEDEs and REDs, ZEDEs and Honduras, and the ZEDEs before and after.

In your hands, you hold a comprehensive starting point to familiarize yourself with the ZEDEs, where they come from, how they are different from the REDs, how they are governed, how they are shaping, what is CAMP, and what can we foresee.

The first paper is by Jorge Colindres, a Honduran lawyer and the director of the Fundación para la Libertad Económica. We decided to put Colindres’ paper first because of its excellent exposition of Honduras’ history prior to the ZEDEs. The paper diligently references Honduran regulations, laws, and codes. It also explains Honduran details known mostly to those familiar with local politics. The paper is great for anyone wishing to dig into the ZEDEs’ background and potential. I believe readers will not be able to ignore the paper’s points, whether they

agree with it. In a nutshell: Colindres argues that the first ZEDE, Próspera, is better equipped with democratic mechanisms than the rest of Honduras.

The second paper presents an interzone comparative analysis between four zones that the author, Professor Tom W. Bell, grouped under his coined term ‘common law zones’. In the most elegant way, the paper gives us a visual understanding of the administrative, organizational, and governance structures of Dubai International Financial Centre, the Abu Dhabi Global Market, Kazakhstan’s Astana International Financial Centre and the Próspera ZEDE. Bell explains how each of these zones import laws from outside sources and how the zones and the states where they nest implement checks and balances (or not). Professor Bell concludes that the ZEDEs, or Próspera, at least, is a more independent type of common law zone than its counterparts. Structured political influence seems to be a weakness of the other three zones in this study. This eye-catching paper shows how.

I am confident that our readers will also find our third paper very interesting. An expository article by the Próspera team, Erick Brimen, Trey Goff and Nicholas Dranias, the third paper details the governance structure of the first ZEDE. It locates the ZEDEs within Honduras’ broader context and tells the story of Próspera’s creation. The paper includes a section where Brimen, Próspera’s Managing Director, narrates in first person the ins-and-outs of the negotiation process. He provides details only known by insiders otherwise. The paper also addresses controversies and critiques surrounding the ZEDEs and provides Próspera’s approaches to the issues raised.

Our fourth paper, written by Jeffrey Mason, Carl Peterson and Daniela Cano from the Charter Cities Institute and the Fundación para la Libertad Económica, complements this issue nicely. First, it explains the precursor of the ZEDEs and its problems, the REDs. It then analyzes the ZEDE law text, articles, amendments, and statutes that have made

the ZEDEs possible. The paper is great for lawyers and for anyone interested in the legal aspect of the ZEDEs. It also addresses some controversies surrounding the ZEDEs law and establishes differences between the two first ZEDEs; Próspera and Ciudad Mozarán.

Our fifth piece is a report by Daniel Fernández and Olav Dirkmaat. While it is not an original piece, we republished this study after subjecting it to peer review for its economic projections of the ZEDEs and what they could mean for Honduras in the long-term. This piece discusses how the ZEDEs share elements with China's and with Dubai's zones. Likewise, it details how ZEDEs can expand to noncontiguous areas, and how the ZEDE frameworks can branch to subZEDEs. The authors call these 'growth hubs' and implement simulations to calculate the economic impact of the ZEDEs and Próspera's growth hubs.

The authors of our sixth paper, Anya Vanecek and Sam Molopulos, from the Mikken Institute School of Public Health and the United States Senate, take

us from Honduras to the United States and the COVID-9 pandemic. The authors propose a new type of federal zone, Medical Countermeasure Manufacturing Zones, as a response to supply chain problems faced during the pandemic. These problems include shortages of equipment, personnel, among others. As the authors explain, Medical Countermeasure Manufacturing Zones could offer tax incentives, short-listing, and speed up processes for businesses within those zones. They could be a route for companies to be considered for the Strategic National Stockpile, and to make sure that the United States is well positioned in times of crisis. This paper is a splendid example of this Journal's mission: to provide a space for academics and practitioners to approach special jurisdictions in novel ways. It pleases us to see here a type of zone that countries might decide to create in the near future.

Our last paper is by Isabela Christo. The paper discusses China's expansionist SEZ policy, and proposes the creation of a Special Economic Zone in the Minas Gerais state, Brazil. Specifically,

Christo states that Pouso Alegre city is ideally suited to attract Chinese FDI and increase the state's economic development. It further proposes the creation of an Export Processing Zone. She argues that Chinese FDI in an EPZ in Pouso Alegre can increase the city's economic development. The paper uses the example of the Xuzhou Construction Machinery Group and its Industrial Park.

Whether you support or are against the ZEDEs' framework, we hope that you learn from this issue as much as our team learnt it in the process of putting it together.



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## The Honduran ZEDEs: From National Politics to Local Democracies

Jorge Constantino Colindres

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### Abstract:

Special Economic Zones (SEZs) are generally lauded for their potential to increase economic growth and foster private investment by introducing business-friendly institutions such as competitive tax and regulatory frameworks. However, a new generation of special zones are also being used to introduce new democratic institutions into poorly governed countries. The economic success of Singapore, Hong Kong, and the SEZs of China and the United Arab Emirates inspired Honduran policymakers to amend the country's Constitution in 2013 to allow for the creation of special Zones for Employment and Economic Development (ZEDEs), a new political subdivision of the State of Honduras with a constitutionally granted autonomy to adopt their own governance structure and laws. In Latin America, however, special jurisdictions are bound by specific international law commitments to democratic governance and respect for human rights. This paper provides an overview of the democratic governance framework adopted by Próspera, the first Honduran ZEDE, while comparing it to the mechanisms for political participation available under the national legal system of Honduras. It further explores the ZEDE regime's potential to foster democratic change by introducing to Honduras more effective legal mechanisms for Hondurans to exercise their civil and political rights through semi-autonomous local governments.

**Keywords:** democratic governance, decentralization, local governments, political autonomy, democratization, special economic zones.

### Resumen

Las Zonas Económicas Especiales (ZEE) son generalmente elogiadas por su potencial para incrementar el crecimiento económico y fomentar la inversión privada mediante la introducción de instituciones favorables a las empresas, como marcos regulatorios y tributarios competitivos. Sin embargo, existe una nueva generación de zonas especiales, las cuales pueden introducir nuevas instituciones democráticas en países mal gobernados. El éxito económico de Singapur, Hong Kong y

las ZEE de China y los Emiratos Árabes Unidos inspiró a los legisladores hondureños a enmendar la Constitución del país en 2013 para permitir la creación de Zonas especiales de Empleo y Desarrollo Económico (ZEDE), una nueva subdivisión política del Estado de Honduras con autonomía constitucionalmente otorgada para adoptar su propia estructura de gobierno y leyes. En América Latina, sin embargo, las jurisdicciones especiales están sujetas a compromisos específicos del derecho internacional con la gobernabilidad democrática y el respeto de los derechos humanos. Este documento ofrece una visión general del marco de gobernanza democrática adoptado por Próspera, la primera ZEDE hondureña, al tiempo que lo compara con los mecanismos de participación política disponibles en el sistema legal nacional de Honduras. Además, explora el potencial del régimen de la ZEDE para fomentar el cambio democrático al introducir en Honduras mecanismos legales más efectivos para que los hondureños ejerzan sus derechos civiles y políticos a través de gobiernos locales semiautónomos.

**Palabras clave:** gobernabilidad democrática, descentralización, gobiernos locales, autonomía política, democratización, zonas económicas especiales.

## **1. The State of Honduran Democracy**

### **1.1. A Brief History of Political Crises.**

During the 1960s and 70s, Honduras was primarily ruled by the country's military, with brief civil governments that were interrupted by military leaders. In 1982, the country adopted a new Constitution which established periodic elections every four years and basic democratic and republican institutions, such as a representative legislative body, the National Congress; an elected head of state and government, the President of the Republic; and a Supreme Court of Justice. Nevertheless, under civil government, Honduras has consistently faced political instability and constitutional crises.

The first President elected under the 1982 Constitution, Roberto Suazo Córdova, tried to evade term limits and unlawfully extend his tenure in power. During the early 1980s, the Honduran State systematically assassinated and disappeared political dissidents thought to be linked to communist movements. In 1985, there was an electoral crisis after National Party presidential candidate, Rafael Leonardo Callejas, obtained the majority of the popular vote but electoral rules gave the victory to the Liberal Party candidate, José Simón Azcona. In the 1990s, the National Congress removed the President of the Supreme Court of Justice, triggering a national debate about judicial independence (Amnesty International, 1992; Consejo Nacional Anticorrupción, 2017; Molina Chocano, 1986; The Scotsman, 2018).

During the early 2000s, the Supreme Court of Justice ruled that binding constitutional interpretation corresponds to the Judicial Power and stated that Congress lacks the power to enact binding constitutional interpretations. However, Congress did not respond positively to the ruling and refused to have it published in the official state newspaper, Diario Oficial "*La Gaceta*", illegally preventing the ruling from ever coming into effect (Corte Suprema de Justicia, 2003; Giron, 2007). In 2009, the National Congress, the

Supreme Court, the Public Ministry, and the Armed Forces collaborated to forcefully remove the President of the Republic, José Manuel Zelaya, because he had aligned with the socialist regime in Venezuela and attempted to enact a new Constitution for the country (García Noriega, 2013).

In 2012 the National Congress led a “*technical coup*” against the Constitutional Chamber of the Supreme Court, replacing four out of the five justices with lawyers aligned with the ruling party (Gutiérrez Navas et al., 2015). Almost three years later, in 2015, the illegally appointed judges of the Constitutional Chamber ruled in favor of *unlimited presidential reelection*, despite a 33-year-old absolute constitutional ban on presidential reelection (Albornóz, 2015).

In 2017, while taking advantage of the Supreme Court’s favorable ruling on presidential reelection, the President of the Republic successfully ran for reelection and triggered a political crisis involving strong allegations of electoral fraud which led to the Secretary-General of the Organization of American States (OAS), Luis Almagro, to call for a do-over of the general elections. Almagro claimed that the process “*was characterized by irregularities and deficiencies, with very low technical quality and lacking integrity*” (Organization of American States, 2017).

The electoral controversy led to mass lootings of private businesses and popular clashes with the military and police forces, which resulted in at least 23 people killed during the two months following the elections. The United Nations High Commissioner for Human Rights noted that “*at least 16 of the victims were shot to death by the security forces, including two women and two children, and at least 60 people were injured, half of them by live ammunitions*” (UNHCHR, 2018, p.2).

## 1.2. Measuring the Democratic Performance of Honduras.



The democratic performance of a country may be understood, among other interpretations, as a measure of how far liberal democratic governments achieve in practice the values which they subscribe in principle (Foweraker & Krznaric, 2000). There are several international rankings which may shine a light on the democratic performance of Honduras, as they provide a comparative country evaluation on indicators related to the state of democracy, electoral freedom, rule of law, government accountability, the enjoyment of civil and political rights, and public perceptions of democracy.

The Electoral Freedom Index, which measures a country's Political Development, Active Suffrage, Passive Suffrage, and Electoral Empowerment, ranks Honduras in the 126th position out of 198 countries analyzed. The index considers Honduras to have the lowest level of electoral freedom in Central America, and the third lowest in Latin America, after Cuba and Venezuela. With a 148th global ranking, Honduras ranks worst in the "Passive Suffrage" sub-indicator, which measures restrictions thereof, requirements for its exercise, entry barriers, characteristics of the election campaign, the election process, and the distortion of the result (Peña, 2020).

The Economist Intelligence Unit's Democracy Index (2019), which "*provides a snapshot of the state of democracy worldwide in 165 independent states and two territories*", regards Honduras as a "hybrid regime"<sup>1</sup>, and places the country in the 89<sup>th</sup> position worldwide with a score of 5.42. The index shows a deterioration in the state of democracy in Honduras, whose score has fallen from a 6.25 in 2006 to 5.42 in 2019 (The Economist Intelligence Unit, 2019). The World Justice Project's (2020) Rule of Law Index, which measures a country's adherence to the rule of law, ranks Honduras in the 116<sup>th</sup> position out of 128 countries

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<sup>1</sup> A hybrid regime is defined by the EIU as a country where "Elections have substantial irregularities that often prevent them from being both free and fair. Government pressure on opposition parties and candidates may be common. Serious weaknesses are more prevalent than in flawed democracies—in political culture, functioning of government and political participation. Corruption tends to be widespread and the rule of law is weak. Civil society is weak. Typically, there is harassment of and pressure on journalists, and the judiciary is not independent"

analyzed, with a regional Latin American ranking of 27 out of 30 countries. The country receives its worst qualitative score in the “Absence of corruption in the legislature” subcomponent, with a 0.09/1 evaluation.

The Freedom in the World Report describes Honduras as a *partly free* country with a 45/100 overall score. 19 of these points fall within the Political Rights subcomponent (maximum 40) and 26 in the Civil Rights subcomponent. This report also shows a progressive decline of freedom in Honduras, with the country score falling from 51/100 in 2013 to 45/100 in 2020 (Freedom House, 2020). From 1996 to 2019, Honduras’ percentile rank in the Voice and Accountability indicator of the World Bank’s World Governance Indicators has dropped from a 43 to a 31.03 ranking. This indicator “*captures perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media*” (World Bank, 2019b).

Support for democracy in Honduras, as measured by the Latinobarómetro public opinion poll, has also declined from 64% of respondents in 1999 to only 34% in 2018, a reduction of 30 percentage points in 19 years. In 2018, 41% of respondents claimed to have no preference with regards to a democratic or an authoritarian regime; 22% expressed the belief that there is no democracy in Honduras, while 43% considered Honduras as a democracy with big problems. Likewise, 73% manifested they felt unsatisfied with Honduran democracy, and 75% considered the country was being governed for the benefit of a small group of people and not the general populace. According to the poll, the least trusted democratic institutions were the political parties, the electoral authorities, and the National Congress (Latinobarómetro Corporation, 2018).

### 1.3. Political Capture and the Structure of Honduran Democracy.

Formally, the Honduran State has adopted a democratic, representative, and republican form of government. The key governmental powers and institutions of the State are enumerated in Title V of the *Constitution of the Republic of Honduras* (1982), which includes the traditional Legislative, Executive<sup>2</sup>, and Judicial Powers<sup>3</sup>, as well as specialized institutions, such as the Public Ministry<sup>4</sup>, the Defense Institutions<sup>5</sup>, the Superior Court of Accounts<sup>6</sup>, the Attorney General<sup>7</sup>, Decentralized Institutions<sup>8</sup>, and the Departmental and Municipal Regime<sup>9</sup>. Other key, constitutionally created institutions include the National Commissioner on Human Rights, the National Registry of Persons, the National Electoral Council, and the Court of Electoral Justice.

The *Constitution of the Republic of Honduras* (1982) provides for free, direct, secret, and universal elections at three levels of the State apparatus: The Presidency of the Republic; the National Congress, composed of 128 legislators; and the 298 Municipal Corporations across the country; all of which are elected for 4-year periods. The President is elected by a simple majority vote, with no run-off election. This has resulted in a diminished legitimacy of the Executive Power, as the President has been elected with a minority percentage of all

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<sup>2</sup> Includes the President of the Republic, the Secretaries of State, and deconcentrated entities.

<sup>3</sup> Composed of a 15-judge Supreme Court of Justice; Courts of Appeals; the Judiciary; the Judges of the Peace; and the courts with exclusive jurisdiction over zones of the country subject to special regimes created by the Constitution (i.e., ZEDEs).

<sup>4</sup> Responsible for criminal prosecution at a national level. It is led by a General Attorney and an Adjunct General Attorney, both elected by Congress.

<sup>5</sup> Includes the Army, the Navy, the Airforce, and the National Council of Defense and Security.

<sup>6</sup> In charge of auditing the public administration and other State powers.

<sup>7</sup> In charge of legally representing the State of Honduras before national and international judicial, quasi-judicial, and arbitration entities.

<sup>8</sup> Decentralized Institutions include State Companies, the National University, the Central Bank, the National Commission on Banks and Insurance, among others.

<sup>9</sup> Composed of the Departmental Governor, the Municipalities, and the Zones for Employment and Economic Development.

votes in the last two general elections. The National Congress and Municipal Corporations are elected through a system of proportional representation with regards to political parties.

At the municipal level, the public votes only for candidates to the office of the mayor of their respective municipality, while the rest of the Municipal Corporation (usually 2 to 10 officials known as *regidores*) is filled by the losing candidates who unsuccessfully ran for mayor and by representatives of the contending parties (Electoral Law and of Political Organizations, 2004). The leaders of the other key public institutions of the country, including the Supreme Court, are appointed by the National Congress. The Congress also has the power to remove these leaders through a political trial (*Constitution of the Republic of Honduras*, 1982). Given this power, it can be safely stated that, under the Honduran constitutional structure, the National Congress concentrates a vast amount, if not the majority, of all political power in the country.

The National Congress, however, is viewed as one of the most corrupt and least trusted public institutions (Latinobarómetro Corporation, 2018; World Justice Project, 2020). The design of the electoral system for electing congress representatives has been pointed out as one of the root causes of congressional corruption, as it is considered to incentivize loyalty to party *caudillos* instead of to the electorate. Electoral politics in Honduras, says local political economist C. Urbizo Solís (2016), is defined by the “internal movements” of political parties. The internal movements are a unified list of candidates for all levels of government; they are created and led by the presidential candidates of each party to compete in the primary elections. These presidential candidates have direct control over candidate lists for Congress and the Municipalities in all or most of the country’s territory.

The electoral law prevents a citizen from running for public office directly, as a member of a political party. A citizen that wishes to run for office is forced by law to join the “internal movement” of a political party. All the candidates running for office in the primary elections have been previously vetted and authorized by the presidential candidates of the internal party movement they are running with. This results in a party loyalty scheme where

elected officials are loyal to the party *caudillos* (presidential candidates) who allowed them to run in the first place (Urbizo Solís, 2016). An alternative is to create a new political party. But doing so is extremely costly.

If a citizen wants to run for office but does not want to submit to a party *caudillo*, he or she would need to form a new party movement, which requires the filing of complete candidate lists for 149 municipalities. This amounts to approximately 1,500 candidates dually identified and documented; lists for Congress in nine Departments (it can be up to 100 candidates); lists for 51% of the delegates to the party's National Convention, which may require 596 up to 1000 people; a list of 20 candidates and 20 alternates to the Central American Parliament; and a petition with signatures representing at least 2% of the total votes obtained by the corresponding political party in the last general election (Urbizo Solís, 2016).

The right of passive suffrage, as indicated by the World Electoral Freedom Index, is heavily hampered by the Honduran electoral scheme, since it is enormously costly to create an internal party movement (Peña, 2020). As a result, the barriers for entry into the political market are extremely high and the most powerful political body in the country, the National Congress, ends up under the control of a few party *caudillos* who have previously vetted and selected the candidates.

In 2008 this electoral scheme was challenged before the Supreme Court. The challengers claimed that their constitutional right to run for office is diminished because their ability to run for office does not depend on their popular support or their personal qualities or merits, but rather on the authorization of the leader of an internal party movement (C. A. Urbizo Solís et al., 2008). The Supreme Court (2010), however, ruled against the claimants and argued that the legal possibility to adhere to an internal party movement, to create a new one, or run as an independent candidate without a political party, was enough reason to consider their political rights were not being diminished.



The next sections of this paper will review the legal nature and origin of the Honduran ZEDE regime, and then proceed to examine the democratic institutions introduced into Honduras by Próspera ZEDE, the country's first ZEDE, while comparing them to the electoral and democratic mechanisms available under national Honduran law and institutions. Among the institutions reviewed, are those related to the delegation of sovereign power to the government, the election of the executive and legislative powers, mechanisms of direct democracy, and the legal guarantees available for enforcing democratic rules.

## **2. The New System of Local Governance**

### **2.1. The Honduran ZEDE Special Regime**

In 2013, the National Congress amended the Honduran Constitution and enacted the ZEDE Organic Law to enable the creation of Zones for Employment and Economic Development (ZEDEs) ("Legislative Decree No. 236-2012," 2013). The ZEDEs are a new form of territorial subdivision of the country, alongside Municipalities and Departments. A ZEDE can be created by private developers, known as the "Promoter and Organizer". They can be established in low-density areas authorized by Congress, through an administrative procedure before the Committee for the Adoption of Best Practices (CAMP). Alternatively, a ZEDE can be created by local communities in high-density zones, through a public referendum with a two-thirds favorable result.

The ZEDE regime allows the developers, whether a private enterprise or a local community, to create a new local government with a constitutionally granted autonomy to exert legislative and taxing powers, design its governance structure, administer public registries, authorize international ports, provide public services, and establish local police, crime prosecution, and penitentiary system, among others. The autonomy of a ZEDE exempts it from most of the national legislation; however, the zone is obligated to operate in

compliance with the Constitution, international treaties, the ZEDE Organic Law, national criminal law, and certain specific legislation, but is otherwise free to adopt its own public governance structure.

On December 29<sup>th</sup>, 2017, the CAMP authorized the incorporation of Próspera ZEDE in a low-density zone within the Honduran island of Roatán, and on December 6<sup>th</sup>, 2019, the CAMP authorized the incorporation of ZEDE Morazán (Ciudad Morazán) in a low-density zone within the mainland city of Choloma, Honduras (Morazán City, 2020; Próspera Zede, 2020). More recently, the CAMP has authorized a third ZEDE known as ZEDE Orquídea.

## 2.2. The Juridical Nature of a ZEDE's Autonomy.

Though substantially different in magnitude, a ZEDE's autonomy as a territorial subdivision of Honduras may be regarded as sharing the same juridical nature as the autonomy recognized to municipalities under the Honduran Constitution. The Constitution states in Article 329 that ZEDEs enjoy a “*functional and administrative autonomy which must include the functions, powers, and duties that the Constitution and the laws confer to Municipalities*” (“Decreto No. 236-2012,” 2012). Therefore, as stated in Article 298, when performing their exclusive functions, and provided they do not contravene the law, municipalities – and ZEDEs by extension – shall be independent of the Powers of the State and shall be accountable to the courts for abuses (*Constitution of the Republic of Honduras*, 1982).

Municipal independence, wrote Alexis de Toqueville (1835), is the natural consequence of the principle of the sovereignty of the people and one of the key circumstances contributing to the maintenance of a democratic republic. Municipal autonomy is an expression of popular sovereignty because, as defined by the Spanish Constitutional Court, it is the right of the local community to participate through its own organs in the government and administration of whichever issues concern them, in accordance with local and supralocal interests. For the exercise of such participation, said the Spanish Court, the representative

organs of the local community ought to be granted with those powers without which no autonomous action is possible (*Sentencia 32/1981 [Ruling 32/1981]*, 1981).

As local autonomous subdivisions of the State of Honduras, both ZEDEs and municipalities are constitutional vehicles through which the residents of a specific territory can exert their sovereignty through a local representative government. Therefore, under Honduran constitutional law, the powers enjoyed by ZEDEs and municipalities are derived directly from the people living within their jurisdiction and not from acts of congressional delegation, which are prohibited by article 206 (*Constitution of the Republic of Honduras*, 1982).

As illustrated by legal historian Philip Hamburger (2014), traditionally, local lawmaking was not understood as a delegated exercise of the State's general legislative power, but rather as a distinctly local sort of representative legislation – authorized and limited by the State but arising from the local populace. Consequently, stresses Hamburger, local consent for the exercise of such powers was essential, for only by this means could the local law be binding. Although a State could establish local governments, including their boundaries, it generally was taken for granted that where a State authorized local legislative power, it had to leave this local legislation in a local representative body which derives its legitimacy from local elections.

Following the same principle, the Honduran Constitution and international human rights treaties require that the residents of a subnational division with the power to tax and legislate be provided with effective mechanisms for political participation in public affairs within their jurisdiction. Consequently, the ZEDE Organic Law requires a positive referendum or plebiscite result to create a ZEDE in a high-density area, as well as to amend or repeal the regime when the population exceeds 100,000 persons. And while ZEDEs in low-density areas are not subject to referendums or plebiscites, their governance structure is required to comply with international law by enabling its residents to exercise the civil and political rights recognized to them by the International Covenant on Civil and Political

Rights, the American Convention on Human Rights, the Inter-American Democratic Charter, and other international human rights treaties (Colindres, 2018).

### 3. Political Representation in Próspera.

#### 3.1. Agreements of Coexistence: Sovereign Delegation to Próspera ZEDE.

Próspera, the first Honduran ZEDE, offers a unique mechanism for Hondurans to exercise their sovereign power. For the first time in history every single Honduran will have the opportunity to expressly consent - or not – to live under the authority of a local representative civil government with a constitutionally granted autonomy to adopt its own laws, taxes, and public administration. Próspera ZEDE (PZ) offers a full-fledged application of the contract theory of government by requiring that any person wishing to become a resident expressly consents, through an Agreement of Coexistence, “*to such delegation of popular sovereignty as is necessary to sustain the power and authority held in trust by the PZ under the PZ Charter for the benefit of the Resident and all other residents*” (*Resolution Approving Natural Person Resident Agreement of Coexistence*, 2019).

Article 21 of the Universal Declaration of Human Rights states that “*The will of the people shall be the basis of the authority of government*” (United Nations General Assembly, 1948). The will of the people in this context does not mean the will of *all* the people, only that of a democratic majority expressed in periodic elections. Próspera ZEDE takes this principle further and rests all its powers and authority on the express, contractual consent of every single person governed by it. This way of delegating sovereign power to government stands in stark contrast with the previous constitutional experience of Honduras, whose people did not get the chance to ratify via referendum the Constitution produced in 1982, as it was theoretically assumed that the Constituent Assembly had expressed the people’s will.

After several years of military rule, Honduras transitioned to a constitutional democracy in 1982. Responding to social and international pressures, the military regime drafted an electoral law, called for elections, and allowed a constituent assembly to produce, enact, and publish a new Constitution for the country. Theoretically, the Constitution represents the will of the Honduran people, who delegated their sovereign power to the Constituent Assembly. However, the constituent process has been criticized for being exclusionary, as it was convened by the military, the electoral rules were established by the military, and the people were not allowed to ratify the constitutional text after it was produced (Mejía Rivera, J.A., Fernández, V., Menjívar, O., 2009; Otero Felipe, 2015). A historically and internationally recognized standard for the constitution making process involves the activation of the process and the ratification of its product by the people, none of which were done in the 1980s (Becker, 2018; Blount, Ginsburg, & Elkins, 2008; Martínez Dalmau & Viciano Pastor, 2010; Lenowitz, 2013).

Furthermore, one of the constitutional framers elected in 1980, Enrique Paz Aguilar (2008), explains that subsequent electoral politics have been dominated by special interest groups who have subverted electoral rules in their favor to control Congress (Paz Aguilar, 2008). While the Honduran people did not enjoy the opportunity to ratify their Constitution, as required by constitution-making tradition, Próspera ZEDE gives Hondurans the opportunity exert their sovereign power by expressly consenting to a local constitutional document such as the *Charter of Próspera*, which sets out the fundamental governance structure of the Próspera jurisdiction.

The delegated sovereign power will be held in trust by Próspera ZEDE, that is, a common-law trust “*for the benefit of the Resident and all other residents*”. Therefore, residents will not only enjoy traditional political rights through which to hold public office holders accountable, but also all the rights and legal recourses available to the beneficiaries of a common-law trust. Próspera’s governing bodies are not theoretical representatives of the residents, but rather real, contractually bound fiduciaries subject to general fiduciary duties,



which are the “*highest standard of care in equity or law*” (*Resolution Approving Natural Person Resident Agreement of Coexistence*, 2019; *Resolution Approving Publication of Próspera Code of Rules and Development of Future Official Derivative Works*, 2020b).

### 3.2. Democratic Rights of Residents as Trust Beneficiaries.

The ZEDE Organic Law mandates that ZEDEs are to be governed through trusts for the provision of public services, management of revenues, and the acquisition and administration of assets (Article 12.3, 44: *Organic Law of the Zones for Employment and Economic Development (ZEDE)*, 2013). The *Charter of Próspera*, which is the jurisdiction’s highest-ranking local norm, complies with this mandate by creating a public trust that holds the popular sovereignty of Próspera residents for the benefit of such residents. The sovereignty held in trust is a key source of legitimacy for the jurisdiction’s legislative and taxation powers over residents. As required by international and constitutional law, the Charter proceeds to enumerate the “*Democratic Rights of Residents as Beneficiaries of the Public Trust*”, which include the right to a) select the Technical Secretary; b) select the majority of Council Trustees; c) repeal Rules through a referendum; d) amend the Charter; and e) replace the Ombudsman (Section 2.06: *Democratic Rights of Residents as Beneficiaries of the Public Trust*, 2020c).

Through the Agreement of Coexistence and the democratic rights recognized to trust beneficiaries, Próspera seeks to ensure that residents “*take part in the conduct of public affairs, directly or through freely chosen representatives*” (United Nations Human Rights Office of the High Commissioner, 1966). The Próspera Council is the jurisdiction’s representative rulemaking body, where all the jurisdiction’s major stakeholders are represented, including the Promoter and Organizer, physical residents, and the landowners. The local rules or norms of Próspera may take the form of Statutes, which set forth the general applicable law; Regulations, which provide detail on how the Statutes are to be

administered and enforced; and Ordinances, which are temporary Resolutions to ensure the efficient delivery of public services. While Próspera Council Resolutions govern the authorization, execution, and administration of the corporate affairs and procedures of the jurisdiction (“Section 3.09: Rules of Próspera,” 2020d).

The Charter guarantees that residents have the right and opportunity to vote and to be elected to the Council at genuine periodic elections, which are to be held every seven years or earlier if a recall election is triggered. The Council is composed of a Technical Secretary, who is the highest-ranking executive officer of a ZEDE, analogous to the mayor of a municipal government, and eight other Council Trustees. Initially, the Promoter and Organizer elects four seats in the Council, the physical residents elect three seats, and landowners elect two seats; however, the democratic power of physical residents will increase progressively, in accordance with population growth.

When the population reaches 1,000 inhabitants, the CAMP shall appoint an Ombudsman with the power to investigate claims of unlawful acts by Próspera and file legal or equitable remedies before the competent arbitration tribunals. Residents will have the right to replace the Ombudsman through referendum. When population reaches 10,000 natural persons, all subsequent rules enacted by Próspera shall be subject to repeal by majority of votes within seven days after adoption; previously adopted rules may be repealed by a two-thirds majority referenda vote. The residents are also able to force a binding referendum on a proposed measure authorized by the Charter if the proposal is accompanied by signatures representing no more than 5% of the total persons who would be eligible to vote.

Additionally, when the jurisdiction reaches Urban Population Density, defined as 6,000 persons per square kilometer, the physical residents will elect five of the nine Council Trustees. A referendum for residents to amend the Charter of Próspera will be held if authorized by a two-thirds vote of the Próspera Council. If such a referendum has not taken place within 35 years after adoption of the Charter, it may be triggered by the Ombudsman.

The Próspera Council will enact by rule all offices and procedures that relate to voting, the delegation of voting rights, recalls, and referenda, as well as to ensure transparency, fairness, and independence in such procedures and processes.

### **3.3. Election of the Technical Secretary: Próspera's Chief Executive.**

As stated above, the Technical Secretary is a ZEDE's highest-ranking executive officer, as well as its legal representative. The Technical Secretary is elected for a 7-year term and the ZEDE Organic Law requires that he or she be Honduran by birth. The Technical Secretary oversees the ZEDE's public administration, authorizes the ZEDE trust, promulgates the ZEDE's internal rules, enforces such rules, promotes the jurisdiction, and issues Ordinances for the efficient provision of public services ("Section II: Technical Secretary: Article 12," 2013). The *Charter of Próspera* elaborates on the position of Technical Secretary and gives it the role of chairperson in the Próspera Council. As chief executive, the Technical Secretary is responsible for enacting, amending, or revoking rules after the prior approval of the Próspera Council.

In accordance with the ZEDE Organic Law, the CAMP is responsible for appointing the Technical Secretary of each ZEDE. When a ZEDE has low population density, its Technical Secretary is appointed by the CAMP upon nomination by the Promoter and Organizer of the ZEDE; and, when a ZEDE has high-population density, its Technical Secretary is appointed by CAMP upon nomination by the residents of that ZEDE. Under article 329 of the Honduran Constitution and the demographic opinion issued by the National Statistics Institute, a specific zone or territory is considered to have high population density if 35 or more persons reside within one square kilometer. Because Próspera ZEDE is being developed in private land with low population density, its Promoter and Organizer nominated

the jurisdiction's first Technical Secretary, Tristan M. Monterroso M., who was then appointed by the CAMP ("Legislative Decree No. 236-2012," 2013).

The Charter states that if Próspera reaches high population density by the end of the 7-year term of its first Technical Secretary, the residents of Próspera shall select a nominee for the position of Technical Secretary and his or her running mate, who shall be the nominee for the position of Vice-Technical Secretary. If no candidate receives a majority of votes casted after the initial round of voting, the two candidates who received the highest number of votes will compete in a runoff election. The candidate who receives the largest number of votes after the runoff election shall be certified as the winner.

The Próspera Council will then submit the nominees for the positions of Technical Secretary and Vice Technical Secretary to the CAMP for approval or disapproval. If the CAMP does not expressly approve or disapprove the nominees within 45 days after the day of submission, the nominees shall be deemed approved and shall assume the role of Technical Secretary and Vice-Technical Secretary.

To ensure that once elected the Technical Secretary will operate in accordance with the law, the *Charter of Próspera* states that no person can be selected as Technical Secretary without first forming a pre-appointment agreement with the Promoter and Organizer that obligates the candidate to abide by the *Charter of Próspera* and the Trust Agreement. After the appointment, the Technical Secretary shall form a definitive agreement obligating himself in a personal and official capacity to abide by the Charter and the Trust Agreement ("Section 4.03: Appointment of the Technical Secretary and Deputy Technical Secretary," 2020).

Próspera ZEDE represents the first instance in which a two-round electoral system is introduced in Honduras. The adoption of a runoff electoral system has long been discussed in Honduras, particularly after the 2013 general elections in which the popular vote was divided into four major parties. A two-round electoral system has been promoted by the international

community, opposition parties, and civil society as a necessary reform to improve the legitimacy of the presidential and municipal mayor elections (Porrás Flores, 2015).

In 2013, the national Presidential vote split into four parties, and President Hernández was elected with only 36.89% of the popular vote, while the other three opposition parties obtained 62.51% of the popular vote at the presidential level (Tribunal Supremo Electoral, 2013). In the 2017 general elections, President Hernández was reelected with 42.7% of the popular vote, while the other two main opposition parties jointly collected 56.16% of the popular vote (Tribunal Supremo Electoral, 2017a). A similar phenomenon has also taken place at the municipal level, such as with San Pedro Sula, the country's key economic hub and the second-most populous city. In 2017's general elections, the mayor was elected with only 31.30% of the popular vote, while the three main opposing candidates jointly gained 51.31% of the popular vote (Tribunal Supremo Electoral, 2017b).

The introduction of a two-round electoral system by Próspera ZEDE into Honduras is an example of how special jurisdictions can be instrumented to facilitate the adoption of new democratic mechanisms into poorly governed countries. Unlike with the presidential and municipal elections, Próspera residents in Honduras will enjoy a democratic guarantee that their chief executive will be elected by a majority vote, thus providing greater democratic legitimacy to the winner, and incentivizing more accountability towards residents. Additionally, by way of the appointment agreements and the coexistence agreements, additional layers of constitutional protection have been added against executive power.

### **3.4. Legislative Power in Próspera ZEDE.**

The Próspera Council acts as the jurisdiction's collective representative legislative body; the Council is composed of the trustees of the Próspera ZEDE trust, which holds the sovereign power that residents have voluntarily delegated to Próspera ZEDE through the coexistence agreement. Under the Charter, *“all governance, rulemaking, and executive power of Próspera*



*shall be exercised by the Technical Secretary only with the prior approval of the Próspera Council...*” (“Section 3.01: Governance, Regulation and Executive Power of Próspera,” 2020). In accordance with article 12 of the ZEDE Organic Law, all rules enacted by the Próspera Council are subject to approval by the CAMP. Therefore, it can be stated that legislative power in Próspera rests jointly in the Próspera Council and the CAMP, which together represent all the jurisdiction’s major stakeholders, including the national government.

The Próspera Council is composed of nine natural persons which include the Technical Secretary, a Council Secretary, a Treasurer, and six other council trustees. The Council Trustees serve for 7-year terms, with no limit on the number of terms they may serve, and, except for the Technical Secretary, the selection of the Council Trustees is not subject to CAMP approval. The most relevant powers of the Próspera Council require a two-thirds majority vote, such as the promulgation, amendment, or repeal of Statutes, Regulations, Ordinances, and Resolutions; the selection of the Council Secretary; the removal or suspension of Council Trustees; presenting a request to the CAMP for the removal of the Technical Secretary; authorizing a referendum through which residents may amend the Charter provisions regarding the Próspera Council; and the termination of certain contracts.

Within the Próspera Council, three classes of stakeholders are represented: a) Physical residents, who are persons residing within the Próspera jurisdiction; b) Landowners, who are persons that have acquired property within the jurisdiction or incorporated their properties into it; and c) the Promoter and Organizer, who secured initial authorization from the CAMP to incorporate Próspera ZEDE, and who has designed, invested, and fostered the development of the jurisdiction. After Próspera reaches Urban Population Density, physical residents will enjoy the right to select five out of nine Council Trustees. Because Council decisions generally require a two-third majority vote, all major public decisions are subject to minimum level of consensus between representatives of both the ZEDE residents and the Promoter and Organizer (*Resolution Approving Publication of Próspera Code of Rules and Development of Future Official Derivative Works*, 2020b).

However, an additional democratic check on legislative power will come into effect when Próspera's population reaches 10,000 natural person residents, as the Technical Secretary and the Próspera Council will be forced to adopt a rule automatically referring to natural person residents of majority of age any subsequently promulgated rule as a measure to be considered for repeal by a majority of the votes available for casting within seven days after adoption. Residents are also allowed to amend Charter Article III: Próspera Council (2020) through a referendum, allowing them to change the jurisdiction's electoral system for the Council. Residents can force this referendum through the Ombudsman if it has not taken place within 35 years after the adoption of the Charter.

By establishing a system of checks and balances among the jurisdiction's stakeholders and providing for a progressive increase of the residents' democratic power, the *Charter of Próspera* attempts to ensure that the Próspera ZEDE government operates under the rule of law and aligns itself with the will of the people living under its jurisdiction. Próspera's legal structure provides Hondurans with a local alternative for political participation and self-governance, where residents enjoy a majoritarian control over the jurisdiction's legislature and ultimate veto power over any of its legislative enactments, thus providing stronger guarantees for the alignment between governmental action and the will of the people, as compared with the national political system.

Próspera's electoral system eliminates the primary restraint over passive suffrage that exists under national electoral law; that is, the requirement that any citizen wishing to run for office through a political party must be authorized to run by the leader or caudillo of one of that party's factions. As examined before, a Honduran citizen cannot run for office if he or she is not accepted by the presidential candidate of an internal party movement; alternatively, to be able to run for office through a political party, a citizen would have to start a new party movement, for which the electoral law contemplates prohibitory requirements such as presenting candidate lists for the Presidency of the Republic, the Central American Parliament, and for Congress and municipal corporations in at least half

of the Departments and municipalities in the country, as well as a formal list of citizens supporting the movement which represent, at least, 2% of the total votes obtained by the corresponding political party in the last general election (“Article 166: Reception of the Bags of Electoral Material in Public Session,” 2004).

In contrast, the Próspera jurisdiction lowers the barriers for entry into the political market and expands passive suffrage rights by allowing its residents to run for office with greater ease, at a lower cost, and without having to submit to a party caudillo or create a national electoral platform to run for local office. The immediate expected effects include a better alignment of interests between candidates for public office and their respective constituencies, as candidates would owe their election to the voters and not to a party caudillo. Lower barriers for entry into the political market would also foster greater political competition, which would help prevent political capture by special party or economic interests (Holcombe, 1991; Mulligan & Tsui, 2008; Springer Verlag, 1999 & Tullock, 1965).

Article 1 of the *Honduran Civil Code* (1906) defines the law as a “*declaration of the sovereign will*”. However, the national legislature remains one of the least trusted institutions in the country. It is perceived as being very corrupt, and public polls show misalignment between the direction of government and what the Honduran people consider is best for them. Through the ZEDE regime, Hondurans have access to a local alternative for self-governance that empowers them with more effective mechanisms for political representation. Próspera ZEDE is one example, as its residents will enjoy greater passive suffrage rights and the right to repeal any legislative enactments by majority vote. Together, both mechanisms would provide for greater popular control over legislation than has ever existed before in Honduras, and thus allow for a better alignment between legislative production and the will of the people.

### 3.5. Direct Democracy: Referendums and Recall Elections.

The *Charter of Próspera* contains two basic mechanisms of direct democracy through which residents can participate in local policymaking: referendums and recall elections. The Charter recognizes citizen forced referendums to repeal rules, approve measures, amend the Charter, and replace the Ombudsman; additionally, it provides for recall elections as a mechanism through which the constituencies represented in the Próspera Council can replace their representatives at any time.

As previously explained, one of the key manners in which a referendum takes place in Próspera is through disapproval voting. Once Próspera's population reaches 10,000 persons, a rule will be adopted which will automatically refer to natural person residents any subsequent promulgated rule as a measure to be considered for repeal by majority vote within seven days after adoption. Therefore, Próspera's legislative production shall be subject to final review by the jurisdiction's natural person residents, who will be able to veto any legislation to their disliking through a majority vote.

Previously promulgated rules are also subject to repeal by residents and landowners through a two-thirds majority vote in a referendum. A referendum, whether to repeal a rule or adopt a measure, will be organized by the Ombudsman of Próspera if a proposed measure expressly authorized by the Charter is submitted to it that has sufficient valid signatures representing, at least, 5% of the total persons who would be eligible to vote in the referendum. Measures will pass by a majority of the votes available for casting of all persons eligible to vote in the referendum unless a higher threshold is specified by the Charter. If the referendum is with regards to the replacement of the Ombudsman, then it will be organized by the Próspera Council (*Resolution Approving Publication of Próspera Code of Rules and Development of Future Official Derivative Works*, 2020b).

Additionally, the *Charter of Próspera* allows the constituencies represented in the Próspera Council to force a recall election on their representatives. Through this procedure,

Council Trustees, including the Technical Secretary, can be removed by the recall at any time by the classes that selected them. The recall shall be made in the same manner as in which the original selection was made unless otherwise specified by the Charter. Though not expressly stated by the Charter, as the specific details of procedures will be enacted by rule in the future, a recall election could presumably be initiated in the same way as a referendum; that is, by submitting a petition with enough valid signatures to represent, at least, 5% of the total persons who would be eligible to vote in the recall (*Resolution Approving Publication of Próspera Code of Rules and Development of Future Official Derivative Works*, 2020b).

As compared with the national system, the Próspera mechanisms for direct democracy represent a major democratic empowerment of the population. National law provides for referendums, plebiscites, and citizen initiatives. However, according to article 5 of the *Constitution of the Republic of Honduras* (1982), referendums and plebiscites can only take place if their organization has been previously approved by the National Congress, and they cannot be forced by citizens. When a proposed plebiscite or referendum concerns ordinary legislation, it has to be approved by a simple majority of Congress, but when the plebiscite or referendum is concerned with constitutional matters, it has to be approved by two-thirds of Congress.

The Constitution states that a plebiscite or referendum can only be requested to Congress by at least 2% of citizens registered in the electoral census, by 10 lawmakers, or by the President of the Republic. Furthermore, article 213 of the Constitution states that a number of at least 3,000 citizens can introduce a legislative initiative in Congress, but citizens cannot force a popular vote on a proposed legislative measure. The Constitution states that the result of a referendum or plebiscite is binding if it achieves at least 51% of the total participation of the last general election and a favorable simple majority vote.

However, no plebiscites or referendums have ever taken place in Honduras, and all the citizen initiatives presented to Congress have been rejected. The differences between the national and the Próspera ZEDE systems of direct democracy may shine a light on why none

of the Constitution's mechanisms of participatory democracy have been successfully put into practice so far.

The first fundamental difference between both systems is that, under the national system, citizens cannot force a referendum, as only the National Congress can authorize a referendum. In contrast, the *Charter of Próspera* allows residents to force a referendum on a proposed measure by presenting a petition containing the signatures of at least 5% of the persons who would have a right to vote in such a referendum. Additionally, the Charter provides for automatic referendums that will take place every time a new rule is promulgated, granting natural person residents the right to strike down a rule by majority vote within the next seven days after such rule has been promulgated.

Because the National Congress falls prey to political capture as a result of the country's national electoral system, the citizens of Honduras have not been able to directly participate in public decision-making through the mechanisms made available by the National Constitution. In Próspera ZEDE, however, even if there is a disconnect of interests between residents and the Próspera Council, residents will still be able to repeal any promulgated rule and force referendums on key issues, including the amending of the *Charter of Próspera*. Another key difference with the national system of direct democracy is that citizen forced referendums will be organized by the Ombudsman, not the Próspera Council, which serves as an additional democratic guarantee that a valid petition will effectively trigger a referendum.

On the other hand, while the citizen initiative contained in the Honduran Constitution effectively allows Hondurans to present a legislative initiative in Congress and force Congress to discuss it, so far none of the citizen initiatives presented to Congress by citizen groups have been approved. The *Charter of Próspera* ensures against such a level of ineffectiveness by providing for resident forced referendums, automatically held referendums, and recall elections. As with the runoff election, the recall election is a wholly new democratic mechanism for Honduras that has been made available to the populace



through the Próspera ZEDE jurisdiction. Unlike with the national system, Próspera residents will enjoy the power to hold their representatives accountable by forcing a recall election at any time and, if the majority so decides, remove representatives from office before their term is over.

The mechanisms of direct democracy that Próspera provides to its residents represent considerable democratic empowerment of the Honduran populace, who now have access to more effective mechanisms of participatory democracy. Therefore, through citizen forced referendums, automatically held referendums, and recall elections, Hondurans living within the Próspera jurisdiction will enjoy the democratic power to secure a greater degree of compatibility between legislative production and the general will of the public.

### **3.6. Exit Clause: Withdrawal of Sovereign Power**

Since Próspera ZEDE's powers over its resident's person and property are derived from an express, contractual, delegation of popular sovereignty, the Agreement of Coexistence through which such delegation is made contains a Termination Clause that allows both parties to end their relationship under certain circumstances. This allows residents not only to opt into the special ZEDE regime but also to opt-out, following the agreed-upon conditions.

A resident may terminate their Agreement of Coexistence for any reason or without cause upon at least seven days prior notice to Próspera. For Próspera to terminate the agreement, there is a probatory period, consisting of the latter of either the first year of the residency term or the period encompassed by the effective date of the contract through December 31<sup>st</sup>, 2021. During this term, Próspera can terminate an Agreement with a resident with at least sixty days prior notice for any reason. After such probatory period, Próspera can only terminate the agreement if the resident has breached any provision of the Agreement and such breach has not been cured. An additional reason is if it is incapable of being cured,

within thirty days after giving notice of the breach to the resident (“Article VI: Miscellaneous Provisions. Section 1: Termination,” 2020).

Upon termination of the contract, a resident is obligated to vacate the jurisdiction, unless such resident procures an e-residency agreement, which allows him to visit and do business in Próspera. If the resident fails to vacate the jurisdiction, Próspera may, in the absence of the resident prevailing in an arbitration or court challenge to the termination of the Agreement, deny access to the jurisdiction, the resident’s real property within the jurisdiction, and all Próspera e-governance services. Additionally, Próspera may eject the resident and all the resident’s movable property, subject to distraint for unpaid fees or taxes under the law.

Twelve months after termination of the contract or thirty days after receiving a final court or arbitration decision sustaining the termination of the contract, the resident shall sell and transfer title to any real property within the jurisdiction to another physical resident or e-resident in good standing (“Article VI: Miscellaneous Provisions. Section 1: Effect of Termination,” 2020). The possibility for residents to terminate their relationship with Próspera ZEDE naturally implies a devolution of the sovereign power originally delegated to it. Through the ZEDE regime, Hondurans have access to multiple options of local governments through which they can exert their sovereignty and participate in key public policy decisions, without leaving the country.

Currently, Honduran residents have the option to live under the default national legal system or under that of ZEDE jurisdictions such as Próspera or Ciudad Morazán. The options do not end there, as more ZEDE jurisdictions with a differentiated legal system can be developed. This is the case for the third and newest ZEDE, Orquídea. Additionally, the Charters of both Próspera and Ciudad Morazán allow for the creation of Special Districts with governance frameworks that may differ materially from those established by their respective Charters. Traditionally, the National Congress of Honduras has dominated public policy decisions at a national level, subjecting the whole country to a single unitary legal

system. If a person did not feel protected or benefitted by the national legal system, the cost of changing jurisdiction was extremely high, as that person would have had to move to a different country. The ZEDE regime provides Honduras with a legal vehicle to regain a substantial part of the popular sovereignty that was theoretically delegated to the National Constituent Assembly of 1982 and exert such sovereignty through a local autonomous government. A person can later change his mind and decide to live under the jurisdiction of a different ZEDE, a Special District, or under the default national legal system.

Because Honduran residents can now elect among a greater variety of legal systems and governments to live under without having to leave the country, a higher level of interjurisdictional competition is expected. In Honduras, the ZEDEs, Special Districts, regular municipalities, and the national government will have to compete for residents and investments. This competition is expected to incentivize public authorities to provide for those public services and policies, in quality and quantity, which they believe would attract residents and investments to their jurisdiction (Douglass, 1993; Tiebout, 1956; Vanberg & Kerber, 1994).

#### **4. Legal Enforcement of Democratic Rights.**

##### **4.1. Overview of the Basic Enforcement Mechanisms.**

The *Charter of Próspera* provides for a series of enforcement mechanisms through which a resident can force Próspera ZEDE to abide by the fundamental norms and democratic guarantees of the jurisdiction. The Charter's text recognizes a series of Democratic Rights in Section 2.06 and a Resident Bill of Rights in Article XII. Nevertheless, as judge Antonin Scalia said, "*Every tin horn dictator in the world today, every president for life, has a Bill of Rights... that's not what makes us free*" (Greenya, 2018, p. 223).

The Honduran Constitution certainly has its own bill of rights, but the enjoyment of such rights depends not on their legal recognition but rather on a system of checks and balances that provides effective guarantees for their exercise. Under this premise, the *Charter of Próspera* provides a series of enforcement mechanisms for its provisions, several of which have already been discussed. This section examines two essential mechanisms for Próspera residents to enforce their democratic rights through a court of justice or an arbitration proceeding.

The first mechanism is the guarantee of independent dispute resolution, whereby any legal controversy between a resident and Próspera, will be resolved before the Próspera Arbitration Center (PAC) or the American Arbitration Association's (AAA) International Centre for Dispute Resolution (ICDR). The second mechanism is that of a democratically accountable Ombudsman with the power to investigate civil rights violations and, if required, sue the ZEDE government on behalf of residents for such violations.

#### **4.2. Access to Justice and the Guarantee of Independent Dispute Resolution**

The residents of Próspera enjoy the power to enforce their civil and political rights against the ZEDE government through a court of law or an arbitration proceeding. Under article 329 of the Constitution and the ZEDE Organic Law, Próspera ZEDE can subject to mandatory arbitration all property, contractual, or labor matters, including legal controversies that arise between Próspera and its residents (*Constitution of the Republic of Honduras*, 1982; "Legislative Decree No. 236-2012," 2013). Article IX of the *Charter of Próspera* regulates the jurisdiction's court system, as well as the establishment of a default arbitration service provider that will resolve all causes of action involving Próspera or arising within Próspera (*Resolution Approving Publication of Próspera Code of Rules and Development of Future Official Derivative Works*, 2020b).

The special ZEDE court system is not yet operative but will come into effect once the CAMP nominates and the Supreme Court appoints the judges with exclusive jurisdiction over the ZEDEs, as per article 303 of the Constitution and article 15 of the ZEDE Organic Law. However, Article V: Dispute Resolution (2020) of the natural person resident Agreement of Coexistence states that except for matters expressly excluded from arbitration by the ZEDE Organic Law, such as those relating to criminal law and the protection of infancy and adolescence, “*the Resident and the PZ shall exclusively resort to, comply with and be subject to arbitration hereunder as the exclusive means of resolving any cause of action, dispute, controversy, or claim between or among the Resident, the PZ, the PZ Trust, the PZ General Service Provider, or any third party*”.

Any arbitration dispute initiated between Próspera and a resident will be resolved before Próspera’s Default Arbitration Service Provider, the PAC (*Default Arbitration Service Provider Resolution*, 2020). However, if a resident objects to the use of the PAC within seven days after receiving notice of the filing of an arbitration demand, then the arbitration proceedings will be administered by the ICDR. The arbitration will be governed by the rules of the arbitration administrator and shall be enforceable and executable as authorized by the Arbitration Statute 2019 (“Article V: Dispute Resolution,” 2020).

The PAC offers dispute resolution services with a roster of arbiters that include former judges who served in the Supreme Court of Arizona, the Arizona Court of Appeals, and the Superior Court of Maricopa County Arizona, as well as legal professionals with experience in key areas of the law from the United States, Australia, and Germany (Próspera Arbitration Center, 2020). For its part, the ICDR (2019) is a globally renowned center that, in 2019 alone, administered US\$18.4 billion in business-to-business claims and counterclaims, which included dispute resolution in the commercial, construction, labor, elections, employment, consumer, and insurance areas. This amount represents over 70% of Honduras’ Gross Domestic Product for that same year (World Bank, 2019a).

Both the PAC and the ICDR are compelling alternatives to the judicial remedies available against governmental action under the national legal system. The ability to challenge governmental decisions before an independent and impartial court of law, under due process, is recognized as a fundamental human right under article 8 of the American Convention on Human Rights. However, under the national system, Hondurans face enormous legal constraints to challenge governmental action in court, and the Judicial Power is generally regarded as slow, subject to corruption, and lacking in independence and impartiality.

In 2018, only 25% of polled Hondurans answered they had much or any sort of trust in the country's Judicial Power (Corporación Latinobarómetro, 2018). In the 2019 Global Competitiveness Report, Honduras ranks 108/141 in judicial independence, with a 2.9/7 qualitative score (World Economic Forum, 2019). In the 2020 Rule of Law Index, Honduras receives a 0.33/1 score in the “*limits imposed on the government by the judiciary*” indicator. Likewise, it received a 0.39/1 score in the “*absence of corruption in the judiciary*” indicator, a 0.33/1 score in “*due process of law*” indicator, and a 0.14/1 score in the “*respect of due process during regulatory enforcement*” one (World Justice Project, 2020).

To challenge governmental decisions, the national legal system provides for constitutional recourses. These include the writ of *amparo* and the *unconstitutionality challenge*. Administrative challenges ultimately end up in the courts of the Jurisdiction of Administrative Disputes. The Supreme Court has the final say in constitutional and administrative disputes. But the justices are elected by Congress. As earlier examined, this makes them subject to political capture by party interests. The Supreme Court is generally considered to be one of the most politicized courts in the country. Every single one of its justices is publicly identified as a representative of a specific political party (Centre for the Independence of Judges and Lawyers, n.d.; La Prensa, 2007, 2016; Ocampos Aguilera & Méndez González, 2020).



The party politicization surrounding the highest court of Honduras is of such magnitude that the last three elections of its justices resulted in a constitutional crisis. Two of them involved the political use of the Armed Forces to intimidate lawmakers during the selection proceedings (Center for Justice and International Law, 2016; Deutsch Welle, 2012; Deutsche Welle, 2016; El Herald, 2014; Estrada, 2019; Gutiérrez Navas et al., 2015; La Prensa, 2009, 2016b). In a diplomatic phrasing, the United Nations Special Rapporteur on the Independence of Judges and Lawyers, García-Sayán (2019), stated in 2019 that the institutional framework of Honduras, as it is, “*is not sufficient to guarantee the independence of the courts*”.

From a strictly procedural point of view, court politicization aside, the legal recourses against governmental action that are available to citizens face three main challenges against their effectiveness. Firstly, access to justice against State action is hampered by requiring that citizens undergo an inquisitorial “*previous administrative procedure*” where the public administration is both a judge and a party to the dispute (“Article 28: Legislative Decree No. 189-87,” 1987; “Article 146: Legislative Decree No. 152-87,” 1997). The second barrier to effective access to justice is logistical, as there are 298 municipalities in Honduras but only two of them have a court with competent jurisdiction over the public administration. Any person willing to challenge a municipality or any government agency must travel either to Tegucigalpa or San Pedro Sula to be heard in court, after he or she has exhausted, of course, the previous administrative procedure. If the controversy is between a person and the national tax administration, there is only one competent court in the whole country, the Fiscal Administrative Court in the capital city of Tegucigalpa (Judicial Power of Honduras, 2020).

The third barrier impeding effective access to justice is the “*solve et repete*” rule (translated as *pay now and protest later*), a pre-constitutional principle dating back to Ancient Rome which requires a person to pay the fees or taxes demanded by the government before he or she can be heard in court. Article 39 of the Law of the Jurisdiction of

Administrative Disputes establishes the *solve et repete* rule in the form of a financial guarantee. As a prerequisite for the admission of a lawsuit against the State of Honduras, the plaintiff must present a financial guarantee representing at least 20% of the claim's economic value (*Article 4: Legislative Decree 266-2013*, 2014).

All these obstacles within the national legal system impede effective access to justice and weaken the rule of law and the enjoyment of basic human rights. Authors like Philip Hamburger (2014), Josefina Barbarán (2005), and Rodríguez Prado (2013) have argued that these obstacles are derived from an unofficial overarching rule of public administration which they refer to as the “*principle of exhaustion of the citizen*”, through which government entities drain the plaintiff's resources in long and costly procedures before he or she can effectively hold them accountable in a court of law (Agustín Gordillo, 2013; Phillip Hamburger, 2014). Próspera ZEDE eliminates all the unconstitutional barriers that impede access to justice under the national legal system and offers Hondurans the possibility to live under a local, independent body of public administration, against which any legal claim will be resolved before world-class arbitration centers such as the PAC or the ICDR.

#### **4.3. The Próspera Ombudsman and the Resident Bill of Rights.**

Another key institution for the enforcement of the democratic rights of a Próspera resident is the Ombudsman. Section 9.03 of the *Charter of Próspera* states that the CAMP shall appoint a local Ombudsman once at least 1,000 natural persons establish their physical residency in Próspera. The Ombudsman will be appointed for a 12-year term and will be subject to replacement through a referendum initiated by residents or landowners. The Ombudsman, states the Charter, shall have power regarding the Resident Bill of Rights contained in Section 12.01 of the Charter, which includes the rights to life, property, freedom of thought, speech, conscience, religion, and contract, due process, privacy, and liberty

*(Resolution Approving Publication of Próspera Code of Rules and Development of Future Official Derivative Works, 2020b).*

As per section 12.02(2) of the Charter, the Próspera Resident Bill of Rights furnishes for each person protected thereby as against Próspera, “*at least as much liberty as the corresponding right guaranteed to a citizen of the United States of America under the U.S. Constitution as interpreted by the Supreme Court of the United States of America as of June 30, 2019*”. The Bill of Rights, however, shall not be considered violated by the exercise of power or authority to enforce any law that Próspera is compelled to enforce under a constitutional provision or treaty governing the Republic of Honduras, provided such enforcement is no more prejudicial than is necessary to fulfill such obligations (*Resolution Approving Publication of Próspera Code of Rules and Development of Future Official Derivative Works, 2020b*).

At the petition of ten residents, the Ombudsman has the power to investigate the facts associated with the petition and to file legal or equitable actions to remedy or negate unlawful or ultra vires acts of Próspera, through public arbitration proceedings before the PAC or the ICDR. The Ombudsman shall have access to relevant confidential information, shall produce a yearly report, and shall be funded by the Próspera Trust, by residents in no more than US\$100.00 per year. It can also be funded by third party grants, subject to Próspera Council approval. The Ombudsman is personally liable for abuse of process and frivolous actions brought against the ZEDE government.

A democratically accountable Ombudsman with the power to investigate facts and sue the ZEDE government for civil rights violations before the PAC or the ICDR, and which takes the resident Bill of Rights and the constitutional case law of the United States as its standard, represents a major strengthening of the human rights protection system of Honduras. The Honduran Constitution provides for a National Commissioner on Human Rights (the National Ombudsman), who is selected by the National Congress to serve a 6-year term. One

initial difference is that the National Ombudsman is not democratically accountable to the people directly as the local Próspera Ombudsman is.

Additionally, the National Ombudsman's powers pale in comparison to that of the local Próspera Ombudsman. The National Ombudsman cannot access classified State information nor sue the government; the National Ombudsman only has symbolic powers, such as that of "*organizing seminars to create a national mystique of human rights protection*"; informing Congress about its activities; asking authorities for information about human rights violations; receiving petitions related to domestic violence and denounce them to the competent authority if deemed criminal; producing human rights reports; creating regional offices; or "*providing immediate attention and follow up to any complaint about human rights violations*" (*Ley Orgánica Del Comisionado Nacional de Los Derechos Humanos [Organic Law of the National Commissioner for Human Rights]*, 1995).

The National Ombudsman lacks any meaningful power to effectively protect human rights and its office is not democratically accountable directly to the people. In contrast, the local Próspera Ombudsman can be democratically replaced by residents and is legally empowered to protect human rights by exerting relevant investigatory powers and, if required, suing the ZEDE government before an independent arbitration tribunal through the PAC or the ICDR. Comparatively, the local Ombudsman enjoys greater institutional capacity to provide the Honduran population with an effective human rights protection function.

## **5. Conclusions.**

As evidenced by public opinion polls, Hondurans have little to no trust in the country's political parties, electoral authorities, Congress, and the Judicial Power, while all major international indicators measuring democracy, electoral freedom, rule of law, enjoyment of civil and political rights, judicial independence, and popular accountability of government, reflect an extremely poor democratic performance by the State of Honduras. Through the

ZEDE regime, however, Próspera can provide its residents with new and more effective mechanisms for democratic participation, many of which are entirely new to Honduras and others, while not entirely new, differ considerably from those available outside of the ZEDE.

After comparing the mechanisms for political participation available under the national legal system with those available under Próspera ZEDE, this author finds that the *Charter of Próspera* represents a major democratic empowerment of the Honduran population, as it provides access to more effective legal mechanisms for residents to force an alignment between the popular will and governmental action.

Among the key democratic innovations introduced into Honduras by Próspera ZEDE, we find the *Agreements of Coexistence*. Through this Agreements, residents can expressly consent to their government and delegate sovereign power by contract. Próspera will hold this sovereign power in trust for the benefit of residents. Próspera ZEDE also introduces a *two-round electoral system* for selecting the chief executive; a greater degree of *passive suffrage rights* in the selection of the local legislature; more effective tools of direct democracy such as *citizen-forced referendums*, *automatic disapproval referendums* for new laws, and *recall elections*; and an *exit clause*. The latter allows residents to withdraw their sovereign power from the ZEDE government for any reason, or no reason at all, thus lowering the costs associated with electing a different government to live under as Hondurans will no longer have to leave the country to live under a different system of law and government.

Additionally, the *Charter of Próspera* provides more effective enforcement mechanisms for securing compliance with the rule of law and the free exercise of civil and political rights. Among these mechanisms, we find the *guarantee of access to justice and independent dispute resolution*, which allows residents to challenge the ZEDE government's actions before world-class arbitration centers, such as the PAC and the ICDR; and that of the local *Ombudsman*, who is democratically accountable to the people and who enjoys the power to access confidential information and sue the ZEDE government before the PAC or the ICDR for civil rights violations.

The institutions introduced to Honduras through Próspera ZEDE provide the country's population with an effective alternative for democratic self-governance at the local level. Hondurans can now opt to participate in public matters through a democratic local government with the autonomy to decide over fundamental issues such as legislation, taxation, public services, security, education, healthcare, regulation, dispute resolution, and international trade. Therefore, this author believes that the public governance framework adopted by Próspera ZEDE as a subnational division of the State of Honduras is a clear example of how democratic institutions can be introduced into undemocratic countries like Honduras through next generation special jurisdictions, such as the special Zones for Employment and Economic Development (ZEDE) regime.

Given its democratic framework and solid enforcement mechanisms, if allowed to expand, Próspera ZEDE has the potential to play a fundamental role in democratizing Honduras from the bottom up and fostering an institutional transition of power from national politics to local democracies.

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## Common Law Zones: An Illustrated Review

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### Abstract

Governments across the globe have created special jurisdictions offering common law rules and practices imported from abroad, the better to attract foreign investment and stimulate local economic growth. Four such common law zones have launched in recent years: the United Arab Emirates' Dubai International Financial Centre, in 2004; the Abu Dhabi Global Market, also in the UAE, in 2015; Kazakhstan's Astana International Financial Centre, in 2018; and the first Honduran ZEDE, in 2020. Each of these common law zones has faced the challenge of transplanting foreign rules and practices into a jurisdiction set apart from that of its host government, which instead follows some mix of Napoleonic Civil Code, Sharia, and/or Soviet legal traditions. The first three zones have answered that challenge by importing the common law of England (and sometimes also Wales) and entrusting its interpretation to courts that, while set apart from the local legal system, remain under the control of government officials. The ZEDE system takes a different approach. It requires each ZEDE operator to come up with its own detailed governance plan, subject to independent review, and carefully insulates ZEDE Courts from Honduran politics. The first such plan to win approval, that of the Próspera ZEDE on the island of Roatán, collects rules from various private sources in a Common Law Code and subjects most disputes to interpretation by private arbitration services. This report from the field thus finds two species of common law zone, a burgeoning genus of special jurisdiction. The first species draws its law from foreign sovereigns and leaves its courts exposed to political interference. The more recently evolved species of common law zone, as evidenced by the Próspera, enjoys greater freedom to choose and interpret its own governing rules. In theory, that should give ZEDEs an advantage over competing zones in providing the rule of law. In practice, the contest between common law zones has only just begun.

**Keywords:** Special jurisdiction, special economic zone, SEZ, private adjudication, common law.

### Resumen

Los gobiernos de todo el mundo han creado jurisdicciones especiales que ofrecen reglas y prácticas de derecho consuetudinario importadas del extranjero. Ésta ha sido una excelente estrategia para atraer

inversión extranjera y estimular el crecimiento económico local. En los últimos años, se han creado cuatro de estas zonas de derecho consuetudinario: el Centro Financiero Internacional de Dubai de los Emiratos Árabes Unidos, en 2004; el mercado global de Abu Dhabi, también en los Emiratos Árabes Unidos, en 2015; El Centro Financiero Internacional Astana de Kazajstán, en 2018; y la primera ZEDE hondureña, en 2020. Cada una de estas zonas de derecho consuetudinario ha enfrentado el desafío de trasplantar reglas y prácticas extranjeras a una jurisdicción distinta a la de su gobierno anfitrión, que en cambio sigue una combinación de Código Civil Napoleónico, Sharia y / o tradiciones legales soviéticas. Las primeras tres zonas han respondido a ese desafío importando el derecho consuetudinario de Inglaterra (y a veces también Gales) y han confiando su interpretación a tribunales que, aunque separados del sistema legal local, permanecen bajo el control de funcionarios gubernamentales. El sistema ZEDE adopta un enfoque diferente. Requiere que cada operador de ZEDE elabore su propio plan de gobernanza detallado, sujeto a revisión independiente, y aísla cuidadosamente a los tribunales de ZEDE de la política hondureña. El primer plan de este tipo que obtuvo la aprobación, el de la ZEDE Próspera en la isla de Roatán, recoge normas de diversas fuentes privadas en un Código de Derecho Común y somete la mayoría de las controversias a interpretación por parte de servicios de arbitraje privados. Este informe de campo encuentra así dos especies de zona de derecho común, un género floreciente de jurisdicción especial. La primera especie extrae su derecho de soberanos extranjeros y deja sus tribunales expuestos a interferencias políticas. La especie de zona de derecho común de evolución más reciente, como lo demuestra la Próspera, goza de mayor libertad para elegir e interpretar sus propias reglas de gobierno. En teoría, eso debería dar a las ZEDE una ventaja sobre las zonas competidoras en la provisión del estado de derecho. En la práctica, la contienda entre zonas de derecho consuetudinario apenas ha comenzado.

**Palabras clave:** Jurisdicción especial, zona económica especial, ZEE, adjudicación privada, derecho consuetudinario.



## 1. INTRODUCTION: THE RISE OF COMMON LAW ZONEs

Recent decades have witnessed a surge in special economic zones (SEZs), created by countries across the globe to attract foreign investment and drive local development (Bell, 2018, pp. 19-27). By definition, each zone offers rules different from those prevailing elsewhere in the host country (Farole, 2011, p. 23). Most do little more than lighten the burdens of custom duties and other trade-related taxes. Increasingly, however, special jurisdictions go beyond mere economic concerns to market entire legal systems, complete with their own rules and courts, designed to compete in the international market for capital and talent. The proven success and widespread use of the common law has made it a popular resource for special jurisdictions seeking rules and practices from abroad. This paper reviews the efforts of four such *common law zones*, as it labels them.

The recent surge in common law zones began in 2004, in the United Arab Emirates (UAE), with the launch of the Dubai International Financial Center (DIFC, 2020a). The success of DIFC inspired another UAE common law zone in 2015, the Abu Dhabi Global Market (ADGM, 2020). Kazakhstan's Astana International Financial Centre followed in 2018 (AIFC, 2020). The DIFC, ADGM, and AIFC share strategies when it comes to importing common law rules and practices. The spring of 2020 brought a fresh approach to the challenge with the launch of the first zone in the Honduran Zona de Empleo y Desarrollo Económico (*Zone of Employment and Economic Development*) system (ZEDE, 2020; Honduras Próspera, 2020).

The DIFC, ADGM, and AIFC invoked the common law of England (and sometimes also Wales) when building the foundations of their zones' rules and set up nominally independent courts to interpret those rules. However, as the analysis below indicates, the judges in those courts appear to remain subject to the influence of local politicians. The ZEDE system, in contrast, requires each private zone promoter to come up with its own detailed

governance plan, subject to independent review, and shelters the judges of ZEDE Courts from the interference by Honduran politicians.

This survey of common law zones, a new and rapidly expanding genus of special jurisdiction, thus finds two major species. The first three zones closely resemble the SEZs from which they evolved. The most recent, the Honduran ZEDE system, takes a new approach to the problem of importing the common law.

In fairness, it bears noting that the DIFC, ADGM, and AIFC are hardly perfect counterparts to ZEDEs. The non-Honduran zones do not face the huge task before each ZEDE: Provide the functional equivalent of a super-municipality complete with a resident population, comprehensive legal system, social benefit programs, and the other trappings of government. Regardless of these differences, however, all four of the special jurisdictions aspire to provide independent and competent common law-based judicial systems. That provides a basis for cross-zone comparisons.

The investigation begins with an overview of each common law zone, from oldest to newest. Section 2 covers the two UAE zones, the DIFC and ADGM, both of which rely on the same national legislation. Section 3 covers Kazakhstan's AIFC; section 4, the Honduran ZEDE system. Each of these overviews offers a brief background, a description of how the zone imports the common law, and an illustrated guide to the zone's functional features. The last of these provides a basis for comparing the independence of the adjudicative bodies in these special jurisdictions, an exercise taken up in the concluding section. This structural analysis gives reason to predict that the design of Próspera ZEDE's legal system will promote the common law's core values of judicial independence, individual rights, and the rule of law better than that of the DIFC, ADGM, or AIFC. Will that theoretical advantage bear out in practice? To answer that question will require continued study of common law zones in their natural habitat, so to speak.

It bears noting that this paper does not discuss the various sovereigns that offer common law legal systems by default, a list that includes Great Britain and the many

countries influenced by England's legal tradition, including 53 other Commonwealth nations and the United States (Commonwealth, 2020). Those perhaps represent common law zones of a sort, but not the sort of interest here. The focus instead falls on special jurisdictions that aim to transplant the common law to new foreign environments.

Despite its claim to "follow the English Common Law," the Qatar Financial Center falls outside the scope of this study because its publicly available laws and regulations do not make evident how it fulfills that claim, if at all (Qatar Financial Center, 2020). The Center explains that it has not yet issued regulations for its civil and commercial courts (*ibid.*). Perhaps it plans to import the common law later.

## **2. UAE FINANCIAL FREE ZONES**

The United Arab Emirates (UAE) governs a federation of seven emirates, each a royalty governed by its own supreme leader, typically titled Ruler or Sheikh. In 2004, the UAE amended its constitution to clear the way for a new kind of special jurisdiction—Financial Free Zones (UAE Constitutional Amendment No (1) of 2004). It thereafter passed a federal law allowing each of its member emirates to create such zones (UAE Federal Law No. (8) of 2004).

With regard to banking, the exchange of stocks, insurance, and other financial services, each zone has considerable independence. The federal law says of each zone, "It and no one else shall be responsible for the obligations arising out of the conduct of its activities." (*id.* Art. 2). Laws criminalizing money laundering and certain other obligations remain in place, however, and Financial Free Zones can self-legislate only in civil and commercial matters (*id.* Art. 3(2)). In contrast to Honduran ZEDEs, these limitations leave the UAE zones far short of semi-autonomous municipalities. Like the AIFC that followed them, the UAE Financial Free Zones focus on economic transactions.

The UAE currently hosts two Financial Free Zones, the DIFC in Dubai and the ADGM in Abu Dhabi. The next two subsections describe each in turn. Figure 1, below, illustrates the functional relations between the UAE and its two zones, and the major structures of the two zones themselves. This picture of the governance of the Financial Fee Zones offers scant evidence of the decentralized and independent decision-making typical of common law systems.

To summarize: A Ruler, acting through the institutional framework of his emirate, effectively controls each zone. The Emirate of Dubai appoints and removes all important officers of the DIFC and legislates for the zone. The Emirate of Abu Dhabi exercises control as completely, but by delegating power to an Executive Council, which legislates for the zone and appoints its officials while serving at the discretion of the Ruler. Further details follow below in subsections examining the DIFC and ADGM, each in turn

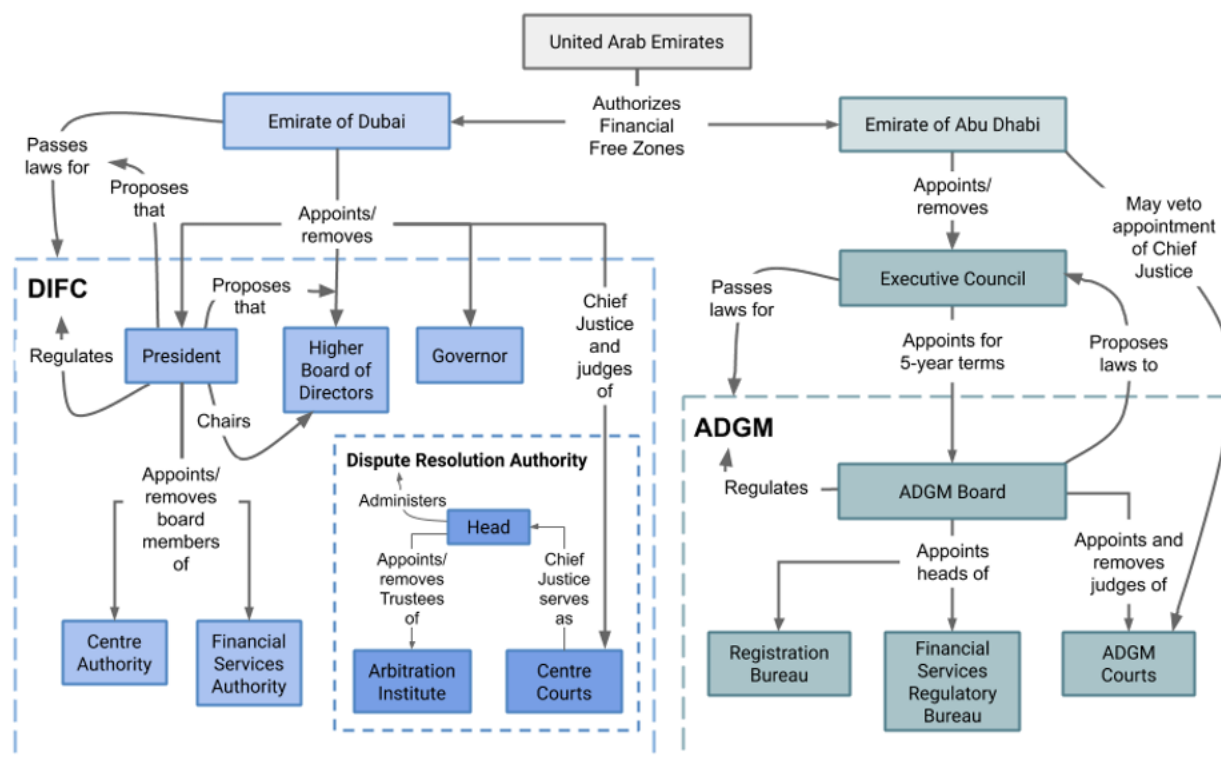


Figure 1: UAE Financial Free Zones' Governing Structures (author's own elaboration)

## 2.1. Dubai International Financial Centre

In 2004, within months of amending its constitution and passing legislation to enable Financial Free Zones, the UAE decreed the establishment of the first, the Dubai International Financial Centre (DIFC) (UAE Federal Decree No. (35) of 2004). Dubai's Sheikh Mohammed Bin Rashid Al Maktoum (Ruler), thereafter issued the Law of the DIFC, defining the zone's governance (Law of the DIFC). The DIFC has by most accounts proven a success (DFIC, 2019a, 2019b). Subsection 2.1.1. explains how it imported the common law to the UAE, a jurisdiction otherwise shaped by a mixture of Civil Code and Sharia Law influences. Subsection 2.1.2. offers a structural analysis of the zone.

### **2.1.1. How the DIFC Imports the Common Law**

The UAE statute creating Financial Free Zones merely removes them from the reach of federal civil and commercial laws; it does not specify what should fill that gap (UAE Federal Law No. (8) of 2004, Art. 3(2)). For the most part, the DIFC has filled it with its own local laws and regulations, which run at some length and in great detail (DIFC, 2020b). Some of these borrow heavily from statutes of the United Kingdom, though legislation from the United States also shows an influence (Horigan, 2009, p. 10). As a general matter and by design, those control most transactions in the zone.

More specifically, the DIFC recognizes a hierarchy of rules. At the top come the DIFC's own enactments (DIFC Law No. 3 of 2004, Art. 8(2)(a)). If those leave a particular issue unresolved, the search moves down the list to inquire whether the concerned parties agreed to have another law control their transaction (*id.*, Art. 8(2)(c)). Failing that, the DIFC adjudicatory body considering the question may itself determine the law “most closely related to the facts of and the persons concerned in the matter ....” (*Id.*, Art. 8(2)(d)). Only if that effort also fails does DIFC law, as something of a last resort, fall back on “the laws of England and Wales.” (*Id.*, Art. 8(2)(e)). In contrast to the ADGM's enabling law, the DIFC Law does not expressly state whether this reference automatically tracks changes to its foreign referent, or whether it instead stays fixed as of the date of the DIFC law's enactment. The DIFC also built the common law into its legal system by hiring experienced judges to run its courts (Krishnan & Purohit, 2014, pp. 523-54), a measure likely to have more practical effect than any merely written provision.

### **2.1.2. Structural Analysis the DIFC**

Dubai's Ruler, Sheikh Mohammed bin Rashid Al Maktoum, acts as the supreme legislator of the DIFC under Article (2) of the DIFC Law, which defines “Centre Law” as “any laws issued by the Ruler in relation to the Centre.” Article (3)2 of the Law of the DIFC gives the Ruler



power to appoint the President of the DIFC. As the title suggests, the President exercises many powers in the DIFC. Unlike some presidents, though, the DIFC's President serves not a voting public or shareholder board but a single ruler: the Ruler. The President's powers within the DIFC include:

- Submitting draft Centre Laws to the Ruler for issuance (id., Art. (5)2)
- Issuing Centre Regulations (id., Art. (5)3);
- Appointing or removing the chairs or members of the Centre Bodies (id., Art. (5)4, (5)5).

The President also holds the purse for all Centre Bodies via the power granted in Article (5)8 to approve (and thus presumably disapprove) their budgets. Their funds come straight from the Government, however, which de facto controls their disbursement through the Department of Finance. The President is not given the power to appoint or remove the head of the Dispute Resolution Authority. In addition to the President, the DIFC's Centre Bodies have an especially powerful influence on the zone's operations. The Law of the DIFC establishes three such bodies:

- The Dubai International Financial Centre Authority (Centre Authority);
- The Dubai Financial Services Authority (Financial Services Authority); and
- The Dispute Resolution Authority (DRA) (id., Art. (3)3).

The DRA includes two sub-institutions of note, the Centre Courts and the Arbitration Institute (id., Art. (8)1st1). (Though sources closer to the ground report that there has been significant functional restructuring of the DIFC court system, the account here applies the applicable law as described by DIFC bodies (DIFC-LCIA Arbitration Center, 2021). In practice, the DIFC-LCIA Arbitration Centre, formed as a joint venture between the Arbitration Institute and the London Court of International Arbitration, has taken a prominent role in local dispute resolution (id.)

The DIFC also includes a Higher Board of Directors, chaired by the President, the members of which the Ruler chooses (id., Art. (3)5). Members of the Higher Board must

include the Governor, the chairs of the boards of the Centre Authority and the Financial Services Authority, and the head of DRA (*ibid.*). The Higher Board evidently serves as something like a board of advisors to the President, who in turn proposes zone legislation to the Ruler and appointments to the Higher Board.

The DIFC has a Governor appointed or removed by the Ruler upon proposal of the President (*id.*, Art. (5)<sup>bis</sup>1). The Governor serves as the managing director of the DIFC, a position that regardless of its practical importance does not have much to teach about how the DIFC's legal system operates. The discussion thus returns to the three Centre Bodies.

The DIFC's founding law insists that the Centre Authority must perform its functions free from interference by other Centre Bodies (*id.*, Art. (6)2). Toward that end, the Authority has its own budget, which it receives straight from the Government of Dubai (which is to say, given the monarchical form of government, the Ruler) (*id.*, Art. (6)3). While guaranteeing the independence of the Centre Authority from other Bodies, this does not appear to prevent the President from controlling the Centre Authority's budget via the approval power set forth in Article (5)8. Similarly, Article (3)6 provides that the President "shall be responsible for supervising the Centre's Bodies and coordinating between them ... without affecting the independence of the Centre's Bodies." This must speak to their independence from one another, as it can hardly speak to their independence from the President, to whom the Authority's board of directors must answer (*id.*, Art. (6)4). That makes sense, given the President's power to appoint or remove the chair or members of the Centre Authority's board, as well as to specify their duties and remuneration (*id.*, Art. (5)4). Combined, these powers give the President considerable influence over the Centre Authority.

The DIFC's founding law gives the Financial Services Authority a similar treatment, insisting that other Bodies must not interfere with its operations, funding it directly from Government coffers, and placing it under the President's direct supervision (*id.*, Art. (7)3-4). As with the Centre Authority, the President controls who sits on the board of directors of the Financial Services Authority, their duties, and their pay.

The founding law starts out treating the DIFC's Dispute Resolution Authority the same way, espousing its independence from other Centre Bodies and promising it Government funding (*id.*, Art. (8)<sup>1st</sup>3-4). Unlike the Centre Authority and the Financial Services Authority, though, the Dispute Resolution Authority is not placed under the control of the President. Instead, the Ruler retains direct control of the Dispute Resolution Authority.

The Law of the DIFC creates this governance structure in a roundabout way. First, it designates the Chief Justice of the Centre Courts as the Head of the Dispute Resolution Authority (*id.*, Art. (8)<sup>1st</sup>5). These courts have exclusive jurisdiction "to interpret the Centre's Laws and the Centre's Regulations," per Article (8)<sup>2nd</sup>7. Some sections later, the Law of the DIFC provides that the Ruler appoints the Chief Justice (*id.*, Art. (8)<sup>2nd</sup>3). Still later, it provides that the Ruler appoints all the judges of the Centre's Courts (*id.*, Art. (8)<sup>2nd</sup>5.e). Add it all up and the Ruler appoints the DRA Head and Centre Court Chief Justice, in one and the same person, and appoints all Centre Court judges.

In contrast to the ZEDE Courts, which have jurisdiction over crimes occurring in their zones, and like their counterparts in the ADGM and AIFC, Centre Courts are forbidden to hear such cases. "The Courts of the Emirate shall have jurisdiction on crimes committed within the Centre," the DIFC's founding law emphasizes (*id.*, Art. (8)<sup>2nd</sup>6). True to their name, and consistent with their statutory subordination to UAE money laundering laws, Financial Free Zones do not offer a special jurisdiction with regard to criminal matters. The Centre Courts' jurisdiction over foreign and domestic awards has become a bone of contention with onshore Dubai Courts, leading the Ruler to decree the creation of a Joint Judicial Committee to resolve the conflict (Walker & Thadani, 2018, p. 28).

The Dispute Resolution Authority also hosts an Arbitration Institute, set up to provide private dispute resolution services for-hire to local and international customers (Law of the DIFC, Art. 8<sup>3rd</sup>). The Arbitration Institute falls under the direct control of the Head of the Dispute Resolution Authority (and Chief Justice of the Centre Courts), who holds the power

to appoint and remove members of the Institute's Board of Trustees (id., Art. 8<sup>3rd</sup>4). This Board runs the Arbitration Institute (id., Art. 8<sup>3rd</sup>5).

The Ruler, acting through the Emirate of Dubai, controls the Dispute Resolution Authority and Centre Courts from one step away, via the power to appoint or remove the Head/Chief Justice. The Emirate controls the Arbitration Institute from two steps away, acting through the Head/Chief Justice's direct control over the composition of the Institute's Board. This structure does not dilute the sovereign's authority so much as delegate it. It offers the Ruler the potential of exercising detailed control over the operations of the DRA and Centre Courts via the power to terminate the Head/Chief Justice and judges. Figure 2, below, highlights the government's control over all important personnel of the DRA.

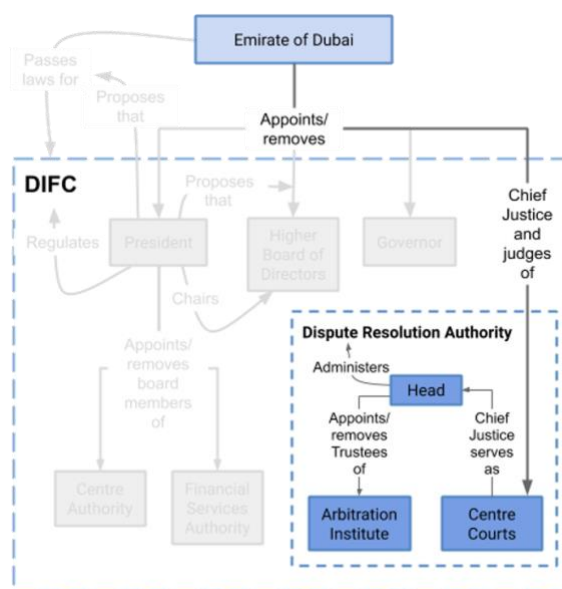


Figure 2: The DIFC Judicial System, Highlighted (author's own elaboration)

The same theme recurs throughout the design of governance of the DIFC. Though the Law of the DIFC proclaims that Centre Bodies shall not interfere with each others' operations, it says nothing against the Ruler influencing or indeed directly commanding the President,

Head of the DRA, Chief Justice, and inferior judges of the DIFC. Against all, he wields the power of termination. The Ruler exercises the same power over the members of the boards of Centre Bodies, acting through the President, and over the trustees of the Arbitration Institute, acting through the Head of the DRA.

Does the DIFC design subjects its courts to undue risk of political influence? Suppose the valued friend of a hypothetical Ruler faced a large claim in the Centre Court, the resolution of which turned on a hotly contested point of law. Suppose further that the Ruler let the Chief Justice know that termination would follow if his friend lost. Would any institution or law stand in the way of this attempt to interfere with the court's deliberations? It seems not (Krishnan & Purohit, 2014, p. 531).

None of this is to say that the present Ruler *would* do such a thing, of course; it speaks only to what under DIFC law a hypothetical Ruler *could* do. In this respect, the DIFC resembles the AIFC and the ADGM, while differing sharply from the ZEDE system or a traditional common law legal system. It bears noting, however, that the DIFC has built an innate defense of judicial independence into its court system by hiring judges of high repute with experience in the common law tradition. Regardless of ideology, a rational politician would have to realize that brute interference with zone courts would likely break the very mechanism that gives them value. The increasingly competitive market for hosting international financial transactions incentivizes the DIFC and other common law zones to respect the rule of law or lose business. Further comparative analysis follows in the concluding section.

### 2.1.3. Abu Dhabi Global Market

In 2013, through Federal Decree No. (15), the UAE authorized the creation of its second Financial Free Zone: The Abu Dhabi Global Market (ADGM) (UAE Federal Decree No. (15) of 2013). Soon thereafter, Abu Dhabi defined the governing structure of the zone in Law No. (4) of 2013 Concerning Abu Dhabi Global Market (ADGM Founding Law). The zone opened

in 2015 with a focus on private banking, wealth management, asset management, derivatives and commodities trading, and similar transactions. Physically, it occupies 114 hectare (282 acre) Al Maryah Island; functionally, the ADGM “enables registered financial and non-financial institutions, companies and entities to operate, innovate and succeed within an international regulatory framework based on common law.” (ADGM, n.d.).

#### **2.1.4. How the ADGM Imports the Common Law**

Like the DIFC, the ADGM builds the common law into its legal system (Reynolds, 2017; Russell & Bognar, 2017). Specifically, ADGM regulations provide that the “common law of England (including the principles and rules of equity), as it stands from time to time, shall apply and have legal force” in the ADGM (ADGM Application of English Law Regulations of 2015, § 1(1)). Unlike the DFIC and AIFC, the ADGM focuses exclusively on English law, eschewing that of Wales. The ADGM also stands apart from its counterpart common law zones in that it gives expressly gives immediate effect to changes wrought by English courts, a relationship of dependency that commentators euphemise as “evergreen” (Reynolds, 2017) or “ambulatory” (Russell & Bognar, 2017).

The ADGM also incorporates by reference a great many English statutes, such as the Statute of Frauds and Partnership Act, that modify the common law (id., § 2(1)). In contrast to its treatment of English common law, however, the ADGM takes care to not give changes to foreign legislation local effect automatically. The ADGM’s regulations for application of English law to the zone provide that, notwithstanding any amendment [to] the law of England made pursuant to an Act or any legislative instrument adopted thereunder at any time after the date of enactment of these Regulations, [the] amendment shall not apply and have legal force in, or form part of the law of, the Abu Dhabi Global Market, unless and until an Abu Dhabi Global Market enactment expressly provides.... (id., § 1(1)(d)). In other words,



no changes to English legislation have local effect unless and until approved by specific ADGM enactment.

#### **2.1.5. Structural Analysis of the ADGM**

A Board of Directors governs the ADGM. Who appoints its members? According to Article (4) of the ADGM Founding Law, “their appointment and remuneration shall be determined by a resolution issued by the chairman of the Executive Council.” The Founding Law here refers to the Executive Council of the Emirate (id., § 1). And who appoints its members? Such appointments give every appearance of falling within the exclusive province of the Ruler (Wikipedia, 2020). It could hardly be otherwise, given the monarchical basis of Abu Dhabi’s government.

The Founding Law states that Board Directors will serve 5 year terms renewable “unless the chairman of the Executive Council decides otherwise.” (ADGM Founding Law, Art. 4). That chairman at present is the Crown Prince of the Emirate of Abu Dhabi, Sheikh Mohammed bin Zayed bin Sultan Al Nahyan (Abu Dhabi Executive Affairs Authority. 2013). The exact scope of the chairman’s discretion remains unclear in the English translation. At any rate, that appears to be the most that any of the zones here under review does toward providing job security to judges.

Article 10 of the ADGM Founding Law creates three zone Authorities, each with its own legal personality and budget:

- The Global Market's Registration Bureau;
- The Financial Services Regulations Bureau; and
- The Global Market's Courts (ADGM Courts).

The Registration Bureau provides administrative support to the zone in a variety of ways, including registering properties and establishments, preparing reports, and proposing regulations to the Board (ADGM Founding Law, Art. 11). The Regulations Bureau oversees financial services in the zone, a power that includes licensing and monitoring them, reporting to the Board, and proposing regulations (id., Art. 12). Those Authorities matter less for present purposes than the ADGM Courts, however, to which consideration now turns.

The ADGM's Chief Justice and other judges are appointed and removed under Articles 6(3) and 13(2) of the ADGM Founding Law. Article (6) provides:

The Board of Directors shall be the supreme authority in the Global Market.... It may exercise all the competencies and authorities necessary to do so, without affecting the independence of all the Global Market Authorities. It shall, in particular carry out the following:... 3. Appoint, remove and replace ... the Chief Justice and judges of the Global Market's Court, and to specify their duties, the terms of their service and their remuneration pursuant to this law and the Global Market's Regulation.

Article (13) of the ADGM Founding Law puts a special limitation on the Board's power to appoint the Chief Justice, though: "2. The Global Market's Courts shall have a Chief Justice appointed by a Board of Directors resolution which shall become effective upon the expiry of 15 days of notifying the Chairman of the [Abu Dhabi] Judicial Department of such resolution and receiving no objections thereto." Because Sheikh Mansour Bin Zayed Al Nahyan serves as the Chairman of the Abu Dhabi Judicial Department (Abu Dhabi Judicial Department, 2020), this provision in effect gives the Emirate of Abu Dhabi 15 days to veto the prospective appointment by the Board of Directors of any judge to the ADGM Court.

The ADGM Founding Law imposes no similar review on appointments by the Board of Directors of officials to the other two zone Authorities, the Registration Bureau and the Financial Services Regulations Bureau. The Ruler evidently wants to subject any prospective

Chief Justice of the ADGM Court to extra scrutiny. Well it might; the Chief Justice controls the appointment of lesser judges under Art. 13(3) of the Founding Law, which provides: “The judges of the Global Market Courts shall be appointed by resolutions issued by the Board of Directors based on the proposal of the Chief Justice of the Global Market Courts.”

Figure 3, below, highlights the relationships through which the Emirate of Abu Dhabi controls ADGM’s judicial processes. In contrast to the Emirate of Dubai’s direct power to shape appointments to DIFC Courts, the Emirate of Abu Dhabi shapes ADGM judicial appointments by determining the composition of Abu Dhabi’s Executive Council, which in turn determines the composition of the ADGM’s Board of Directors, which itself appoints (subject to an Emirate veto of Chief Justice candidates) and removes the judges of the ADGM Courts. On a purely structural basis, this gives the ADGM Courts more protection against political influence than enjoyed by DIFC Courts.

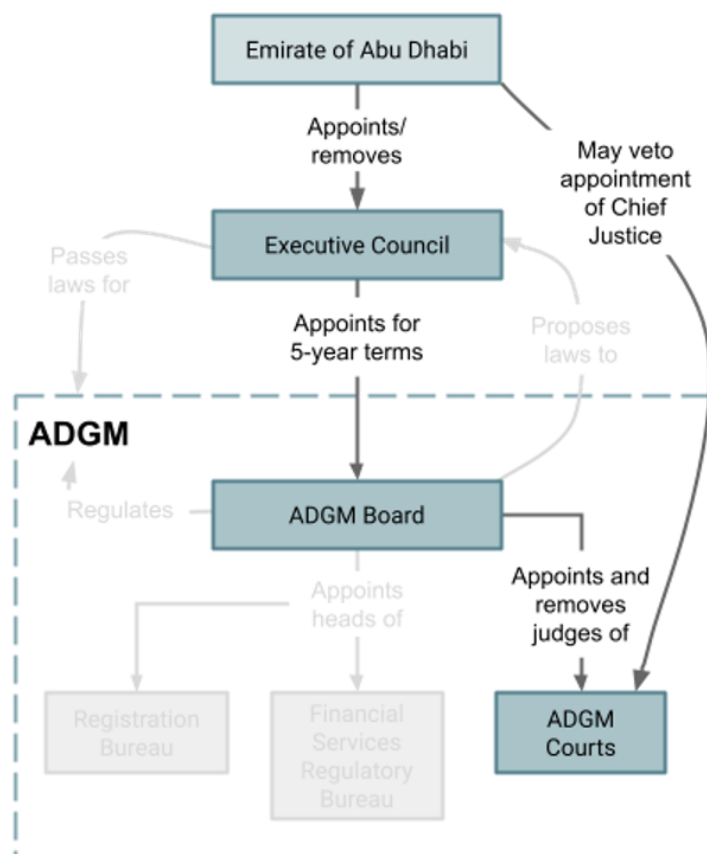


Figure 3: The ADGM Judicial System, Highlighted (author's own elaboration)

Further details of the appointment and removal of judges in ADGM Courts appear in regulations issued by the Board of Directors (ADGM Court Regulations). These regulations clarify the meaning of the ADGM Founding Law's requirement that the Board make appointments "*based on the proposal of the Chief Justice*" (Art. 13(3), *emphasis added*)--a condition that admits to various interpretations. The regulations evidently read it to mean that the Chief Justice must nominate judges to fill vacancies, unless he thinks they may remain unfilled, which nominations the Board must approve (*id.*, §§ 195(6), (7), & (11)). The

Board may at most “request the Chief Justice to consider a person” for a judicial appointment (*id.*, § 195(9)).

The ADGM Court Regulations go beyond the Founding Law to grant the Chief Justice the power to remove lower judges. They provide that such judges “shall hold [] office during good behaviour, subject to a power of removal by the Board on the recommendation of the Chief Justice.” (*Id.*, § 196(2)). The regulations moreover continue by giving the Chief Justice exclusive authority to initiate the removal of lower judges for bad behavior, saying, “It is for the Chief Justice alone to recommend to the Board the exercise of the power of removal” in such cases (*id.*, § 196(3)).

Note that this power granted to the Chief Justice in ADGM Court Regulations operates not in lieu of the Board’s power to remove judges but in addition to it. The ADGM Founding Law, which predominates over the regulations, provides in Article 6: “The Board of Directors shall be the supreme authority in the Global Market.... It shall, in particular carry out the following:... Appoint, remove and replace ... the Chief Justice and judges of the Global Market’s Court...” No mere regulation could strip the Board of its power and indeed duty under the Founding Law to remove wayward ADGM judges. The ADGM Court Regulations merely create a way—a limited way, since only the Chief Justice may exercise it—to initiate the removal of a judge for bad behavior.

### **3. ASTANA INTERNATIONAL FINANCIAL CENTRE, KAZAKHSTAN**

On July 5, 2018, the Republic of Kazakhstan launched the Astana International Financial Centre (AIFC), promising low taxes, streamlined treatment of foreign commerce, and a bespoke legal system combining advanced financial regulations with independent resolution of disputes (Business Standard, 2018). Though physically located in the capital city, Nur-Sultan, deep in the heart of the steppe that sweeps through the east and north of Kazakhstan,

the AIFC makes its judicial services available across the globe through electronic means. The AIFC offers a special jurisdiction with its own common law-based court system and other selling points reminiscent of those offered by the UAE Financial Free Zones and Honduran ZEDEs. This section offers an overview of the AIFC. Subsection 1 explains how the zone mandates but does not command adoption of the common law. Subsection 2 offers a structural analysis of the AIFC, with particular focus on judicial independence.

The AIFC exhibits a number of notable features. Transactions in the zone may be denominated and executed in a currency of the parties' choosing, winning broad exemptions from Kazakhstan currency regulations and controls (Constitutional Statute of the AIFC, 2019, Art. 5). AIFC bodies and participants enjoy wide-reaching exemptions from corporate income taxes on financial transactions and services conducted in the zone until the year 2066 (*id.*, Arts. 6.2-6.4). During that same period, foreign nationals working for AIFC bodies or participants owe no personal income taxes (*id.*, Art. 6.6), and AIFC bodies and participants owe no property or land taxes for facilities located in the zone (*id.*, Art. 6.8). Foreigners seeking to conduct business in the AIFC enjoy privileged treatment of entry and work permits (*id.*, Arts. 7-8). English serves as the official language of the AIFC (*id.*, Arts. 15-20).

The global pandemic has not left Kazakhstan unscathed, alas, leaving the fate of the fledgling zone uncertain as of this writing. At the most recent AIFC Management Council meeting, in early July of 2020, Kazakhstan's President Kassym-Jomart Tokayev (who by Presidential Decree chairs the Council) reportedly said that the funding of the AIFC should be directed to help the country's economy recover from its current woes, and while noting that the AIFC was not designed with that mission in mind, "it is high time to change the situation" (Beer, 2020). What the President and Chair's new policy will mean for the finances and independence of the AIFC remains as yet unclear.

### **3.1. How the AIFC Imports the Common Law**



Though inspired by the DIFC and ADGM, the AIFC does less than its UAE predecessors to mandate the importation of the common law to the zone. The Constitutional Statute of the AIFC responsible for its creation provides that its internal regulations, “may be based on the principles, legislation and precedents of the law of England and Wales and the standards of leading global financial centres” (Constitutional Statute of the AIFC, 2019, Art 4.1(2)); further, that the AIFC Court shall be governed by rules “based on the principles and legislation of the law of England and Wales and the standards of leading global financial centres.” (*Id.*, Art. 13.5). Notably, the enabling statute invokes not just the common law of England and Wales but their legislation, too.

This call to place the zone under rules based on foreign sources would seem to speak with great authority. The Constitutional Statute for the AIFC follows only Kazakhstan’s Constitution and international treaty obligations in terms of its rank in the applicable legal hierarchy, placing it above any mere presidential decree, AIFC act, or other Kazakhstan law (Constitutional Statute of the AIFC, 2019, Articles 4 & 10.3(3); Decree of the President, 2015, Art. 1.2). That would mark a notable change in a jurisdiction formerly inspired by Soviet socialist and Islamic legal traditions (Yeung, et. al., 2020, p. 67). On closer examination, however, the Statute merely encourages the AIFC to take the common law and other foreign laws into account.

That the enabling statute for the AIFC merely invites the importation of the common law, rather than requiring it, shows clearly in the contrasting verb phrases of Article 13(6): “In adjudicating disputes, the AIFC Court is bound by the Acting Law of the AIFC and may also take into account final judgements of the AIFC Court in related matters and final judgements of the courts of other common law jurisdictions.” (Constitutional Statute of the AIFC, 2019, Art. 13(6)). In other words, whereas the AIFC legal system *must obey* the Constitutional Statute and higher authorities in Kazakhstan’s legal system, they *may take account of* common law precedents. The AIFC’s noncommittal approach to the common law also shows in Article 13.6’s evident refusal to recognize the concept of binding precedents, a

characteristic feature of common law legal systems and one that distinguishes them from their civil law counterparts.

Further references to the common law appear in the AIFC Court Regulations issued by the AIFC Management Council, the body authorized to run the zone. These require that judicial appointees to AIFC Courts have “significant knowledge of the common law and experience as a lawyer or judge in a common law system ....” (AIFC Court Regulations, 2017, Articles 12(6)(b) & 12(7)(b)). The Regulations also require that AIFC Courts “be guided by decisions of the Court and decisions made in other common law jurisdictions.” (*Id.*, Art. 29(2)). Consistent with the rest of the AIFC’s approach to the common law--making it a matter of choice rather than mandate--the Regulations allow AIFC courts to “provide common law courses and accreditation for lawyers and judges” (*id.*, Art. 49(1)(f)). In these ways, the AIFC makes the common law more of an aspirational ideal than a functioning institution.

### **3.2. Structural Analysis of the AIFC**

How does the AIFC work? Its moving parts, functionally speaking, include the:

- AIFC Management Council;
- Governor of the AIFC;
- AIFC Authority;
- Astana Financial Services Authority (AFSA);
- AIFC Court; and
- International Arbitration Centre

A survey of each of these bodies’ powers and limitations follows. Figure 4, below, portrays the relationships between the various institutions involved with or in the AIFC.

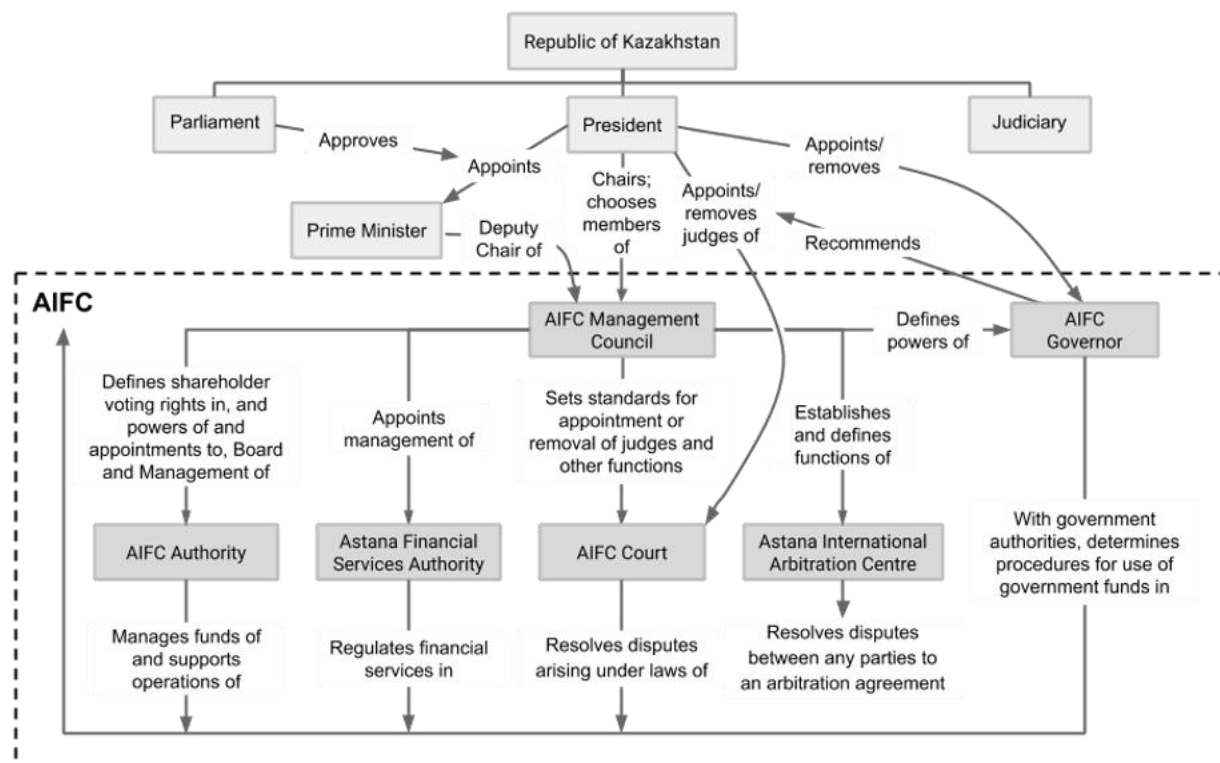


Figure 4: AIFC Governing Structures (author's own elaboration)

### 3.2.1. AIFC Management Council

The Management Council sets general policy for the AIFC, defines subordinate bodies, makes select staffing decisions, and issues AIFC Acts in the form of binding resolutions (Constitutional Statute of the AIFC, Art. 10.2-.3). The scope of these Acts extends to relationships between AIFC participants and employees in civil, financial, and administrative matters (id., Art. 4.3). AIFC Acts “may be based on the principles, legislation and precedents of the law of England and Wales and the standards of leading global financial centres,” a common law-friendly approach that the AIFC shares with Honduran ZEDEs and UAE Financial Free Zones (id., Art. 4.1(2)).

The President of Kazakhstan exercises considerable control over the AIFC Management Council. The President chairs the Council (*id.*, Art. 10.1), or if absent from the Council, may have the Prime Minister (whom the President appoints) serve as Deputy Chair (Decree of the President, 2015). The President must also approve the rules regulating Council operations and its members (Constitutional Statute of the AIFC, Art. 10.4). That statute does not give any other person or institution a say in Council membership, making the fact that its “composition” is “to be approved by the President” (*ibid.*) effectively a grant of unilateral power to determine its membership.

### **3.2.2. AIFC Governor**

The AIFC statutory framework leaves the Management Council with wide discretion to determine the powers of the AIFC Governor (*id.*, Art. 10-1.2). It specifies, however, that “procedures for exercising control to ensure the targeted and efficient use of the funds of the republican budget allocated to the AIFC” shall be jointly determined by Kazakhstan officials and the Governor (*id.*, Art. 9.4). Exactly how that joint responsibility gets handled remains unclear. The Governor also enjoys a statutory power to recommend the appointment or removal of judges by the President (*id.*, Art. 13.3-1). That does little to guarantee the independence of the AIFC judiciary, however, because the President has unfettered control over the appointment and removal of the Governor (*id.*, Art. 10-1.1).

### **3.2.3. AIFC Authority**

The AIFC Authority is “a non-profit organisation established by the National Bank of the Republic of Kazakhstan” with a mandate to manage funds received from the government, fee paying participants, and other sources in support of AIFC functions (*id.*, Art. 11.1-.2). It also

fulfills a number of advisory, reporting, budgeting, outreach, and administrative functions (*id.*, Art. 11.4).

A Board of Directors oversees the AIFC Authority; a Management Board handles day-to-day operations (*id.*, Art. 11.2-1). The AIFC Management Council appoints the members of those bodies, sets the terms of their employment, and determines their powers, as well as the powers exercised by shareholders of the AIFC Authority in their general meetings (*ibid.*). By separate decree, the President has defined the AIFC Authority as the “working body of the Council,” formed as a company of shareholders Decree of the President, 2015, Art. 1.3).

#### 3.2.4. Astana Financial Services Authority

The Astana Financial Services Authority (AFSA) touts itself as “an independent regulator of financial services and related activities” in the AIFC (AFSA, 2020b). Its budget comes “from funds of the republican [i.e., national state] budget, in the form of targeted transfers through the AIFC Authority in accordance with the budget legislation of the Republic of Kazakhstan, as well as fees and payments contributed by AIFC Participants.” (Constitutional Statute of the AIFC, Art. 12.1). The AFSA thus appears independent of the AIFC Authority but not of the Republic of Kazakhstan in terms of funding, whereas the Council appoints the AFSA’s management (*id.*, Art. 10.3(5)). It remains uncertain whether such regulators, who rely on the national government for financial support and on the AIFC Council (over which the President exercises considerable control) for their continued employment, will find it easy to exercise independent judgment.

#### 3.2.5. AIFC Court

The AIFC Court has exclusive jurisdiction over disputes between AIFC participants, bodies, and their expatriate employees, disputes relating to activities in the AIFC governed by its law, and disputes transferred to the Court by the consent of the parties (*id.*, Art. 13.4). It has

no jurisdiction over criminal or administrative proceedings, however (*ibid.*). (How that limitation of the AIFC Court's jurisdiction jibes with the statute's simultaneous grant to AIFC Acts of authority over "administrative procedures" in *id.* Art. 4(3-4) remains unclear.) In addition to a court of first instance, the system includes an appellate court, from which no further appeals are allowed, and a Small Claims Court with expedited procedures for claims up to the value of US \$150,000 (AIFC, 2020a). The AIFC Court's electronic filing system "enables parties to file cases electronically from anywhere around the world without their having to be physically present in Nur-Sultan." (*Ibid.*). Like other AIFC bodies, the Court's activities are governed by the AIFC Management Council, "based on the principles and legislation of the law of England and Wales and the standards of leading global financial centres." (Constitutional Statute of the AIFC, Art. 13.5).

The AIFC Court declares itself "an independent common law court operating to the highest international standards" (AIFC, 2020c). Indeed, it by law is "not a part of the judicial system of the Republic of Kazakhstan." (Constitutional Statute of the AIFC, Art. 13.2). And the Management Council's regulations proclaim, "Neither the Government of the Republic of Kazakhstan, the AIFC Authority, or any other person or entity, shall interfere with the judicial duties or decisions" of the Court (AIFC Court Regulations, 2017, Art. 11(2)).

The judges of the AIFC Court enjoy nothing like tenure, however. They "are appointed and removed by the President of the Republic of Kazakhstan on the recommendation of the Governor of the AIFC." (Constitutional Statute of the AIFC, Art. 13.3-1). As discussed above, the President has exclusive authority to appoint or remove the Governor. In effect, therefore, judges of the AIFC serve at the discretion of the President, who of course is not bound by the stance taken by the AIFC Court Regulations against interference.

### **3.2.6. AIFC International Arbitration Centre**



Though established within the institutional framework of the AIFC, and presumably marketed to its bodies, participants, and employees, the International Arbitration Centre aims to serve anyone who appears before it “on the basis of an arbitration agreement between the parties.” (*Id.*, Art. 14.1). Like the AIFC Court, the International Arbitration Centre provides its services electronically, across the globe, via the AIFC “eJustice” system (AIFC, 2019). The relevant law emphasizes that awards of the body merit the same respect as awards issued by other arbitration bodies in Kazakhstan, once they have been translated from the English used in the AIFC into the Kazakh or Russian more common elsewhere in the country (Constitutional Statute of the AIFC, Art. 14.3). It says nothing specific about who manages the AIFC International Arbitration Centre or its internal structure, presumably leaving such matters at the discretion of the Management Council, which establishes the Centre (*id.*, Art. 14.2) and determines its structure (*id.*, Art. 10.3(4)).

### **3.2.7. Summary of AIFC Judicial Independence**

The AIFC’s governing structure gives the President almost unchecked power to appoint or remove judges of the AIFC Court, albeit upon recommendation of the AIFC Governor. That is not likely to serve as much of a check on the President, given that the President has unchecked power to appoint or remove the Governor. The President alone controls who sits on the AIFC Management Council, too, which controls all other aspects of the zone’s Court and International Arbitration Center. Figure 5, below, highlights these governing structures, which have the combined effect of giving the President considerable control over the AIFC legal system.

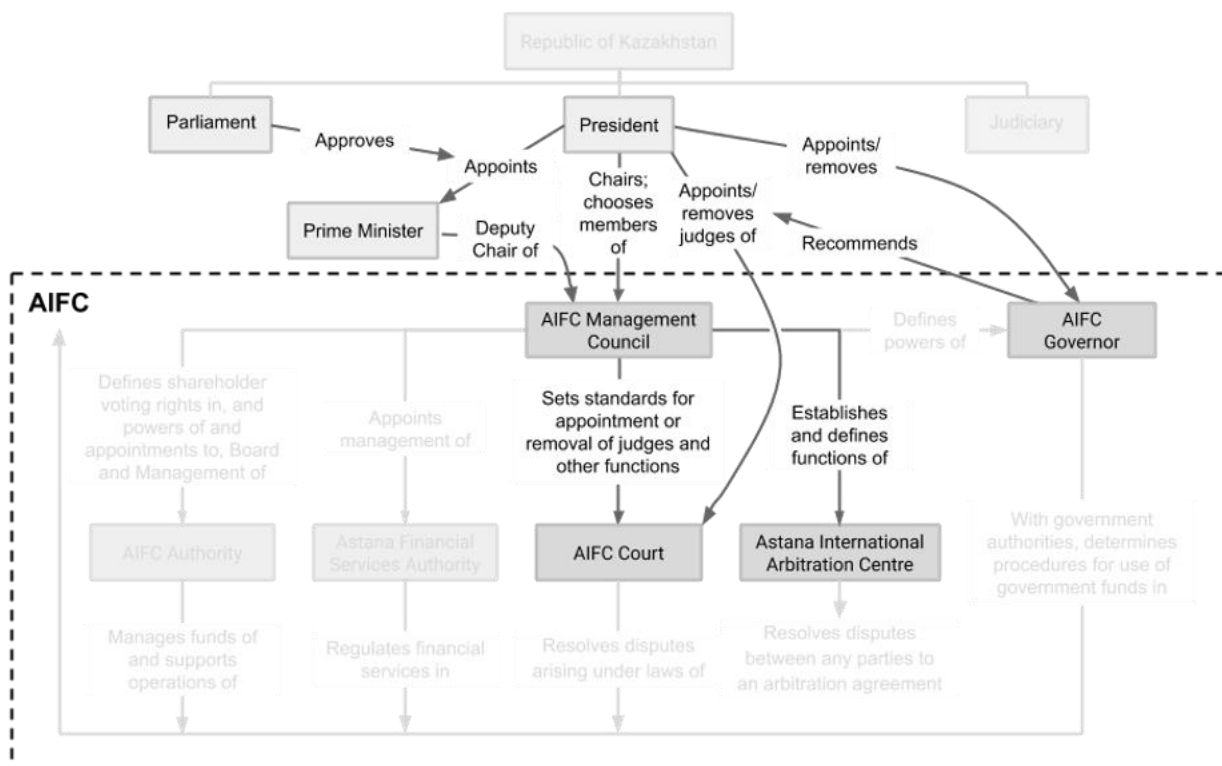


Figure 5: The AIFC Judicial System, Highlighted (author's own elaboration)

Suppose that a party somehow affiliated with the President--a cousin, say--were to come before the AIFC Court with a very high stakes case. Suppose further that the hypothetical President let the judges know they would be fired if they decided against his friend. What result? One might of course cite in opposition to the President's interference many fine words, quoted from policy statements and regulations of the AIFC. But none of those would legally bind the President in this scenario.

This critique has nothing to do with the current President of the Republic of Kazakhstan, who doubtless embodies the virtues typical of a public servant and national leader. A structural analysis of special jurisdiction takes no notice of individual personalities.

Just as bridge engineers plan for worst-case storms, those who design legal systems must plan for worst-case politicians. At present, the AIFC design leaves the judges of its courts as exposed to political influence. On that count, it does about as well as the DIFC, a bit worse than the ADGM, and much worse than the ZEDE system. Further comparative analysis follows below, in the concluding section.

#### 4. HONDURAN ZEDES

In September 2013, the Republic of Honduras passed legislation authorizing a new kind of special jurisdiction in that country: Zones of Economic Development and Employment, called *ZEDEs* (ZEDE Organic Law). The enabling legislation gives each ZEDE wide ranging autonomy to pass its own laws and resolve disputes via private dispute resolution. Indeed, the ZEDE system puts the onus on each ZEDE's developer to enact local legislation, subject to CAMP veto and adjudication by ZEDE Courts. The ZEDE Organic Law thus leaves many details of zone governance unspecified, subject to later determination. The first subsection reviews how the ZEDE system encourages rather than mandates importation of the common law, and how the only ZEDE to date, Próspera, has responded to that invitation. The second subsection describes the particular features of the ZEDE system, illustrated below in Figure 6.

##### 4.1. How the ZEDEs Import the Common Law

The enabling legislation calls on the Honduran Judicial Council and the ZEDE Committee for the Adoption of Best Practices (called *CAMP* from its Spanish name, *Comité para la Adopción de Mejores Prácticas*) to cooperate in building the common law (among other options) into a system of ZEDE Courts. These “autonomous and independent courts with exclusive competence in all instances on matters that are not subject to binding arbitration”

have exclusive jurisdiction over a select few classes of disputes (ZEDE Organic Law, Art. 14). The legislation directs ZEDEs to generally rely on binding arbitration except for “penal matters, those concerning children, and those concerning adolescents” (*id.*, Art. 20)—cases that *must* go to ZEDE Courts. And through them comes the only mandate, such as it mostly is *not*, that Honduran lawmakers issued on behalf of importing the common law.

Article 14 of the enabling legislation says ZEDE Courts “shall be created by the Judiciary through the Judicial Council at the proposal of the Committee for the Adoption of Best Practices and shall operate under the common law or Anglo-Saxon tradition, or any other in accordance with Article 329 of the Constitution of the Republic.” (*Id.* Art. 14). Strictly speaking, that “or any other” clause leaves ZEDEs open to legal traditions other than those that originated with the Anglo Saxons and that have come to us today under the banner of the common law. This shows a spirit quite different from that evinced in the DIFC and ADGM, both of which tied themselves more directly to the laws of England. It more resembles the AIFC’s ambivalent approach to the common law. Honduran lawmakers evidently wanted to leave those creating ZEDEs with as much freedom to choose their own laws as permissible under its constitution and international law. Perhaps, too, lawmakers wanted to avoid the unseemly appearance of putting their territory under the laws of a specific foreign sovereign. On that count, the Hondurans can boast of preserving its national dignity better than did the UAE or Kazakhstan.

The “or any other” clause in the ZEDE Organic Law does not, however, mean anything goes; ZEDE courts must operate “in accordance with Article 329 of the Constitution of the Republic.” (*Ibid.*). And what does that mean? Judging from the constitutional text, it means that legal traditions or systems from elsewhere must do at least as well protecting human rights as Honduran law and win prior approval of the National Congress (Constitution of the Republic of Honduras, 2013, Art. 329). In other words, ZEDE Courts operate under general common law principles by default, but may apply to operate under another system.

The only other reference in the ZEDE Organic Law to the common law appears in Article 17, which provides that ZEDE Courts “must be composed of legal professionals of high standing and proven track record of domestic or foreign jurisdictions, always having to prove extensive knowledge and experience in the application of Common Law or Anglo-Saxon or other legal traditions in accordance with Article 14 of this Law.” In sum, therefore, the ZEDE Organic Law does nothing more to mandate the common law than to make its general principles the default for ZEDE Courts. Given that those courts have exclusive jurisdiction only over a select few kinds of cases, moreover, a ZEDE might in theory govern itself with very little reference to the common law. The common law will likely prevail in practice, though, as evidenced by the governance system approved for the first ZEDE, Próspera.

Próspera ZEDE launched in spring 2020 on the Caribbean island of Roatán (Gómez, 2020). To date, it remains the only ZEDE with a governance system approved by CAMP and in operation (Próspera ZEDE, n.d.; Próspera Arbitration Center, 2020). Though Ciudad Morazán ZEDE won CAMP approval of its Charter and Bylaws, it does not appear to have submitted internal legislation or dispute resolution mechanisms for review (Ciudad Morazán, 2020). The proposed Mariposa ZEDE remains for now even less developed (Mariposa, 2020). Próspera has had a strong start. Its President, Erik Brimen, reports that it closed its series A round of funding “oversubscribed by a wide margin” and has begun developing land on Roatán acquired for the project (Charter Cities Institute, 2020). From that base, if events do not veer too far from plans, the ZEDE’s jurisdiction will expand to other areas of Honduras (Próspera ZEDE).

What does Próspera demonstrate about internal governance in the ZEDE system? The popularity of the common law. Though Próspera’s legal system borrows from many sources, at its core runs the *Roatán Common Law Code*, a name it earned thanks to the many *Restatements of the Common Law* incorporated into it by reference (Próspera ZEDE, 2018). In notable contrast to the court opinions and statutes borrowed from foreign sovereigns by

the DIFC, ADGM, and AIFC, Próspera's *Roatán Common Law Code* thus borrows only from private, non-governmental sources for its laws of contracts, property, and other matters.

## 4.2. Structural Analysis of the ZEDE System

Figure 6, below, offers an overview illustration of the governing structure of the Honduran ZEDEs worth several thousand words. The accompanying text will thus forego lengthy descriptions in favor of establishing exactly whence comes the legal authority for each particular feature under consideration. Consistent with the prevailing theme, this survey will focus on the legal system--*systems*, actually--of the ZEDEs.

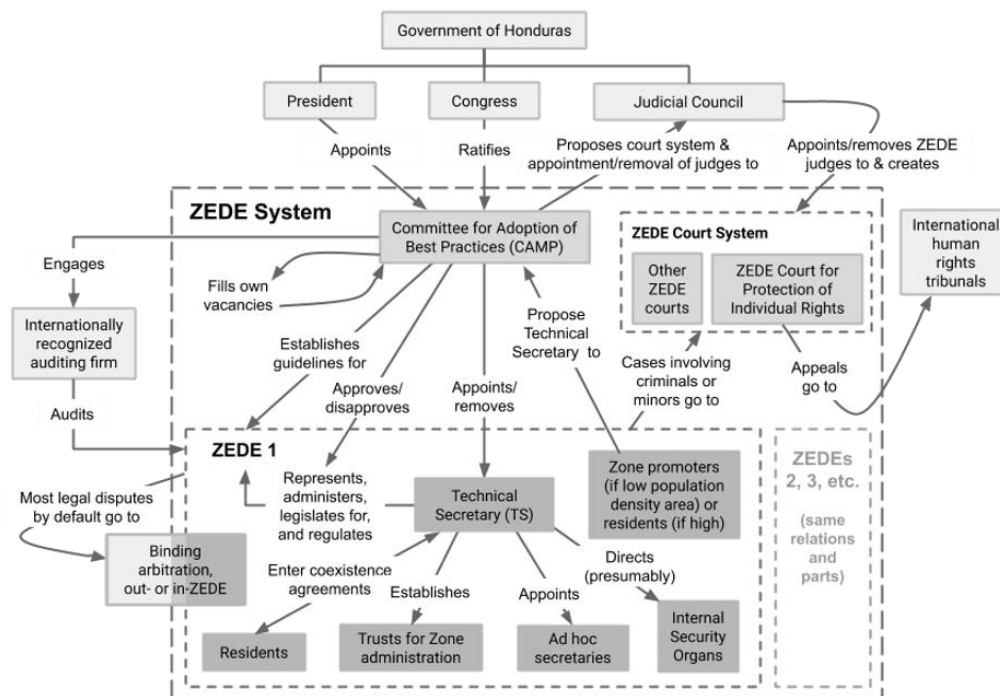


Figure 6: Honduran ZEDEs' Governing Structure (author's own elaboration)

#### 4.2.1. ZEDE Courts



The ZEDE Organic Law calls for “autonomous and independent courts” to decide questions arising under the zones’ legal systems (ZEDE Organic Law, Art. 3). As noted above, it calls for the Judicial Council to create a ZEDE Court following a proposal by CAMP, which is to ensure that the Court will “operate under the common law or Anglo-Saxon tradition” by default (*id.* Art. 14). Its judges must “prove extensive knowledge and experience in the application of common law,” per Art. 17. CAMP determines the “structure, powers and jurisdiction of the courts ... and the duration in office and the requirements for the appointment of judges” (*ibid*). Article 11(6) directs CAMP to propose ZEDE judges to the Judicial Council. Article 15 gives the Council the power to appoint judges from the CAMP’s list of candidates.

Those provisions give CAMP and the Judicial Council shared authority to appoint and regulate judges of the ZEDE Court. What about their removal? The ZEDE Organic Law strongly suggests that the Judicial Council has the sole authority to exercise that power upon a recommendation of removal from CAMP, too. Article 11(6) calls on CAMP “to recommend removal when appropriate” and the Judicial Council’s power to appoint arguably includes the power to revoke an appointment.

Query whether the Judicial Council could legally remove a ZEDE judge without the CAMP’s recommendation or whether the President or another Honduran government body shares the Council’s removal power. With regard to both questions: likely not. Opening ZEDE judges to removal by unilateral act of the Judicial Council, without CAMP recommendation, or by anybody other than the Judicial Council, would gut the autonomy and independence of ZEDE Courts and violate one of the common law’s most characteristic and deep-seated traditions. Article 19 reinforces that reading, saying the ZEDE courts, “must exercise their functions independently, free from any interference” and calling for “penalties for those who interfere or seek to interfere with the exercise of the judicial function.” It thus seems most likely that ZEDE judges can be appointed or removed only by the Judicial Council upon CAMP’s request.

Despite their all-encompassing name, the ZEDE Courts in fact have original and exclusive jurisdiction under only a portion of cases arising under the ZEDE Organic Law. Parties within a zone's jurisdiction "may contractually agree to the submission to arbitral or judicial jurisdiction different from" the ZEDE Courts (*id.*, Art 14). The ZEDE Organic Law furthermore directs that zones "should make use of binding arbitration for all matters involving contracts or property." (*Id.* Art 20). Clauses calling for such arbitration will presumably appear in the "agreements of coexistence ... consistent with universal moral principles" that zones must enter into with "people who wish to live or reside freely within" them (*id.*, Art 10(1)).

Cases subject to mandatory arbitration may be heard by ZEDE Courts only if the parties "previously signed an agreement in which they waived arbitration and established their decision to present their case to" those courts (*ibid.*). The ZEDE Organic Law expressly exempts from mandatory arbitration only cases involving penal matters or minors (*ibid.*). Those cases evidently represent the only ones over which the ZEDE Courts exercise original and exclusive jurisdiction.

The ZEDE Organic Law requires the zones' judicial system to include a Court for Protection of Individual Rights (*id.*, Art. 16). Appeals from that body do not go to a higher ZEDE or Honduran court, but to unspecified international tribunals. Lawmakers perhaps had in mind the Inter-American Court of Human Rights, to which Honduras and other members of the Organization of American States have agreed to submit human rights claims (though it is not clear how an individual litigant could win standing in the IACHR, given limits on that body's jurisdiction) (Inter-American Court of Human Rights (2020). Regardless of the proper administration of such appeals, it bears noting that neither ZEDE courts nor Honduran ones have the final say about alleged violations of individual rights in the zones. That represents a singularly powerful safeguard of the rule of law, unique not only among common law zones but among common law jurisdictions, generally.

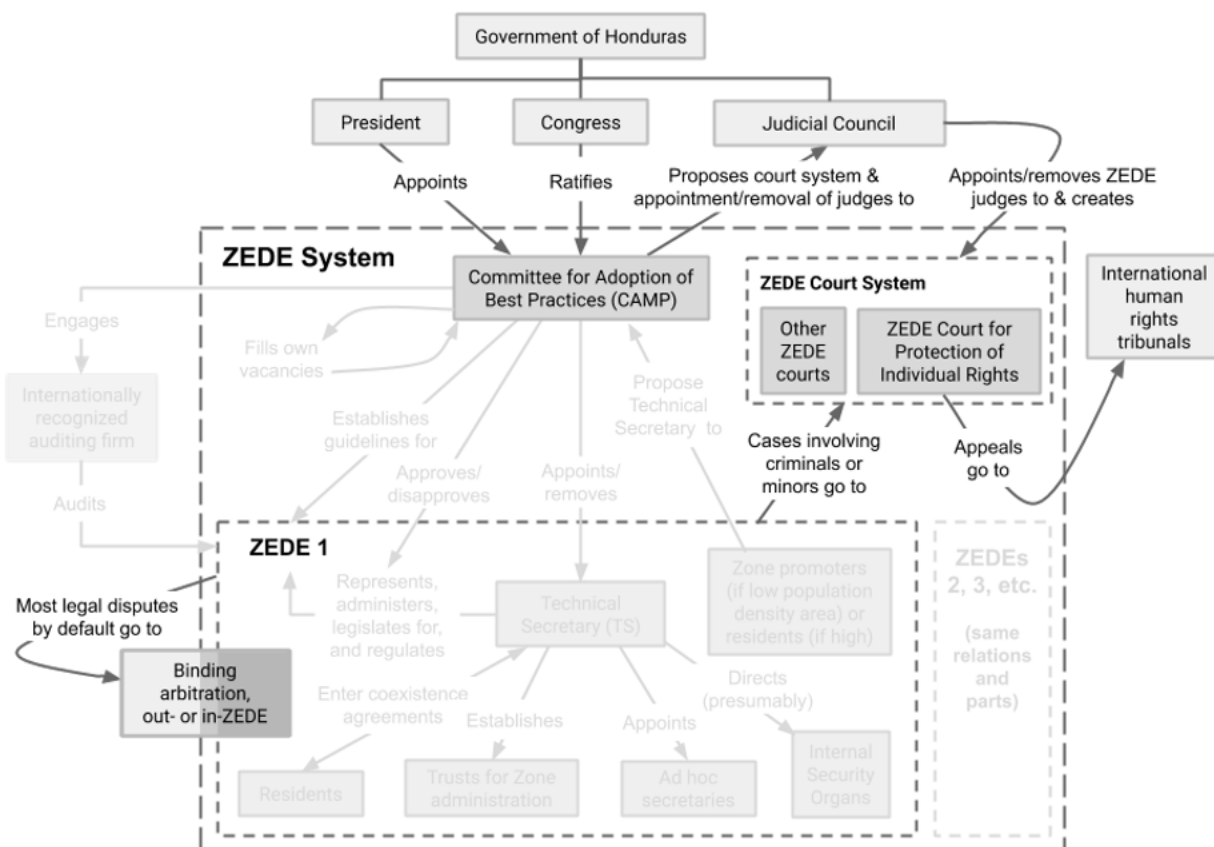


Figure 7: ZEDE System Judicial Features, Highlighted (author's own elaboration)

Figure 7, above, highlights the features of the ZEDE judicial system. The number of independent parties given a say in the appointment and removal of judges to the ZEDE system proves especially notable when contrasted to the judicial systems of the DIFC, ADGM, and AIFC. So does the distribution of judicial powers across the ZEDE Courts created by CAMP and the Judicial Council, the private arbitration services of the various ZEDEs, and entirely independent international human rights tribunals.

Suppose for instance that a child of the President were embroiled in a legal dispute subject to the jurisdiction of ZEDE law. If the case involved anything but suspected criminals or minors, it would go before the private dispute resolution service set up by the ZEDE in question. The President would of course have no power to terminate those arbitrators or otherwise legally interfere with how they resolve the dispute. If the case involved crimes or children, it would go to the ZEDE Court, the judges of which the President again would have no power to terminate or otherwise legally threaten.

#### **4.2.2. The CAMP**

The well-connected position it occupies at the center of Figure 6 demonstrates that the CAMP plays an important role in ZEDE governance. The ZEDE legislation gives the President the power to appoint the first twelve CAMP members, subject to ratification by the Congress, thereafter leaving the Committee to control its own membership and operations (ZEDE Organic Law, Art. 11(10)). Relevant to the CAMP's power to implement the common law, it provides candidates to the Judicial Counsel to serve as judges or magistrates in ZEDE Courts (*id.*, Art 11(6)). As noted above in § 4.2, the enabling statute gives ZEDE Courts exclusive jurisdiction over select cases and encourages them to operate under common law principles.

The CAMP has a much more direct yet complicated relationship with the other major player in the ZEDE system, the Technical Secretary. Article 11(2)-(3) of the ZEDE Organic Law gives the CAMP power to approve or disapprove the conduct, appointment, or regulations of a Technical secretary. Beyond that, the CAMP can only "establish general guidelines for domestic policy and transparency of" the zones. It thus has no power to direct the specific operations of a particular ZEDE or its Technical Secretary. Note in particular that the CAMP has no power to choose a Technical Secretary. Article 11(3) gives a zone's residents (if it is in a high population area) or developers (if in a low population area) the

exclusive right to propose their own Technical Secretary. The CAMP can only approve or disapprove their nomination to the post.

These provisions make the relationship between the CAMP and the Technical Secretary nothing like those of a principal to an agent or an employer to an employee. The law instead puts CAMP in the place of a government oversight board, and the Technical Secretary as the head of one of the private entities it oversees. In that model, the Technical Secretary may well aim to keep the CAMP happy, but ultimately works for a ZEDE. True, Article 12 makes a Technical Secretary "responsible for his actions before" the CAMP. But that means only that the Technical Secretary must answer to the CAMP—not that it employs him. And that same Article also calls the Technical Secretary the zone's "highest level executive officer and its legal representative," again making clear that he works for his (or as it may turn out in the actual event, *her*) ZEDE rather than for the CAMP.

#### **4.2.3. The Technical Secretary as Alcalde**

Article 3 specifies that a ZEDE has "the functions, powers and duties that the Constitution and laws confer upon municipalities." Because a ZEDE is modeled on a municipality in Honduran law, it makes sense to analogize the Technical Secretary to an *alcalde* (Spanish for "mayor") who serves the ZEDE, rather than as an agent of the CAMP or, through it, an agent of the national government. If a ZEDE resembles a municipality, in other words, the Technical Secretary resembles an *alcalde*.

CAMP represents the interests of the national government. According to Art. 11(10), its members are "appointed by the President of the Republic . . . [and] ratified by Congress." In that, the CAMP resembles one of the 18 departmental governors that, in the Honduran system of government, represent the executive branch in specified regions of the country. (U.S. Federal Research Division, 1995, pp. 168-69). A department governor has comparatively little authority over *alcaldes* in the Honduran system, who thanks to the 1990

Law of Municipalities instead enjoy considerable autonomy from the national government (*ibid*). The same hands-off relationship should thus prevail between the CAMP and any Technical Secretary that it oversees.

That model reveals the deep structure of the ZEDE Organic Law: It aims to create something like a new kind of municipality in the governing system of Honduras. In both variations on the theme, the national government appoints a regional representative—governors for departments and the CAMP for ZEDEs. Operating largely free of national control of matters within their purview, alcaldes run their municipalities in much the same way that Technical Secretaries run their zones.

The parallel between a municipality and a ZEDE recurs in how locals—residents in the case of a densely populated zone and developers in the case of sparsely populated one—get to choose their own leaders (ZEDE Organic Law, Arts. 11(3)(a), (b)). This suggests that Technical Secretaries will exercise at least as much autonomy from the national government's direction, whether exercised directly or via the CAMP, as the autonomy enjoyed by the alcaldes chosen by municipalities to manage local affairs. Given the vastly greater range of powers that TSs enjoy, they might justly lay claim to even more autonomy than alcaldes.

The ZEDE system thus somewhat replicates the structure of its parent government, that of the Republic of Honduras. Consider the parallels between the relationship of the national government, departmental governors, alcaldes, and municipalities on the one hand, and the national government, CAMP, Technical Secretaries, and ZEDEs on the other. The most notable difference between the two systems reflects their deeper unity: Whereas voters in a conventional municipality elect a new alcalde every four years, a Technical Secretary serves for a seven-year term (*id.*, Art. 12). By way of counterbalance, however, the CAMP acts as an independent check on a Technical Secretary's exercise of authority, standing ready to protect locals by disapproving the conduct, regulations, or appointment of a wayward Technical Secretary. Taken together, these measures show that Honduras carefully crafted



ZEDEs to function analogously to municipalities making allowance for the CAMP's supervisory powers over Technical Secretaries.

## 5. SUMMARY AND CONCLUSION

This illustrated review of common law zones concludes with a summary of the findings. Two species of the genus have emerged: 1) government-run zones of limited scope that import the common law of a foreign sovereign to courts exposed to political interference; and 2) zones run as public-private projects with broad responsibilities and that rely on non-governmental sources for their laws and that shelter judges from political interference. The first three common law zones to arise, the DIFC, ADGM, and AIFC, represent the first species. The ZEDE system, at least as exemplified in Próspera, represents the second.

Table 1, below, summarizes across the separate sections to show the source that each zone draws on for its common law and how it uses the referenced authority:

<b>Zone</b>	<b>Source</b>	<b>Use</b>
DIFC	Common Law of England and Wales	Given local effect; fixed?
ADGM	Common Law of England	Given local effect; evergreen
AIFC	Common Law of England and Wales	Invoked as model; evergreen?
ZEDE	Restatements of the Common Law	Given local effect; fixed

Table 1: Sources Used by Common Law Zones (author's own elaboration)

The distinction between the two species stands out clearly in Table 1, as does the overwhelming popularity of England and Wales among those zones willing to tie their fates to foreign sovereigns. That dependence on England and Wales doubtless reflects the dominance of London bankers and lawyers among those who helped Dubai, Abu Dhabi, and Kazakhstan set up their common law zones. In some cases, a zone's enthusiasm for foreign

law reaches beyond court decisions to embrace great tranches of statutory law, as in the ADGM's embrace of several English statutes. (ADGM Application of English Law Regulations of 2015, § 2(1)). Próspera ZEDE's use of the Restatements gives its common law a distinctly American flavor.

Table 1 also tracks how each zone uses the kind of common law that it references. In most cases, foreign law has a direct effect. Uniquely, the AIFC limits itself to invoking merely the principles of the common law, a vague and thus non binding commitment. Table 1 also shows that the ADGM alone ties its laws to those of a foreign state on a so-called evergreen basis, a somewhat original arrangement in international law. Because it cites only published Restatements for its common law, Próspera ZEDE definitely does not walk in lockstep with foreign authorities. The DIFC does not expressly state its position, weakly suggesting that the DIFC Law embraces only the common law as it stood upon the law's enactment. The AIFC likewise does not speak to the matter, but its loose invocation of principles rather than precedents suggests it would smile on authorities keeping up-to-date with foreign developments.

Table 2, below, addresses another issue of autonomy: whether courts in a common law zone can, like courts in common law jurisdictions proper, perform their duties without suffering interference by political authorities. There being no way to measure such things directly, the analysis instead relies on hypotheticals designed to test each zone's institutional protections of judicial independence. The first species of common law zone does not fare well on that measure. In the DIFC and AIFC, the local sovereign has executive authority to summarily terminate judges; in the ADGM, that power is tempered only by delegation to a Council staffed at the Emirates discretion. In no such zone can judges count on institutionalized checks and balances to protect them against the consequences of issuing politically unpopular decisions.

<b>Zone</b>	<b>Most Direct Route for Political Influence</b>
DIFC	Executive power to terminate judges
ADGM	Executive power to terminate Council members, who may terminate judges
AIFC	Executive power to terminate judges
ZEDE	Legislative amendment via supermajority?

Table 2: Most Direct Means for Politicians to Influence Zone Judges

With regard to the second species of common law zone, the Honduran ZEDE, Table 2 wavers. It is not as easy to trace the most direct route for Honduran politicians to influence ZEDE because no route can get them there easily. The CAMP, an unelected and self-sustaining body, stands between the rest of the Honduran government and ZEDE Court. Although the Judicial Council must also agree, no judicial appointment to or removal from the ZEDE Court can happen without the CAMP's approval. A politician intent on interfering with a ZEDE Court could hope for little more than influencing the Judicial Council to disapprove of a judge. Alas for Honduras, it is not difficult to imagine a politician successfully swaying the deliberations of the Judicial Council. (Bowen 839-40). But that would have little effect if CAMP, sequestered beyond political influence, disagreed with the Judicial Council about the merits of a ZEDE judge. As for the deliberations of the private adjudication services that will in practice handle the bulk of legal disputes in the ZEDE system, those operate entirely free of political machinations.

The susceptibility of Honduran judges to political pressure suggests that litigation targeting the foundations of the ZEDE system or the scope of the ZEDE Organic Law might provide the most direct route to undermining the autonomy of the zone's courts. Not even the plainest language can resist a judge determined to destroy a constitutional or statutory limitation on government power. At the same time, though, Honduran politicians can only go so far toward subverting the rule of law before they risk frightening away foreign investment, a prospect that must give even the most corrupt of them pause.

Perhaps the least indirect route to interference with the ZEDE judicial system would have politicians amend the responsible statute. Because the Honduran Constitution makes express provision for ZEDEs, however, the ZEDE Organic Law has more than the usual legislative stability. As it notes, “In accordance with the provisions of Article 329 of the Constitution, this Act may only be modified, amended, interpreted or repealed by two-thirds (2/3) in favor of the members of Congress.” (ZEDE Organic Law, Art. 45). At that price, it is hard to see how corruption could pay.

As a theoretical ideal, a common law court functions independent of any political influence, deciding each case based solely on its facts and the applicable law. To the extent that a given court in practice fails to meet that standard, it cannot claim to render justice impartially, which amounts to saying that it cannot render justice at all. A court subject to outside interference, such as political pressure to decide an important case in a convenient way, does not bring peace to the contesting parties but rather submits both to the force of another’s will. That might sadly describe how actual governments function, but it cannot describe the rule of law. A court that presumes to administer the common law requires the backing of institutions capable of guaranteeing judicial independence from political influences. Of the four judicial systems under consideration here, all but the ZEDEs show structural weaknesses on that count.

Even the most calculating politicians might respect the independence of a special jurisdiction’s courts, reasoning that they gain more by maintaining the good standing of the courts than by meddling with its decisions. And, of course, many politicians will honor courts’ independence, regardless of what Machiavelli might counsel, because they also honor justice. But good legal system design calls for anticipating worst-case politicians for the same reason that good bridge design anticipates 100 year storms. On the basis of theory alone, the legal system of the ZEDEs looks most likely to shelter judges from political forces, allowing them to bring peace to contesting parties. Whether the same will hold true in practice remains for now an open question, and one that only further research of common law zones can answer.

### **Disclosure**

As discussed in *Your Next Government? From the Nation State to Stateless Nations* (Cambridge University Press 2018), the author advised special jurisdiction projects in Honduras and created Ulex, the open source common law-based legal system. The audiobook version of *Your Next Government?* (2020) notes that the Próspera ZEDE's Roatán Common Law Code implements Ulex. The author helped design and install the Roatán Common Law Code and other aspects of the Próspera governance system as part of a team of coders, enjoys friendly relations with parties responsible for the ZEDE program's success, and holds a small equity interest in Próspera by way of gift and investment.

### **Disclaimer**

Opinions expressed herein represent those of the author only, who bears sole responsibility for their publication, and do not represent the opinions of any employer, client, or associate.

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## The Honduran ZEDE Law, from Ideation to Action

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### Abstract

Honduras has struggled to attract the investment needed to spur sustained economic growth in recent decades, and as a result remains one of the poorest countries in Latin America and the Caribbean. To attract greater foreign investment, the Honduran government passed a groundbreaking special economic zone (SEZ) law in 2012 creating Zonas de Empleo y Desarrollo Económico (Zones for Employment and Economic Development) or ZEDEs. Among the most innovative special jurisdictions in the world, ZEDEs grant sweeping legal and regulatory autonomy to allow for improved governance and economic competitiveness, in order to attract greater investment in Honduras. In this paper, we detail the political and legislative history of the ZEDE law, offer a textual analysis of the ZEDE statute, discuss the principal objections to the ZEDE law and responses to those objections, and provide case studies of the first two ZEDEs.

**Keywords:** ZEDE; Honduras; special economic zones; ciudades modelo; decentralized governance; economic development; Próspera; Ciudad Morazán

### Resumen

Honduras ha luchado por atraer la inversión necesaria para impulsar un crecimiento económico sostenido en las últimas décadas y, como resultado, sigue siendo uno de los países más pobres de América Latina y el Caribe. Para atraer una mayor inversión extranjera, el gobierno hondureño aprobó una innovadora ley de zonas económicas especiales (ZEE) en 2012, creando Zonas de Empleo y Desarrollo Económico (Zonas de Empleo y Desarrollo Económico) o ZEDEs. Entre las jurisdicciones especiales más innovadoras del mundo, las ZEDE otorgan una amplia autonomía legal y regulatoria para permitir una mejor gobernanza y competitividad económica, con el fin de atraer una mayor inversión en Honduras. En este documento, detallamos la historia política y legislativa de la ley ZEDE,



ofrecemos un análisis textual del estatuto de la ZEDE, discutimos las principales objeciones a la ley ZEDE y las respuestas a esas objeciones, y proporcionamos estudios de caso de las dos primeras ZEDE.

**Palabras clave:** ZEDE; Honduras; zonas económicas especiales; ciudades modelo; gobernanza descentralizada; desarrollo económico; Próspera; Ciudad Morazán

## 1. INTRODUCTION

Honduras is among the least developed countries in Latin America and the Caribbean. The average Honduran's income is only two-thirds that of their neighbors in El Salvador and Guatemala (World Bank, 2019). Honduras requires better governance and sustained investment to have even the slightest opportunity to reach economic parity with its neighbors, let alone become a fully developed, high-income country.

In 2009, economist and future Nobel Laureate Paul Romer developed the idea of charter cities—new cities with special jurisdictions to allow for significant improvements in governance to help alleviate poverty. In 2010, Romer found willing partners in the Honduran government to implement this vision. And in 2013, Zonas de Empleo y Desarrollo Económico (Employment and Economic Development Zones) or ZEDEs, were signed into law. Among the most innovative special jurisdictions in the world, ZEDEs devolve nearly all administrative, fiscal, regulatory, and judicial authority to the city level.

ZEDE advocates contends that the zones have the potential to create the same kind of special economic zone-driven growth that pulled hundreds of millions out of poverty in China over the last four decades in Honduras (Fernández and Dirkmaat, 2019). ZEDE detractors contend the zones are a mechanism to usurp land rights and impose foreign corporate governance on indigenous populations and the poor (Geglia, 2016).

This article aims to provide a clear analysis of the ZEDE law and the issues surrounding it. Section 2 details the political and legislative history of the ZEDE law, including precursor legislation, up to the latest developments as of early December 2020. Section 3 provides a rigorous textual analysis of the ZEDE law itself, explaining ZEDE governance and the powers devolved to ZEDE administrators. Section 4 addresses principal objections to the ZEDE law and responses to those objections. Section 5 offers case studies on the two ZEDEs that have been declared—Próspera and Ciudad Morazán. The article concludes by briefly considering the immediate future of the ZEDEs.

## **2. POLITICAL AND LEGISLATIVE HISTORY OF THE ZEDE LAW**

### **2.1. Precursor to the ZEDES—REDs**

In 2009, economist Paul Romer gave a now-famous TED Talk introducing the concept of charter cities—new cities with new special jurisdictions in low-income countries, administered by a well-governed “guarantor” country (Romer, 2009). Romer theorized that effective governing institutions are the principal requirement to raise living standards, rather than from resource rents or new technologies, and that effectively importing good governance through a special zone or charter city could alleviate substantial poverty. Introduced in 1980, China’s special economic zones offered evidence in favor of Romer’s theory, that allowing for city-led innovations in governance could generate tremendous economic growth (Romer, 2010).

Romer first gained traction with this idea in Madagascar, where he won support from then-President Marc Ravalomanana in late 2008. However, an unrelated political crisis emerged at the same time over a deal to lease large tracts of land to South Korean auto manufacturer Daewoo. In January and February 2009, violence broke out and nearly 30 civilians were killed by police outside of the presidential palace, with Ravalomanana subsequently forced to leave office, ending any chance of a Malagasy charter city (Mallaby, 2010).

Romer’s next, and final, attempt at creating a charter city was in Honduras. After hearing the 2009 TED Talk, President of the Honduran National Congress Juan Orlando Hernández began advocating for a Honduran charter city. Romer met with Hernández and President Porfirio Lobo, who was also convinced of the idea. Shortly thereafter, a constitutional amendment was passed in February 2011 to create the precursor to the ZEDES, Regiones Especiales de Desarrollo (REDs), or Special Development Regions, with only one vote in opposition. (Romer, 2011).

In July 2011, the statute detailing the powers and governance structure for REDs was also passed by an overwhelming margin. The statute described REDS as: “entities created with the purpose of accelerating the adoption of technologies that allow producing and providing services with high added value, in a stable environment, with transparent rules capable of attracting national and foreign investment.” (Decreto No. 123-2011, Art. 2). REDs were declared to be an indivisible part of Honduras subject to the authority of the Constitution and the national government, but with substantially devolved administrative, fiscal, judicial, and other authorities (Decreto No. 123-2011).

Because REDs would be granted such a significant degree of autonomy, the RED Statute established that each RED would initially be governed by a nine-member transparency commission (Decreto No. 123-2011, Ch. IV, Sec. 1). These transparency commissions would first be appointed by the President, and then the commissions would appoint a governor for their RED (Decreto No. 123-2011, Art. 80).

In December 2011, the first transparency commission was appointed by President Lobo. The first five pro tempore appointees included Romer, former Singapore Power and Temasek Holdings executive Ong Boon Hwee, Center for Global Development President Nancy Birdsall, former INCAE Business School Rector Harry Stratchan, and Nobel Laureate in economics George Akerlof (Fuller, 2011).

## **2.2. The End of the REDs**

Despite the apparent progress towards a RED being established, within a year the development began to unravel. Romer released a statement on September 22, 2012 stating that he and the other four transparency commission members were no longer involved with the project, as the Honduran government had reportedly signed an agreement with a private firm to develop a RED without the commission’s knowledge. The agreement was kept secret from the commission members, and because the commission appointments had never been

formally published in the Honduran government gazette, Romer and the other commission members possessed no legal right to see the private agreement upon demand (Cowen, 2012).

The Memorandum of Understanding in question had been signed several weeks prior with MGK, a private group led by libertarian theorist and businessman Michael Strong (Fernholz, 2012). MGK planned to invest \$15 million in infrastructure for a project near the town of Puerto Castilla, which would create an estimated 5,000 jobs within six months. Upwards of 200,000 jobs were expected to be created in the years following. The project was opposed by various groups, including the indigenous Garifuna community, whose land was included in the planned development (Doherty, 2012). However, the project would never move forward and within a month of the announcement of the agreement and the collapse of the transparency commission, Honduras' experiment with REDs would be over.

On October 17, 2012, the full Honduran Supreme Court declared the RED law unconstitutional by a vote of 13 to one, after the Constitutional Chamber of the Supreme Court previously voted four to one against the RED amendment (Miller, 2015). The court declared that the amendment establishing the REDs was unconstitutional on the grounds that the changes made to Articles 304 and 329 of the Constitution violated Honduran territorial integrity, sovereignty, and independence (El Herald, 2014).

Later in the year, the same four justices of the Constitutional Chamber voted against a police reform bill supported by the ruling National Party. President Lobo publicly denounced the members of the Supreme Court that had voted against the police reform bill in response to the ruling. On December 12 in a 4:00am session with the military stationed outside the congressional building, the Congress voted to remove the same four justices from the Supreme Court. New justices were quickly appointed by President of the Congress Hernández (Williams, 2012). The dismissal of the Supreme Court justices was described by commentators as an illegal violation of Congressional authority, as justices can only be removed for administrative reasons, not on the basis of their rulings (Acre, 2012).

### **2.3. Enter the ZEDEs**

In January 2013, a new constitutional amendment was approved that replaced the REDs with Zonas de Empleo y Desarrollo Económico (Employment and Economic Development Zones) or ZEDEs, followed by an enabling statute in September (Decreto No. 236-2012; Decreto No. 120-2013). The new ZEDE amendment and statute remedied the unconstitutional elements that led to the RED legislation being struck down, discussed below in the textual analysis.

In addition to creating the legal framework for ZEDEs, the ZEDE Statute also created the Comité para la Adopción de Mejores Prácticas (CAMP), or the Committee for the Adoption of Best Practices, to oversee the ZEDEs. The 21 members of CAMP are responsible for approving the internal regulations of ZEDES in line with global best practices, overseeing the Technical Secretary in charge of each ZEDE, and other related advisory and administrative functions (Decreto No. 120-2013, Ch. III, Sec. 1).

The first 21 CAMP appointees were a global collection of conservative and libertarian free market advocates with experience in government, business, academia, and the nonprofit sector (Lutter, 2014). While the ZEDEs represent a reduction in the autonomy that had been granted to REDs, the initial CAMP appointees versus that of the RED transparency commission suggests a shift in approach to ZEDE governance by the ruling National Party. While the RED transparency commission was comprised of largely non-ideological academics with interests in international development, CAMP was dominated by more openly ideological appointees with a clear inclination for market-oriented policymaking.

In February 2014, the 21 CAMP appointees were announced in the government gazette: Georgian politician and businessman Kakha Bendukidze; conservative activist and Leadership Institute President Morton Blackwell; Atlas Network CEO and President Alejandro Chafuen; Danish banker Lars Seier Christensen; American oil and gas executive Alex Cranberg; Honduran Congressional advisor Ebal Díaz, Peruvian intellectual Enrique Gherzi; Austrian economist and free market advocate Barbara Kolm; Ronald Reagan and



George H.W. Bush administration official Mark Klugmann; former Honduran President Ricardo Maduro; American anti-tax activist Grover Norquist; advisor to President Lobo Octavio Rubén Sánchez Barrientos; Panamanian businessman and free zone administrator Surse Pierpoint; American economist and Cato Institute scholar Richard Rahn; American conservative media personality Michael Reagan; American economist Mark Skousen; American federal court judge Loren Smith; Honduran Presidential Secretary Ricardo Leonel Cardona López; European architect Gabriela von Habsburg; Omani government official Salem Ben Nasser Al-Ismaily; and Reagan administration official Faith Whittlesey (Decreto No. 368-2013).

With CAMP established and a Supreme Court ruling in favor of the ZEDE law's constitutionality in May 2014, the government appeared well-positioned to begin pushing for ZEDE projects to commence (Kroth, 2014). And since becoming President in 2014, Juan Orlando Hernández campaigned extensively on the potential benefits of ZEDEs. A McKinsey study commissioned by the Honduran government estimated that 600,000 jobs in auto manufacturing, call centers, and other such industries could be created with several ZEDEs, a strong campaign pledge. However, action towards creating an actual ZEDE was limited until 2017. The original CAMP group only met once, in March 2015 (The Economist, 2017).

The delay between the formation of CAMP and the approval of the first ZEDE has been attributed to a combination of infighting and fiscal mismanagement within CAMP, a lack of actual interest in developing ZEDEs from President Hernández, electoral distractions, and potential investors shying away amid political uncertainty, according to an individual familiar with the details that spoke to the authors of this paper on condition of anonymity.

However, CAMP's performance appears to have improved since Honduran attorney and consultant Carlos Pineda Pinel became CAMP Secretary in 2016. On December 29, 2017, the first ZEDE was authorized when CAMP issued a certificate declaring what would later become the Próspera ZEDE (Próspera 2020a). The second ZEDE, Ciudad Morazán, was declared by CAMP on December 6, 2019 (ZEDE Morazán, 2020). Both ZEDEs are discussed

in detail in detail later in this article. To date, these are the only two declared ZEDEs and both have begun actual on-site operations. In response to the new ZEDEs, popular opposition from Honduran municipal governments, indigenous groups, legal associations, and other organizations has been on the rise (Criterio, 2020). However, there is no indication that the ruling National Party intends to roll back the ZEDE law and so it appears likely that ZEDE development will continue, absent an opposition coalition victory in the 2021 general election.

### **3. TEXTUAL ANALYSIS OF THE ZEDE LAW**

The ZEDE Statute itself presents three types of legal issues that need analysis: (1) constitutional issues within the Honduran Constitution; (2) the powers of the ZEDE itself as laid out in the ZEDE Statute; and (3) the influence and power of treaties and international law

#### **3.1. The Honduran Constitution**

As discussed above the Honduran Constitution was amended in 2013 after the failure of the RED Amendment and Statute, so that any future statute that sought to allow special jurisdictions would be upheld as constitutional. To that end, this amendment, known as the ZEDE Amendment, altered three articles in the Honduran Constitution: (1) Article 294; (2) Article 303; and (3) Article 329 (Decreto No. 120-2013). Each alteration to an article addressed an issue of sovereignty or alienation of territory, which had been the prime concerns of the Honduran Supreme Court when it struck down the RED Amendment and Statute (Bell, 2013).

These concerns were centered around Article 374, which prohibits the amendment of any Article of the Honduran Constitution dealing with “...the form of government [or] national territory...,” among other items (Honduran Const. Art. 374). Furthermore, Article

374 allows for the Honduran Supreme Court to declare an amendment as unconstitutional if that amendment alters the national territory (Miller, 2015). When the Honduran Congress passed the ZEDE Amendment it took care to word the language of the Amendment in such a manner as to avoid being struck down again on the same grounds that the RED Amendment and Statute had been.

First, Article 294 is the article in the Honduran Constitution which creates political sub-divisions within the country. The Article reads: “The national territory shall be divided into departments. Their establishment and boundaries shall be determined by the National Congress. The departments shall be divided into autonomous municipalities administered by corporations elected by the people, according to law. Without prejudice to that established in the previous paragraphs, the National Congress may create zones subject to special regimes in accordance with Article 329 of this Constitution” (Honduran Const. Art. 294).

The amendment consisted of the addition of the final sentence of the Article, which addressed the Honduran Supreme Court’s objection that the creation of a zone alienated Honduran territory in violation of the unamended Article 294, which specified the manner in which the country could be subdivided (Bell, 2012). Amending this article clarified that the zones were in fact a part of Honduran national territory and could not be alienated.

Second, Article 303 creates independent courts and lays out the basic structure of the Honduran Courts. The relevant part of the Article as amended in 2013 reads: “The judicial branch consists of a Supreme Court of Justice, the Courts of Appeals, the courts, by tribunals with exclusive competence in zones of the country subject to special regimes created by the Constitution of the Republic and additional offices specified by law” (Honduran Const. Art. 303). This was amended from the previous language which read “The Judicial Power is composed of a Supreme Court of Justice, by the Courts of Appeals, the Courts and other dependencies that the Law specifies” (Honduran Const. Art. 303). The addition of the language about tribunals with “exclusive competence” and “additional offices specified by law” gave the Honduran Congress the constitutional authority to write a law allowing for the

creation of a special court system within the zones. Creating an independent court structure and legal system provides zones with greater autonomy, because they must no longer be tethered to the existing Honduran legal system (Miller, 2015). Amending this article clarifies that the creation of a legal system with greater autonomy is not a violation of Honduran sovereignty, because the autonomous court system is subject to Honduran constitutional and legal restraints.

Third, Article 329 addresses economic and social development, and the language in this article was altered extensively with the ZEDE Amendment. In the 2012 form, the Article used sweeping language which allowed for the zones to sign treaties and international agreements (Honduran Const. Art. 329). Furthermore, while the 2012 form of Article 329 required the zones to be subject to Articles 12, 13, 15, and 19 of the Constitution, this left out Articles 10 and 11, which like the Articles 12, 13, 15, and 19 deal with Honduran territory, and serve to explicitly describe that territory (Miller, 2015). By removing the zones' ability to enter into treaties and international agreements, and adding the incorporation by reference of Articles 10 and 11, the ZEDE Amendment sought to assuage concerns that the zones violated the prohibition against altering the government or territorial integrity of Honduras (Miller, 2015). Amending this article painted the zones in a less radical light than had been done with the Article's previous form, which helped to avoid the appearance of the article being in violation of Article 374 (Miller, 2015).

By addressing the issues in the ZEDE Amendment that caused the RED Amendment and Statute to be struck down, the Honduran Congress sought to ensure that the ZEDE Amendment and subsequent statute would not face the same fate as its predecessor. It appears that the effort was likely successful (National Lawyers Guild, 2014).

### **3.2. The ZEDE Statute**

The ZEDE Statute itself provides the structure for what ZEDEs can and cannot do. A significant amount of this relates back to the Honduran Constitution, but there are powers given to the ZEDEs that derive from the ZEDE Statute without specific relation back to the Honduran Constitution. The analysis of the ZEDE Statute follows the structure of the law, beginning with the Preamble and then going through the six chapters of the law: (I) General Principles; (II) Fundamental Rights and Duties of the Residents; (III) Administrative Structure; (IV) Economics and Finance; (V) Education, Health, Social Security, Science, Religion, Work, and Environment; and (VI) Final and Transitional Provisions. However, this analysis is not exhaustive and does not include an assessment of every article within the ZEDE Statute, only those which strike the authors as the most innovative or relevant to this article, and the authors hope that other scholars examine the law in even greater detail.

The Preamble of the ZEDE Statute introduces the statute, the statute's purpose, and cites where in the Honduran constitution the authority to create the law comes from. This part of the statute begins by acknowledging the ZEDE Amendment that altered Articles 294, 303, and 329 of the Honduran Constitution, which are discussed above (Decreto No. 120-2013). Articles 303 and 329 are cited specifically for the purpose of asserting that the "Constitution authorize[s] the establishment of courts with exclusive competence over the [ZEDEs]" (Decreto No. 120-2013). Finally, the Preamble notes that the Honduran Congress is enacting this law pursuant to its powers under Article 205, Attribution 1 of the Honduran Constitution, which gives the Congress the power "[t]o make, enact, interpret, amend, and repeal laws" (Decreto No. 120-2013). By taking care to cite to Constitutional Articles in three separate paragraphs, the Preamble serves as an appeal to a higher legal authority which makes the associated statute constitutional.

The first chapter of the ZEDE Statute, Chapter I: General Principles, both cites back to the Constitution and provides law that establishes what the Statute is supposed to do generally. The citations to the Constitution that the General Principles chapter makes are to Article 329 and to Articles 10, 11, 12, 13, 15, and 19 (Decreto No. 120-2013, Ch. I, Art. 1).

Article 329 being the Article of the Constitution that specifically gives enabling power to create ZEDEs (Honduran Const. Art. 329), and Articles 10, 11, 12, 13, 15, and 19 that all deal with the territorial definition and integrity of Honduras (Miller, 2015). All of these articles were addressed above in the section addressing constitutional issues surrounding the passage of the ZEDE Amendment, but the inclusion of these articles in the Statute itself must be addressed independently. This inclusion of these articles in the General Principles chapter acts in a similar manner to the inclusion of Articles 294, 303, and 329 in the Preamble of the Statute, which is to create an attachment between the Constitution and the Statute (Decreto No. 120-2013). By creating an explicit attachment between the Statute and the Constitution, the Statute seeks to give itself legitimacy.

As noted above, Article 329 in the 2012 Constitution under the RED Amendment was more expansive in the scope of powers that special jurisdictions were given, whereas the ZEDE Amendment is less radical in the powers that are given to the zones (Miller, 2015). In conjunction with the inclusion of the Articles defining the territory of Honduras and protecting its integrity, the inclusion of Article 329 serves to ground the ZEDE Statute within the Honduran Constitution and to protect the Statute from constitutional attacks using Article 374, which is the article prohibiting the amendment of any constitutional article dealing with the form of government or national territory. The reference to these Articles in the Statute is a clear signal to a court that the ZEDE Statute does not seek to alter either the form of government for Honduras where it applies or in any way to remove the zones from the sovereignty or territorial integrity of Honduras.

However, the chapter on General Principles does not only act as a bridge between the Constitution and the Statute. This chapter also includes four notable articles which define and delegate powers to the zones: Article 2, which states the aims of the zones; Article 3, which gives the zones independent courts and legal systems; Article 4 which gives the zones fiscal independence; and Article 8, which provides the hierarchy of law that the zones must follow.



First, Article 2 states that the aim of the zones is to develop various types of institutions such as National and International Financial Centers, International Business Courts, and Renewable Energy Districts, among others (Decreto No. 120-2013, Ch. I, Art. 2). Second, Article 3 gives the zones operational and administrative autonomy equivalent to that enjoyed by municipalities under the Honduran Constitution, and autonomous and independent courts which can follow “legal systems or traditions from elsewhere” (Decreto No. 120-2013, Ch. I, Art. 3). The ability to adopt legal systems and traditions from elsewhere is significant because it allows zones to adopt a common law system that is often favored by businesses. Furthermore, this article allows not only for the straight adoption of a foreign jurisdiction’s legal system, like was done with the Dubai International Financial Center (DIFC, 2020), but also allows for the adoption of truly innovative legal systems, such as the open-source Ulex legal system (Bell, 2018).

Third, Article 4 gives the zones the ability to “create their own budgets, the right to collect and manage their taxes, to determine the rates they charge for their services, and to be held to all types of agreements or contracts to meet its objectives over time” (Decreto No. 120-2013, Ch. I, Art. 4). Fiscal independence is a critical part of autonomy and allows for the zones to pursue the development aims stated in Article 2 without needing to rely on the Honduran government for backing.

Fourth, Article 8 provides that the hierarchy of rules in the zones begins with the Honduran Constitution, followed by international treaties to which Honduras is a party, the ZEDE Statute, laws mentioned in Chapter VI of the ZEDE Statute, and finally the internal regulations of the zones (Decreto No. 120-2013, Ch. I, Art. 8). This article serves two functions, to further ground the zones within the Honduran Constitutional order, and to layout for legal professionals a clear hierarchy to follow if and when legal conflicts arise between the stated laws. Chapter I not only further grounds the ZEDE Statute within the Honduran constitutional order, it also gives the zones autonomous powers to adopt

innovative legal systems and operate their own finances, and provides critical legal guidance in the form of the hierarchy of law that the zones must follow.

The second chapter of the ZEDE Statute, Chapter II: Fundamental Rights and Duties of the Residents, does not touch on any overt constitutional issues or explicitly reference any article in the Honduran Constitution. Instead, this chapter deals with the relationship of Hondurans and non-Hondurans within the zones. Article 9 provides that “All persons in the [zones] are equal in rights and duties without discrimination of any kind” except for certain functions that are reserved for Hondurans or ZEDE residents given in the Constitution or the Statute (Decreto No. 120-2013, Ch. II, Art. 9).

The only other article in Chapter II, Article 10, states the intent is that all those who are residents of the zones should respect each other, humanity, and the law (Decreto No. 120-2013, Ch. II, Art. 10). Furthermore, Article 10 requires the zones to establish agreements of coexistence and create public spaces where residents can assemble to defend their rights (Decreto No. 120-2013, Ch. II, Art. 10). While it is the shortest chapter in the Statute, Chapter II establishes that all residents are equal before the law, except where otherwise carved out, and that residents have both the freedom to demonstrate to defend their rights and will have specially designated places to do so. These articles serve as both signals to Hondurans and non-Hondurans that their rights will be respected, and to the international community that the zones are not areas exempt from democratic freedoms.

The third chapter of the ZEDE Statute, Chapter III: Administrative Structure, is broken into four sections: (I) Committee for the Adoption of Best Practices; (II) Technical Secretariat; (III) Audit; and (IV) Dispute Resolution and Internal Security. The first three of these sections each has only a single article, but the fourth section has a total of nine articles. The articles in each of the first three sections are examined, as well as five of the articles in Section IV.

In Section I, Article 11 creates the Committee for the Adoption of Best Practices (Decreto No. 120-2013, Ch. III, Sec. I, Art. 11). This committee serves as the governing body

of the ZEDEs and is composed of 21 persons of “of recognized integrity, leadership, executive capacity, and international reputation” across the public and private sectors, as well as nonprofits and academia (Decreto No. 120-2013, Ch. III, Sec. I, Art. 11).

This article lays out the Committee’s ten functions: (1) approving regulations; (2) approving or disapproving of actions taken by the zone’s executive, the Technical Secretary; (3) to appoint or remove the Technical Secretary; (4) “[t]o establish general guidelines for domestic policy and transparency; (5) “[t]o approve or disapprove the regulations approved by the Technical Secretary;” (6) to propose to the Judicial Council a list of qualified candidates for judicial office, and to recommend the removal of judicial officers when appropriate; (7) to fill its own vacancies; (8) designate areas for future expansion; (9) engage the services of an internationally recognized auditing firm, and to publish respective reports; and (10) to fulfill any other duties given to it by the Statute (Decreto No. 120-2013, Ch. III, Sec. I, Art. 11). Furthermore, this article requires that the Committee be appointed by the President of Honduras and their appointment must be ratified by the Honduran Congress (Decreto No. 120-2013, Ch. III, Sec. I, Art. 11).

Finally, this section also provides that the Committee can begin its duties when a quorum of 12 members has been appointed and ratified (Decreto No. 120-2013, Ch. III, Sec. I, Art. 11). While this committee effectively serves as an oversight and quasi-legislative body of the zones, the structural form is more analogous to a corporation with a board which appoints corporate officers, and passes major resolutions, while also approving, disapproving, or ratifying actions taken by those officers. This structure both falls within the constitutional order of Honduras, with Committee members being appointed by the Honduran President and ratified by the Honduran Congress, while providing access to foreign stakeholders by allowing non-Hondurans to be appointed to the Committee. Furthermore. The article serves as a delegation of the powers to the legislative body within a governance structure that separates powers.

Section II of Chapter III contains Article 12, which provides the structure of the executive body of the zones, the Technical Secretariat. The article provides that the Technical Secretariat is the chief executive of a zone and its legal representative, and is a position that runs for a seven year term that can be renewed or revoked (Decreto No. 120-2013, Ch. III, Sec. II, Art. 12). Furthermore, the article requires that the Technical Secretariat must be a Honduran national by birth (Decreto No. 120-2013, Ch. III, Sec. II, Art. 12).

Next, the article lays out the eleven functions of the Technical Secretariat: (1) to represent the zone; (2) “[s]ubscribe to legal stability agreements for matters deemed necessary;” (3) establishing fiscal and budgetary management measures and instruments necessary for the function of the zone; (4) managing the administration and government of the zone, and implementing policy measures prescribed by the Committee; (5) suggest to the committee appropriate measures for compliance with the purposes of the zone; (6) enacting legislation and submitting it to the Committee for approval or disapproval; (7) applying the rules of the zone within the framework of the Statute; (8) appointing ad hoc Secretaries to assist in the management of the zone; (9) issuing temporary resolutions, called ordinances, to ensure the efficient delivery of public services and competitive markets; (10) developing a plan for the promotion of the zone and its operation; and (11) any other powers governed by the Statute or delegated by the Committee (Decreto No. 120-2013, Ch. III, Sec. II, Art. 12). Article 12’s requirement that the executive must be a natural born Honduran citizen is a further bulwark against the perception that a zone is at risk of being alienated from Honduran territory. Additionally, this article follows a similar function as Article 11, by providing a description of the powers of a zone placing them in a system of separation of powers.

Section III of Chapter III contains Article 13, which requires an audit (Decreto No. 120-2013, Ch. III, Sec. III, Art. 13). Specifically, the article mandates the Committee employ a “prestigious international organization” to perform the audit (Decreto No. 120-2013, Ch. III, Sec. III, Art. 13). Furthermore, the resulting reports must be published and presented to

the Honduran President and Congress (Decreto No. 120-2013, Ch. III, Sec. III, Art. 13). This article serves to provide transparency into the finances and workings of a zone, which is beneficial for both public perception in Honduras and the perception of outside stakeholders and investors.

Section IV of Chapter III contains nine articles related to dispute resolution and internal security, five of which are examined here. First, Article 14 establishes that zones are subject to a special jurisdiction and “shall have autonomous and independent courts.” These courts have exclusive jurisdiction within the zone over all matters that are not subject to binding arbitration (Decreto No. 120-2013, Ch. III, Sec. IV, Art. 14). This article also stipulates that the courts are to be established by a Judicial Council at the proposal of the Committee, and that the courts may use “Anglo-Saxon” common law or any other legal system permitted by Honduran constitutional Article 329 (Decreto No. 120-2013, Ch. III, Sec. IV, Art. 14). Finally, this article also gives parties who contract in the zone the right to have choice of law clauses in contracts (Decreto No. 120-2013, Ch III, Sec. IV, Art. 14). Businesses engaged in international operations often prefer to use “friendlier” common law jurisdictions, and so permitting zones to select their legal systems allows for a wide range of experimentation and innovation. Furthermore, allowing for parties to enter into contracts that have choice of law clauses increases the appeal of the zones to business interests which often use such clauses in contracts.

Second, Article 15 mandates that judicial officers are appointed by a Judicial Council from a list compiled by the Committee (Decreto No. 120-2013, Ch. III, Sec. IV, Art. 15). This article also requires that the list be “composed of those who hold the greatest ability to perform such work” (Decreto No. 120-2013, Ch. III, Sec. IV, Art. 15). This article is yet another example of the separation of powers principle, where in this case the judicial officers of the zone must go through a selection process performed by the Committee and an approval process by the Judicial Council.

Third, Article 16 requires that a zone have “a Court of Protection of Individual Rights” (Decreto No. 120-2013, Ch. III, Sec. IV, Art. 16). This court may be comprised of as many judicial officers as the Committee sees fit to appoint and protect the fundamental rights of residents (Decreto No. 120-2013, Ch. III, Sec. IV, Art. 16). Additionally, this article allows for appeals from this court to “international tribunals.” Finally, this article requires that zones must indemnify Honduras in the event that Honduras is condemned for rights violations in the zone, and that zones must “comply with the recommendations, injunctions, or regulations issued by international human rights bodies” (Decreto No. 120-2013, Ch. III, Sec. IV, Art. 16). This article is further assurance to concerned parties and stakeholders that the rights of residents will be respected. It provides this assurance via a two-part mechanism that first, has an internal recourse in the form of a Court of Protection of Individual Rights, and second, an external recourse in the form of the right to appeal to international human rights tribunals.

Fourth, Article 19 requires that the courts are able to exercise their functions independently and free from outside interference, and also mandates that penalties be established for those who attempt to interfere with the independence of these courts (Decreto No. 120-2013, Ch. III, Sec. IV, Art. 19). This article also establishes judicial immunity for judicial officers, which protects them from legal action over matters related to the performance of their judicial office (Decreto No. 120-2013, Ch. III, Sec. IV, Art. 19). The protections that this article provides are important to ensure the independence of the courts and the officers of these courts.

Fifth, Article 22 requires that a zone form its own internal security organs, ranging from police and intelligence bodies to penitentiary bodies, and also to link the security strategy of the zone to the security strategy of Honduras (Decreto No. 120-2013, Ch. III, Sec. IV, Art. 22). This article serves two functions, to once again link the zones back to the constitutional order and territorial integrity of Honduras, and to require the zones to provide their own security.



The fourth chapter of the ZEDE Statute, Chapter IV: Economics and Finance, deals with the fiscal duties of the zone, property rights within the zone, expropriation, taxation, monetary policy, trade policy, and customs. First, Article 23 requires that zones maintain a fiscal balance, and transfer resources to the rest of Honduras as provided for in the Statute (Decreto No. 120-2013, Ch. IV, Art. 23). This helps ensure that the zones do not become financial burdens to Honduras, and that Honduras as a whole can benefit from the successes of the zones.

Second, Article 24 requires that when a zone is declared in an urban area that title rights to real estate in that area are recognized, taxes on the value of land are created, and that for those taxation purposes periodic appraisals of the value of the land in the zone be made (Decreto No. 120-2013, Ch. IV, Art. 24). This article both protects the rights of urban residents who get subsumed into a zone and sets out clear taxation policies in the zones.

Third, Article 25 allows for the zones to administer ownership issues in the zone when the zone has been established in an area of low population, and that Honduras may expropriate land after indemnifying the owners with the fair value of the land as determined by comparison to similar land outside of the zone (Decreto No. 120-2013, Ch. IV, Art. 25). This article clarifies that Honduras has the ability to expropriate the land of a zone in a low population area, but also gives limitations on how that may be done.

Fourth, Article 28 gives Honduras the power to expropriate land for the purpose of creating a zone, requires the payment of just compensation for the expropriation of such land, and requires that opposition to such expropriation be made in arbitration at the expense of the zone (Decreto No. 120-2013, Ch. IV, Art. 28). Article 28 ensures that landowners subject to expropriation are treated fairly in both legal proceedings and in compensation for that expropriation.

Fifth, Article 29 requires that zones have a separate tax regime, that this policy should be guided by a policy of low taxes, and then delineates what a zone's options are for implementing this policy (Decreto No. 120-2013, Ch. IV, Art. 29). The policies in Article 29

favor ideas of free markets and ensure that these ideas will be supported with policy by limiting what a zone can do regarding tax policy.

Sixth, Article 30 states that the monetary exchange control policies of Honduras do not apply to zones, that zones may create their own monetary exchange control policies and even their own monetary policy, but that zones must ensure that the flow of capital into the rest of Honduras complies with the relevant national standards (Decreto No. 120-2013, Ch. IV, Art. 30). The ability of zones to create their own monetary policy is an enormous grant of autonomy to the zones and allows the zones to be much more economically competitive than they would be without the ability to engage in their own monetary policy.

Seventh, Article 31 is another article that promotes the ideas of free markets, but in this case more directly by requiring the zones to operate on a policy of free trade and competition (Decreto No. 120-2013, Ch. IV, Art. 31). This article also gives zones the ability to manage sea and air travel, as well as ports of entry (Decreto No. 120-2013, Ch. IV, Art. 31). Article 31's mandate for zones to operate in a free-market system ensures that the zones will be economically competitive, and the power to control commercial traffic and ports of entry gives the zones a tool to increase their competitive edge.

Eighth, Article 32 creates ZEDEs as offshore tax and customs areas, which allows them to avoid having to enforce the standard tariffs and fees that goods being imported to the rest of Honduras are subject to (Decreto No. 120-2013, Ch. IV, Art. 32). The exemption of the zones from the standard customs laws of the rest of Honduras allows for the zones to further create their own trade policies in line with free market principles. Overall, Chapter IV aims to ensure that ZEDEs operate as low tax-free trade zones that are easy to do business with. Such policies are aimed at ensuring that ZEDEs are profitable jurisdictions which can in turn help bring prosperity to Honduras as a whole.

The fifth chapter of the ZEDE Statute, Chapter V: Education, Health, Social Security, Science, Religion, Work, and Environment, provides the framework for ensuring that the people of ZEDEs are able to live productive, healthy, fulfilled, and protected lives. This

chapter has one article, Article 35, which cites back to the Honduran Constitution. Otherwise, the remaining articles independently create law for the ZEDEs. Article 35 of the Statute protects the labor rights of workers in the zones and does so by citing provisions coming from organizations like the International Labor Organization (ILO) (Decreto No. 120-2013, Ch. IV, Art. 35). Furthermore, the article cites Article 139 of the Honduran Constitution, which states: “The State has an obligation to promote, organize and regulate conciliation and arbitration procedures for the peaceful settlement of labor disputes” (Honduran Const. Art. 139). Article 35 of the Statute then requires that this constitutional mandate be met with “mechanisms of mediation, conciliation and arbitration for the peaceful settlement of disputes” (Decreto No. 120-2013, Ch. V, Art. 35). This article helps to reassure residents of zones that their labor rights will be looked after, and that those rights will be defined not by a market oriented ZEDE government, but by respected international bodies like the ILO. This reassurance is further bolstered by the incorporation by reference of Article 139 of the Honduran Constitution, which requires arbitration and promotes the peaceful settlement of labor disputes.

There are three other notable Articles in Chapter V of the ZEDE Statute: (1) Article 33; (2) Article 34; and (3) Article 36. First, Article 33 gives ZEDEs broad authority to establish “their own systems of education, health, social security, and promotion of science, as well as to guarantee freedom of conscience, religion, labor protection, and freedom of association” (Decreto No. 120-2013, Ch. V, Art. 33). The article mandates that ZEDEs do this through the promulgation of their own rules (Decreto No. 120-2013, Ch. V, Art. 33). This article once again is giving broad authority and autonomy to the zones to create their own policies. Such a high degree of latitude in the ability to design and implement these social systems allows for the zones to engage in experimentation and innovation that would not be available with more prescribed methods.

Second, Article 34 requires the zones to create their own curriculum and policy at all levels, and prohibits licensing or mandatory association, but allows for accreditation

requirements for certain professions (Decreto No. 120-2013, Ch. V, Art. 34). This article is notable because it requires that the zones create their own curriculum, thereby implying a duty to provide an education within a zone's jurisdiction. However, this article also does more work advancing the ideas of a market-oriented system by prohibiting licensing systems or mandatory membership in a professional or labor association. Though, the article also promotes standards for professionals by allowing zones to implement accreditation requirements for certain professions.

Third, Article 36 mandates that: "All things being equal, preference shall be given to Honduran workers over foreign workers" (Decreto No. 120-2013, Ch. V, Art. 36). Furthermore, the article requires that no less than 90 percent of the workers in a zone are Hondurans, and that those Honduran workers must make at least 85 percent of the wages that their employers pay out (Decreto No. 120-2013, Ch. V, Art. 36). Like many other articles in the Statute, this article has two functions, in this case to bolster the perception of the zone being an integral part of Honduran territory, and to ensure that the bulk of the benefits of the economic success of a zone goes to the Honduran people. It is notable that this article is in the chapter advancing positive social policies within the zones and not the chapter addressing the economic policies of the zones. The social policies of the zones strike a balance between advancing market-oriented solutions to social problems and mandating that the zones still provide social services.

The final chapter of the ZEDE Statute, Chapter VI: Final and Transitional Provisions, has articles that both refer back to the Honduran Constitution and articles that advance policies that are not rooted in the Constitution. There are two articles in the Statute that make reference to the Constitution: (1) Article 38; and (2) Article 39. First, Article 38 sets forth the rules that the Honduran Congress must follow when creating ZEDEs by decree (Decreto No. 120-2013, Ch. V, Art. 38). This article has two prongs, one for determining the rules for declaring a ZEDE in a low population density area, and one another for determining

the rules for establishing a ZEDE in a high population density area, and each prong has a different reference to the Honduran Constitution (Decreto No. 120-2013, Ch. V, Art. 38).

The first prong requires that “[w]hen the area to be declared has a low population density, the National Statistics Institute (NSI) must certify the situation in accordance with the provisions of Article 329” (Decreto No. 120-2013, Ch. V, Art. 38). The provisions of Article 329 are discussed extensively above. The second prong requires that when a zone is declared in a high population density area, that a plebiscite must first be conducted, and that a ZEDE may only be established if the result is favorable under Article 5 of the Honduran Constitution (Decreto No. 120-2013, Ch. V, Art. 38). Article 5 of the Honduran Constitution requires that the government is to “be founded on the principles of popular sovereignty, the self-determination of the people, and participatory democracy” (Honduran Const. Art. 5) Furthermore, Article 5 of the Honduran Constitution lays out the requirements for a referendum or plebiscite (Honduran Const. Art. 5).

Second, Article 39 of the Statute deals with the establishment of zones in “areas with low population density in the municipalities in the departments adjoining the Gulf of Fonseca and the Caribbean Sea” (Decreto No. 120-2013, Ch. VI, Art. 39). This article lays out specific requirements for establishing zones in these areas. Additionally, this article incorporates by reference Articles 10 and 329 of the Honduran Constitution (Decreto No. 120-2013, Ch. VI, Art. 39). Both articles are discussed extensively above. The constitutional articles that are cited in Article 39 of the Statute are mostly familiar, Article 10 dealing with the sovereignty and definition of Honduran territory, and Article 329 that establishes the structure that the ZEDEs can operate under (Honduran Const. Art. 10, 2013; Honduran Const. Art. 329). Both references help ensure that any court reviewing the validity of the ZEDE Statute can find more evidence that the Statute passes scrutiny when examined with a Constitutional Article 374 test.

There are three additional articles in Chapter VI that must be examined for the purposes of this analysis: (1) Article 41; (2) Article 42; and (3) Article 43. First, Article 41

gives the Honduran national laws that must apply in a ZEDE. These laws are the laws which establish “the national anthem, national emblem, national flag and other national symbols;” the laws “concerning the Territorial Sea and the Contiguous National Zone;” and criminal laws, which can either be incorporated by reference from the laws of Honduras or which the ZEDEs can create themselves (Decreto No. 120-2013, Ch. VI, Art. 41). This article is once again doing multiple things at once, ensuring that Honduran territorial integrity is promoted through the presence of Honduran national symbols and recognition of Honduran territorial claims, and giving the zones a relatively easy way to establish a sensitive area of law, criminal law.

Second, Article 42 allows for outstanding foreign judges, attorneys, or academics to be employed as judicial officers while “human resources are being formed and capabilities [are being] developed” in the zones (Decreto No. 120-2013, Ch. VI, Art. 42). This article gives the ZEDEs greater flexibility in the appointment of judicial officers by being able to select those officers from a larger pool of qualified candidates.

Third, Article 43 prohibits the ZEDEs from “[carrying] out acts that violate the property rights of indigenous peoples and Afro-descendants on the land they have been granted by certificates granted by the [Honduran] Government” (Decreto No. 120-2013, Ch. VI, Art. 43). Article 43 also incorporates by reference Convention 169 of the ILO and applies it to all ZEDEs (Decreto No. 120-2013, Ch. VI, Art. 43). This article seeks to assure both Hondurans and international stakeholders that the rights of Honduran minority groups will be respected and protected, and that those protections will be determined by an international standard set by the ILO. Chapter VI contains a range of articles that address areas that are not addressed in other parts of the Statute. This Chapter also reinforces the assertion that the Statute falls safely within the requirements for not altering the government or territorial integrity of Honduras.

The ZEDE Statute provides a highly autonomous framework for establishing innovative jurisdictions within Honduras, and it does this by methods that ensure the



government and territory of Honduras are not altered in a way that would fail a constitutional Article 374 test. However, the ZEDE Amendment and ZEDE Statute are not the only bodies of law that are relevant to the legal landscape of ZEDEs. There are also relevant treaties and international agreements.

### **3.3. International Legal Issues**

There are seven treaty instruments or international agreements to which Honduras is a member state and have been cited as impacting the legality, legitimacy, and powers of ZEDEs. These instruments are addressed in accordance with their relationship to the rights of Hondurans that they protect: (1) Rights Concerning Self-Determination and Democratic Participation; (2) Property Rights; (3) The Rights of Indigenous Peoples; and (4) Obligations of Business and Human Rights.

First, Rights Concerning Self-Determination and Democratic Participation are backed by three separate documents: the American Convention on Human Rights (ACHR), the International Covenant on Civil and Political Rights (ICCPR), and the International Covenant of Economic, Social, and Cultural Rights (ICESCR). Article 23 of the ACHR provides a right to participate in government (Organization of American States, 1969). Detractors of the ZEDEs assert that the governance structure is not sufficiently democratic (National Lawyers Guild, 2014). However, this argument is likely not strong enough to invalidate the ZEDE Statute (Miller, 2015). Additionally, the ICCPR contains language that is substantially similar, though as noted above, this line of attack is unlikely to invalidate the ZEDE Statute (International Covenant on Civil and Political Rights, 1966; Miller, 2015). Third, both the ICCPR and the ICESCR stipulate that “All people have the right to self-determination” (UN General Assembly, International Covenant on Economic, Social and Cultural Rights, 1966). Yet, once again, this line of attack likely does not invalidate the ZEDE Statute (Miller, 2015).

Second, Property Rights are backed by two documents: the ACHR, and the Bay Islands and Wyke-Cruz Treaty of 1859. The ACHR confers the right to the use and enjoyment of property, and the prohibition against state seizure of property without just compensation (OAS, 1969). However, the ZEDE Statute clearly addresses these issues in Articles 25 and 28 discussed above. Furthermore, arguments that the Bay Islands and Wyke-Cruz Treaty of 1859 prevents the formation of ZEDEs based on the treaty's prohibition against ceding the right of sovereignty over any of the described territories "to any nation or State whatsoever" (Bay Islands and Wyke-Cruz Treaty, 1859). Objections to the ZEDE Statute using the Wyke-Cruz Treaty also likely do not carry any weight as the Statute is already well insulated from an attack using Article 374 of the Honduran Constitution, which is a much more relevant document asserting the inviolability of Honduran territory.

Third, the Rights of Indigenous Peoples are backed by the Indigenous and Tribal Peoples Convention of 1989 (ILO 169), and the United Nations Declaration of the Rights of Indigenous Peoples (UNDRIP). ILO 169 and UNDRIP both require Honduras to consult with indigenous peoples whenever there are administrative changes that will affect them directly. Detractors have asserted that they are "not aware of any efforts that the government has made to initiate consultations with affected groups" (National Lawyers Guild, 2014). However, Article 43 of the ZEDE Statute does prevent the ZEDEs from violating the property rights of indigenous groups and also incorporates ILO 169.

Fourth, Obligations of Business and Human Rights are backed by the United Nations Guiding Principles on Business and Human Rights (Guiding Principles). The Guiding Principles expect businesses to recognize "at a minimum...those [rights] expressed in the International Bill of Human Rights and the principles concerning fundamental rights set out in the International Labor Organization's Declaration on Fundamental Principles and Rights at Work" (UN Human Rights Council, 2011). Detractors of the ZEDE Statute assert that they are concerned about the possibility of business interests becoming "complicit in the human rights violations committed by the Honduran state" (National Lawyers Guild, 2014). These

detractors claim that any business operating in a ZEDE would be complicit in any violation of rights that the Honduran government was engaged in, such as a denial of the right to political participation (National Lawyers Guild, 2014). However, as addressed above, it is not likely that ZEDEs violate any right to political participation or self-determination, as Article 5 of the Honduran Constitution has been incorporated into the ZEDE Statute by reference, and this article requires the government to “be founded on the principles of popular sovereignty, the self-determination of the people, and participatory democracy” (Honduran Const. Art. 5).

#### **4. PRINCIPAL OBJECTIONS TO THE ZEDE LAW**

This section will address two of the most notable criticisms of the ZEDE law, that ZEDEs are (1) a violation of Honduran sovereignty and (2), that ZEDEs represent a threat to property rights through expropriation, especially with regard to indigenous communities.

The sovereignty criticism was used to strike down the original RED legislation, and similar charges have been levied against the ZEDE legislation, including recently by the Honduran Bar Association (Márquez, 2020). The previous section evidenced the weakness of this line of attack against the constitutionality of the ZEDE law. Therefore, it will not be discussed further in this section. However, the concerns regarding the violation of property and indigenous land rights through expropriation warrants further discussion.

##### **4.1. Property Rights and Expropriation**

Expropriation of land by eminent domain to create or expand a ZEDE is a chief concern of the law’s critics. Fears of expropriation tend to revolve, although not exclusively so, around lands held by Honduras’ Afro-indigenous minority, the Garifuna. For years, the Garifuna

have been subject to intimidation and outright violence over their lands by the Honduran police and military, drug cartels, and private firms (Clark, 2020).

Under the ZEDE statute, ZEDEs are supposed to be developed in accordance with International Labor Organization Convention 169 on free, prior, and informed consent of indigenous communities. However, Alford-Jones (2017) notes that the Garifuna have criticized the Honduran government for failing to ensure that such consent was given for a (now seemingly abandoned) ZEDE project near the coastal city of Trujillo. Alford-Jones also alleges that the broad expropriation powers enumerated in Article 25 of the ZEDE statute are a violation of Inter-American Development Bank policies on involuntary resettlement and indigenous peoples. The National Lawyers Guild (2014) is similarly critical of the expropriation clauses in the ZEDE statute, and Martin and Geglia (2019) note that ambiguities surrounding the process by which expropriations can occur has exacerbated fears of future displacement.

From a legal perspective, concerns about the expropriation clauses have been addressed in the previous section—titled land cannot be expropriated *carte blanche* without just compensation, as is standard in virtually all countries in the Global North. For example, the Fifth Amendment to the United States Constitution states that no private property may be taken by the government for public use, such as the construction of a road, without just compensation, typically in the form of the fair market value of the property (Legal Information Institute, 2021). Key international laws and conventions relating to land rights are either directly referenced in the ZEDE law or apply to ZEDEs by virtue of Honduras being a signatory.

Fodder (2019) notes that the recognition of the rights of landowners at all, and that any takings of titled land must be accompanied by just compensation, is a significant departure from past policy of the Honduran government. Furthermore, Fodder argues that the protections afforded to indigenous peoples in the ZEDE statute are “among the most innovative” when compared to other special jurisdictions. While laws on paper are not an

ironclad guarantee of land rights for low income and indigenous Hondurans, thought has been afforded to this issue.

Despite a trend towards less arbitrary and uncompensated expropriation by the Honduran government, the poor state of land titling in rural Honduras and the communal nature of land ownership by indigenous peoples leave open the possibility of expropriations that result in insufficient or nonexistent compensation. Continuing to pursue land titling, including communal land titling, could help the Honduran government preempt such disputes from arising in the first place when titling is unclear (World Bank, 2017).

It is worth noting that Honduras scores incredibly poorly on indices that account for access to justice, such as the rule of law indicator within the Worldwide Governance Indicators. Honduras ranks within the 15<sup>th</sup> percentile of all countries, significantly underperforming Latin America and the Caribbean (49<sup>th</sup> percentile) and low-income countries (20<sup>th</sup> percentile) (Worldwide Governance Indicators, 2019). As previously stated, laws and policies on paper do not guarantee perfect access to justice, but a ZEDE with a functional and low-cost court system may indeed represent a substantial improvement in access to justice for ordinary Hondurans.

As is discussed later in the case studies of Próspera and Ciudad Morazán, ZEDE developers are clearly aware of the public relations challenges they face in developing ZEDes, especially regarding expropriation. To that end, neither ZEDE developer has engaged in acts of expropriation to date and each has either issued a blanket public statement against expropriation or requires compensation well above what is required by law.

## **5. ZEDE CASE STUDIES – PRÓSPERA AND CIUDAD MORAZÁN**

To date, two ZEDes have been declared: Próspera and Ciudad Morazán. Both ZEDes were announced in 2020, seven years after the ZEDE law was first passed. Although both projects are still in the early stages of development, they represent two contrasting visions of how the ZEDE law can be applied in practice.

### 5.1. Próspera

Próspera is a 58-acre development on the Caribbean island of Roatán, a popular tourist destination where English is the primary language (Próspera 2020b). The Próspera development plan targets a variety of knowledge economy sectors like finance, education, and medical tourism, but also traditional tourism and manufacturing (Próspera 2020c). In addition to business development, Próspera is also pursuing luxury housing development through a partnership with British firm Zaha Hadid Architects (Próspera, 2020d).

Próspera is governed by a common law framework that incorporates restatements of US common law and international common law standards based partially on the open-source common law Ulex system developed by Chapman University law professor Tom Bell (Brimen, 2020). Próspera features a unique and highly flexible regulatory regime, where businesses may choose to adopt the regulatory code of Honduras or any OECD country, adopt common law regulation with three times enhanced liability and injunctive relief, or propose an entirely new regulatory framework subject to approval from the Próspera Council (Próspera, 2020e).

In addition to the flexible regulatory framework, Próspera has adopted a series of business regulations targeted at making the ZEDE among the most competitive business environments in the world while also benefiting the local population of Roatán. To register a business, Próspera only requires three steps (sign a coexistence agreement, fill out a brief application with information for a background check, and purchase liability insurance) that can be completed in a single day, outperforming Honduras in ease of business registration by several orders of magnitude, at much lower cost. Permitting compliance is also orders of magnitude cheaper and easier than in Honduras or in the United States (Próspera 2020e).

Regarding labor law, Próspera requires that at least 90 percent of day labor employees are Honduran and that the minimum wage paid must be at least 10 percent above the Honduran national minimum wage. Employer contributions to employee savings accounts



equal to 8 percent of gross compensation is also mandated. Employers can choose to adopt either a six day/48-hour workweek or provide 125 percent overtime compensation (Próspera, 2020e).

Próspera also boasts a light tax burden—a 10 percent tax on presumed income sourced within the ZEDE, a five percent retail value-added tax, and a one percent tax on the unimproved value of land. Estimated aggregate tax revenue as a percentage of GDP is just 7.5 percent, compared to 23.36 percent in Honduras or 33.3 percent in the United States (Próspera 2020e).

Finally, Próspera has its own arbitration center that will serve as the default court for the ZEDE. Unlike traditional arbitration centers, the Próspera Arbitration Center (PAC) is intended to be open to the public. Details of resolved cases will be made available, rather than kept private. In addition to commercial dispute resolution, the PAC will also handle labor disputes and even criminal matters, which for relatively minor offenses may be addressed in Próspera through a schedule of criminal fees, rather than imprisonment (Brimen, 2020).

Despite Próspera's ambitious development plan, innovative legal system, and competitive business environment, the project has encountered difficulties in recent months. In September 2020, a video showing local police confronting Próspera CEO Erick Brimen during a meeting with Crawfish Rock (a community of Roatán) residents about the project quickly went viral. The video was accompanied with accusations that Próspera was planning to use eminent domain powers granted under the ZEDE law to confiscate property on Roatán to expand the ZEDE, and that local residents had not been consulted about the project prior to its commencement (Ernst, 2020).

In response, Próspera issued a statement rejecting the allegations of property expropriation and affirmatively stated that all past land acquisitions had been through voluntary transactions, as would all future acquisitions. The statement notes that it would not be legal for Próspera to expropriate land under the ZEDE law, and that only the

Honduran government possesses this power. The statement also condemns both the beating of Próspera officials and threats of illegal arrest by the local police (El Heraldo, 2020). Próspera also shared a resolution that had been adopted the previous month affirming the ZEDE's commitment to respecting the property rights of Roatán residents, including indigenous communities on the island. The resolution proclaims that Próspera does not have the power to, and will not, engage in any expropriation of land, will only incorporate new territory with the voluntary request of property owners, and shall not use its resources to assist any other governmental body in executing an expropriation (Próspera 2020f).

## 5.2. Ciudad Morazán

Ciudad Morazán is a 50-acre development near the city of Choloma, north of San Pedro Sula. While the economic focus of Próspera is clearly international in nature, targeting knowledge-based economic activity and high-income residents, Ciudad Morazán is focused entirely on attracting industrial development and Honduran residents (La Prensa, 2020). Although less information about Ciudad Morazán is available compared to Próspera, a recent interview with Technical Secretary Carlos Alfonso Fortín Lardizábal and the ZEDE's first published regulations offer insight into its objectives and business environment.

Ciudad Morazán intends to mirror the typical *maquila*-style industrial park, but to also provide residential areas and public services. While the Choloma area attracts significant in-migration already, Ciudad Morazán is intended to help fill the gap in quality housing, schools, public services, security, and more. The first round of investment, approximately \$100 million, will build out the infrastructure and services to support 8,000 residents. The first 100 families are expected to move in by Spring 2021 (La Prensa, 2020).

A common criticism of ZEDEs is that they lack democratic legitimacy, however, Ciudad Morazán allows for residents to vote for a Technical Secretary and certain members of the Morazán Council, once the city hits a minimum population threshold. Other seats of the Morazán Council are voted on by landowners, with votes allocated by land owners (ZEDE

Morazán, 2020). This distribution of representation somewhat mirrors Hong Kong's Legislative Council, where seats are split between geographic constituencies and "functional" constituencies that represent various interest groups like trade unions, financial services, agriculture, and others (Registration and Electoral Office, 2020).

Regarding the business environment, all individuals and firms are taxed at a fixed rate of seven percent of all Morazán-sourced income, although options for lump-sum annual payments may be made available (ZEDE Morazán, 2020). Technical Secretary Lardizábal has specifically noted that the ZEDE is not intended as a tax haven, and that an individual living in Ciudad Morazán but working elsewhere in Honduras or abroad would be subject to standard Honduran taxation (La Prensa, 2020). Furthermore, starting on January 1, 2030 or when the city reaches 50,000 residents, aggregate tax revenues in excess of seven percent of Ciudad Morazán GDP will be returned to taxpaying residents and landowners. Beyond taxation, a new court and a default arbitration service provider will be established by the ZEDE (ZEDE Morazán, 2020).

In addition to the regulatory policies detailed in the bylaws, Ciudad Morazán has also published an extensive labor law statute. Weak labor protections have been a principal objection to the ZEDEs, although Ciudad Morazán offers protections that appear to challenge this categorization (National Lawyers Guild, 2014). Many of Ciudad Morazán's labor provisions are similar to those advertised by Próspera, like a minimum wage greater than that in the rest of Honduras (Ciudad Morazán Labor Statute Chapter V; Villela, 2020). The labor statute also includes legal protections for collective bargaining and union membership, another common area of criticism, among other labor protections (Ciudad Morazán Labor Statute Chapter IV).

The Ciudad Morazán Charter and Bylaws also establish a Resident Bill of Rights, which includes a requirement that any eminent domain powers shall not be exercised without compensating the property owner 200 percent of whichever is greater, the fair market value of the property prior to the taking or the monetary value of the loss sustained by the property

owner. The Resident Bill of Rights further recognizes rights to life, property, contract, due process, thought, speech, conscience, religion, security and privacy, liberty, and protection against ex post facto prosecutions (ZEDE Morazán, 2020).

Although Ciudad Morazán has been subject to some criticism as part of a general political backlash against the ZEDEs in Honduras, it has not received the same level of scrutiny as Próspera following the September 2020 incident in Crawfish Rock.

## 6. CONCLUSION

Próspera and Ciudad Morazán are moving closer to having their first operational businesses and first residents. It remains to be seen if these ZEDEs end up closer to the advocates' dream of a Latin American Shenzhen or the detractors' fears of corporate abuse run amok. Given the information available about the governing frameworks for each ZEDE, there is reason to be optimistic about their potential for their economic and popular success.

At the same time, ZEDE developers must tread carefully. Much of the Honduran public is hostile to the ZEDEs and any abuses of power or failure to deliver on key responsibilities could signal the death knell for a ZEDE and permanently scare off investors. The ongoing uncertainty regarding President Hernández's connections to drug trafficking and money laundering, including the conviction on drug trafficking charges of his brother in U.S. federal court, threatens the integrity of the ZEDE experiment (Asmann, 2020). Since the 2009 coup and constitutional crisis that brought Hernández's National Party to power, the Party and its leaders have become increasingly authoritarian—undermining Honduran democracy and with it the legitimacy of the ZEDEs (Olson, 2019).

As Próspera and Ciudad Morazán develop both in a physical sense and in terms of their governing frameworks, the authors hope that scholars will thoroughly analyze each project as the first true applications of the ZEDE law. Implemented well, the ZEDEs can be an extremely powerful anti-poverty tool that provides economic opportunities for all

Honduras, especially the poor and marginalized. The next five to 10 years will prove decisive for the success or failure of the ZEDE experiment in Honduras.

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## Creating the First Honduran ZEDE: Lessons in Political Economy, Institutional Design, and Governance Systems

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### Abstract

This paper is a case study of the creation of the first ZEDE (Zones for Economic Development and Employment) in Honduras, the Próspera ZEDE, from 2016-2021. We provide a detailed accounting of the process by which the first ZEDE was formed, how its governance structures came to be, and what challenges and difficulties it faced. We draw from this experience lessons about institutional formation, political economy in the process of special jurisdiction formation, errors made in the formation process, and generalized lessons for future efforts. While the authors led the effort described in the case study, we focus on an objective factual accounting of what occurred as well as the internal reasoning processes by which decisions were made in an effort to transparently highlight lessons learned and contribute unique insights to the institution building literature.

**Keywords:** Institutional economics, political economy, special jurisdictions, ZEDE.

### Resumen

Este artículo es un estudio de caso de la creación de la primera ZEDE (Zonas de Desarrollo Económico y Empleo) en Honduras, la ZEDE Próspera, de 2016 a 2021. Aquí detallamos el proceso de formación de la primera ZEDE, cómo surgieron sus estructuras de gobierno y qué desafíos y dificultades enfrentó. De esta experiencia, extraemos lecciones sobre formación institucional, economía política en el proceso de formación de jurisdicciones especiales, errores cometidos en el proceso de formación y lecciones generalizadas para esfuerzos futuros. Si bien los autores lideraron el esfuerzo descrito en el estudio de caso, nosotros nos enfocamos en una contabilidad fáctica objetiva de lo que ocurrió, así como en los procesos de razonamiento interno mediante los cuales se tomaron las decisiones en un esfuerzo por

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<sup>10</sup> Disclaimer: All authors are affiliated with Honduras Próspera Inc.

resaltar de manera transparente las lecciones aprendidas y contribuir con conocimientos únicos a la literatura del desarrollo institucional.

**Palabras clave:** Economía institucional, economía política, jurisdicciones especiales, ZEDE.

## **1. Introduction: Background: Special Jurisdictions, Charter Cities, and ZEDEs**

This paper begins with an introduction to the concepts of special jurisdictions as herein defined as well as the ZEDE program in Honduras. Section 2 provides an account by Erick Brimen, author of this paper and founder of Honduras Próspera Inc., regarding the approval process for the initial creation of the ZEDE special jurisdiction. Section 3 details the negotiation process by which the governance institutions of the Próspera ZEDE were created, as well as the reasoning behind them.

The commonly used term for a special jurisdiction is special economic zone, which The World Bank describes as having the following characteristics: “geographically delimited area, usually physically secured (fenced-in); single management/administration; eligibility for benefits based upon physical location within the zone; separate customs area (duty-free benefits) and streamlined procedures” (The World Bank, 2010, p.9). However, the focus of this case study is fundamentally different from a traditional special economic zone as described above. Instead, this case study focuses on the creation of a special jurisdiction—a legally distinct, partially autonomous geographically delimited area of a sovereign nation with autonomy from the central government’s traditional legislative bodies over most areas of public policy within the jurisdiction. This is not to be confused with the term “special jurisdiction” as it exists in the legal field’s scholarly literature, which refers to a specific court with a unique jurisdiction to hear certain forms of litigation as delineated by statutory law. The reason for this terminological delineation will be clarified below.

This case study examines the first such special jurisdiction created in Honduras under the auspices of the ZEDE law. (space to explain what ZEDE is). This unique legal regime was inspired by Paul Romer’s 2009 TED talk, titled “Why the world needs charter cities” (Romer, 2009). In this talk, Romer points out an uncomfortable fact about global economic development, described herein by Mason and Lutter (2020, p.4):

Governance is the most important determinant of long-term economic outcomes (Rodrik, Subramanian, and Trebbi, 2002). Unfortunately, poor governance has led to persistent poverty in much of the Global South (World Bank, 2018). In many countries, the cost in fees, time, and bribes to register a business or secure permits functionally prohibits entrepreneurship in the formal sector. For example, according to the World Bank Ease of Doing Business Index, it takes on average 36 percent of per capita income just to legally register a business in sub-Saharan Africa (World Bank, 2020). While economists largely agree on the importance of institutions for economic growth, reforms that change long-run growth rates are rarely implemented for public choice reasons (Acemoglu, Johnson, and Robinson, 2004).

Mason and Lutter explain how charter cities can solve this seeming conundrum (2020, p.4):

In existing jurisdictions, would-be improvements in governance are too often stifled by entrenched interests and ineffective bureaucracies (Mason 2019). By creating a special jurisdiction in a new city built on greenfield land, charter cities avoid these public choice problems that often stymie reforms in existing jurisdictions without radically changing the rents enjoyed by elites in existing cities. Greenfield sites therefore allow for deeper institutional change than would otherwise be politically feasible. A city is the optimal unit for implementing reforms that can generate sustained economic growth. Villages are too small to lead to meaningful impact, and nationwide reforms can be politically difficult to adopt and eliminate choice for individuals (Romer 2009). Cities, on the other hand, are large enough to fully exploit the benefits from economies of scale and from

density. And while a charter city would initially be small, initial investments from large employers can create a critical mass of people to justify additional investment in and migration to the charter city, creating a virtuous cycle of growth.

Charter Cities appeared to be the solution to stagnation and the inability to change governance institutions for the better in the developing world. However, Romer focused on the physical form which these developments may take—cities, as the name suggests. This focus on the physical instantiation obscures the true “magic” which could make a charter city successful: deep and lasting institutional improvement. These kinds of institutional improvements are only possible in new special jurisdictions that are fully or partially autonomous, within which a charter city can be created.

It should be noted that this concept of a special jurisdiction is separate both from charter cities and from special economic zones. A charter city can be built upon a special jurisdiction, but so can many other things. As the World Bank described, special economic zones are typically quite small, cannot expand geographically, and most importantly, do not solve any deep institutional issues. Instead, they focus on reducing barriers to trade via altering tariffs and duties, and perhaps bureaucratic and administrative processing, to marginally reduce the friction involved with operating in the zones. Lower import duties and one-window permitting does not lasting economic development make; only special jurisdictions can do that (The World Bank, 2008).

Further, in Romer’s initial conception, charter cities were to be governed and administered by other, more prosperous nation states. While this makes intuitive sense, it is uncomfortably close to neocolonialism, as several scholars have rightly pointed out (Amavilah, 2011; Van de Sand, 2019; Cao, 2019). Furthermore, it ignores the fact that institutional formation occurs nested in a specific geographic, economic, and cultural context, necessitating local input in the new institutional framework. The institutions

which make Singapore prosperous may not work well in Honduras. Singapore is an entrepot with a highly financialized economy and high population density, while Honduras is a rural and underdeveloped nation with vastly different geographic, cultural, and economic circumstances. As such, having Singapore create institutions for a special jurisdiction in Honduras makes little sense.

Given the power of the special jurisdictions Romer hypothesized to catalyze rapid economic development in underperforming nations, Honduras is a logical place to begin. In 2009, the year Romer gave his seminal talk, Honduras' GDP per capita was a mere \$1,789 and nominal GDP was \$14.5 billion (The World Bank, 2020), or less than two weeks of Amazon's revenue in 2020 (Protalinski, 2020). Perhaps most importantly, Honduras was ranked 133<sup>rd</sup> on the World Bank's Doing Business Index in 2009—a suitable proxy for overall institutional quality (The World Bank, 2009). Given this reality, Honduras seemed an excellent place to launch the first of these special jurisdiction formation efforts.

In late 2010 and early 2011, Romer's talk caught the attention of a group of young reformers in Honduras who had already been considering and developing highly similar ideas organically for well over a decade. One of these reformers, Octavio Sanchez, was Chief of Staff to Porfirio Lobo, President of Honduras at that time. The notoriety of someone of Paul Romer's stature endorsing the concept of special jurisdictions elevated its legitimacy, making possible the passage of legislation enabling the creation of such semi-autonomous zones in Honduras.

Because they had already been working on these ideas for some time, Sanchez and the Honduran reformers were able to act swiftly. By the end of the summer of 2011, the Honduran Constitution was amended and enabling legislation was passed allowing for the creation of the semi-autonomous zones. However, this initial attempt was not meant to succeed. These initial zones, known as Region Especial de Desarrollo (RED Zones), were ruled unconstitutional in 2012 by the Honduran Supreme Court, who cited their

lack of democratic accountability and total exclusion of the Honduran judicial hierarchy, among other concerns (Colindres, 2018).

Undeterred, the Honduran reformers soldiered on, amending the law and its related constitutional amendments to remedy the issues the Supreme Court found with the law. This new system of special zones, known as ZEDEs (Zonas De Empleo Y Desarrollo Económico), are subject to a number of democratic approval mechanisms and possess a judiciary which is integrated into the Honduran judicial hierarchy. These and many other important changes were met with broad support in the Honduran Congress in 2013, with the President of the National Congress and soon-to-be President Juan Orlando Hernandez leading the charge. The ZEDE Constitutional amendments and ZEDE Organic Law were approved by an overwhelming majority of the Honduran Congress, with 102 of 128 deputies voting in support (La Prensa, 2013). The law was immediately challenged on constitutional grounds, but unlike REDs, was found to be constitutional in a unanimous vote of the Honduran Supreme Court.

Given the reputation of Honduras for corruption and impunity, the authors of the ZEDE regime knew they would need to insulate the legal stability of the ZEDE system from the day-to-day affairs of the legislature as much as possible. As such, the ZEDE organic law has three strong elements of legal stability, despite the provision of the Honduran constitution stating that ZEDEs are “subject” to national legislation “in all topics related to sovereignty, application of justice, national defense, foreign relations, electoral matters, and issuance of identification documents and passports” (Constitute, 2020, p.74). First, a two-thirds vote of Congress is required under the ZEDE amendments for any future legislation that would invoke this constitutional provision to amend or otherwise repeal the ZEDE organic law to expand the national laws that currently apply within ZEDEs (Constitute, 2020). Second, Honduras’ treaty obligations to investors in



Kuwait, (La Gaceta, 2014),<sup>11</sup> the United States (United Nations, 1995), and CAFTA member nations (USTR, 2004) guarantee that Honduras will not abrogate the ZEDE program as an obligation of the treaties. Third, CAMP, the Committee for the Adoption of Best Practices, has expressly and by non-objection agreed to comply with such treaty obligations and to resolve disputes concerning Próspera's legal authority by private arbitration, which agreement is enforceable by the promoter and organizer of any given approved ZEDE under CAFTA-DR (Próspera 2019d).

Put differently, substantially amending the ZEDE Organic Law and constitutional amendments in such a way that materially changes the legal autonomy of the jurisdiction requires a 2/3rds majority vote of Congress in a highly partisan legislature, which would then put Honduras in violation of treaties with Kuwait, the United States, and CAFTA member nations, while simultaneously opening the Honduran government up to international litigation on the world stage for rescinding investor protections. The reputational and pecuniary damages this could cause to the Honduran government serve as powerful bulwarks protecting the legal stability of the ZEDE program.

Recognizing the aforementioned importance of autonomy and the ability to “start from scratch,” the ZEDE Organic Law and enabling constitutional provisions create ZEDEs as nested within the Honduran governmental hierarchy akin to municipalities, but with an extraordinary degree of autonomy. Out of dozens of articles that make up the Honduran constitution, the ZEDE amendments provide that only six articles, which pertain to treaties, human rights, and territorial integrity, are fully applicable within ZEDEs (Constitute, 2020). While ZEDEs are “subject to” national legislation in all sovereign matters, the ZEDE organic law, in turn, states that the “only” national

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<sup>11</sup> This treaty was duly signed by public officials from both countries on January 15, 2014, as well as ratified by the Honduran National Congress; the Honduran Committee for Adoption of Best Practices has represented that the treaty is in effect and we are awaiting confirmation of effectiveness from the Foreign Ministry of Kuwait.

legislation that currently applies within the “spatial ambit” of any ZEDE are those concerning national symbols, national territory, and criminal law (La Gaceta, 2013). Thus, all other types of national laws have been impliedly repealed within the jurisdiction of an approved ZEDE by the Organic Law. Therefore, an approved ZEDE is free to adopt governing structures and rules that differ from the national laws of Honduras in most areas of public policy, subject to oversight and approval by CAMP”, which is an independent Honduran agency also established under the ZEDE Organic Law.

## **2. Creating the Próspera ZEDE: The Initial Approval Process**

The journey to the creation of the first ZEDE began in 2016. I (Erick Brimen) founded an investment fund focused on, among other things, funding special jurisdiction projects of the type described herein. I set out not to create a ZEDE or a special jurisdiction, but provide funding for those that existed around the world in the style of a venture capitalist. As such, in searching for investable deals, I was eventually led to Honduras, with its unique enabling legislation, which we later discovered was the most advanced in the world. I initially began conversations with some individuals who were leading very early stage ZEDE efforts within the country, which led to an introduction to CAMP, the body which oversees ZEDes.

After several phone conversations, my business partners and I came to meet with CAMP in Tegucigalpa in the spring of 2016, where they pitched us on Honduras generally and the ZEDE program specifically. This instigated a six month long legal due diligence process with the Honduran government to confirm the “realness” of the ZEDE program, if the Honduran government was credibly committed to it, and what the status of the nascent ZEDE projects were at the time. While this was going on, I was continuing to scour the global for investable special jurisdiction projects, with very few promising leads appearing.

Visiting Honduras, the potential of the nation seemed apparent to me. In my time in Tegucigalpa and on Roatan conducting due diligence, the sheer entrepreneurial spirit of the people I met signaled a massive amount of untapped potential, if only Honduras' institutions would allow it to be unleashed. This realization occurred at the same time we realized how “real” the ZEDE program was, and how advanced the enabling legislation was. The combination of the sheer grit of the Honduran people, the structure of the ZEDE law, and the lack of credible deal flow elsewhere led me to an inevitable conclusion: rather than investing in special jurisdictions, I must focus all my efforts on building the first one here, on Roatan and in Honduras.

This, in turn, changed the tone of our conversation with CAMP. Rather than conversing in the context of a potential investor in other ZEDEs, we began discussing what it would take to create the first real ZEDE. CAMP's requirements were stringent. Among other things, they requested:

- A full master plan with a vision of population, density, industries to target, and more
- Geographic location with proof of land ownership and clear title to property
- Job generation estimates
- Aggregate investment amount from both us and third parties over the coming 10 years
- Proposed institutional structure and governance framework
- Proof of financial means
- Deep KYC and due diligence on shareholders and principal officers

These efforts took several months to develop, from October 2016 to the fall of 2017, and included courting investors, wireframing a best practices-based governance system, contracting and developing master plans and associated business plans, and much more. This

document included a wireframe overview of the governance structure which would later begin the Charter of the ZEDE of North Bay (later changed to Próspera ZEDE). While this early version was bereft of details, it provided enough structure to convince CAMP we were heading in the right direction. Further, given that the jurisdiction was starting from a greenfield site and would not have any population for at least a year, the initial application did not require a fully fleshed out institutional environment, as that would be hammered out with CAMP over the coming year. CAMP was highly responsive and helpful during this time period and throughout the entire ZEDE formation process, responding to queries, reviewing draft versions of the proposal and providing feedback, and generally helping structure the proposal so as to ensure it carried out the original vision of the ZEDE legislation: creating prosperity in Honduras.

All of this culminated in the approval of the then named ZEDE of North Bay on December 29<sup>th</sup>, 2017 (Próspera 2017).

### **3. Building Governance Institutions from Scratch**

With ZEDE approval in place, we turned our attention toward crafting best practices based governance institutions that would rapidly catalyze prosperity and attract investment. Over the course of Q1 2018, we heavily conversed with CAMP on the institutional structure and devoted ourselves almost exclusively to those efforts. Once we exhausted what could be done via phone and zoom calls, we travelled to Roatan to meet with CAMP for extensive in-person work sessions. These work sessions culminated in what is known internally as the Roatan Memo (CAMP 2018). This Memo, signed by key Próspera team members as well as the executive committee of CAMP, laid out the general structure and specific rules for institutional structures which had been negotiated and agreed upon between CAMP and Próspera. At only five pages, it was a short document, but contained both the meat and the guardrails for what would later become the Charter of the ZEDE of North Bay.

The original charter of the ZEDE of North Bay which was borne from the Roatan Memo was approved by CAMP on the 23<sup>rd</sup> of August, 2018, at the Honduran Embassy in Washington, DC. Clocking in at 8,917 words, roughly 1,400 more than the full US Constitution and amendments. After significant suggestions for improvements from a number of international legal and governance experts, the charter was subsequently heavily amended and improved on September 13<sup>th</sup>, 2019. We will first review the charter in its current form as currently applicable within the Próspera ZEDE, then briefly discuss the changes made from the original charter as approved in 2018 to the subsequent revision in 2019.

Próspera as a legal entity was organized shortly after CAMP appointed a Technical Secretary to promulgate rules for the “ZEDE Village of North Bay.” The ZEDE Village of North Bay was created as a special economic zone when an initial parcel of land located just south of the Crawfish Rock village and North of the Carrtera Principal (main road) was registered and incorporated into the ZEDE regime with the approval of CAMP by Honduras Próspera LLC, as promoter and organizer, on December 29, 2017 (CAMP, 2017). On August 23, 2018, as his first act of rulemaking, under the ZEDE organic law, the Technical Secretary promulgated the governing Charter and Bylaws for the establishment of the ZEDE Village of North Bay, the name of which was later changed by amendment to Próspera ZEDE effective September 13, 2019 (Próspera, 2018).

### **3.1. A Public Trust with An Explicit Social Contract**

The legal team which worked on the Charter come from a variety of backgrounds and were well versed in international best practices in governance. As such, the team focused on taking aspects of governance institutions which function well in prosperous jurisdictions around the world and applied those lessons in Próspera, improving upon them wherever possible. The current form of the Charter is not a direct expression of just the Próspera legal team, but has

a strong Honduran influence as well. Not only is the Technical Secretary a Honduran, but each and every word, phrase, and section had to be reviewed and approved by the standing committee of CAMP which oversees the ZEDEs. CAMP's Standing Committee is led by a Honduran, Carlos Pineda, and consists of several other Hondurans as well, Octavio Sanchez and former Prime Minister Ebal Diaz among them. The Standing Committee is comprised only of Hondurans. Ultimately, this was a collaborative and creative effort between Próspera and CAMP that produced the Próspera ZEDE's governance structures as currently enforced.

Próspera's governance structure is designed to function as a public trust with strong checks and balances, as well as the actual and express consent of the governed, human rights guarantees, and eventual democratic participation. This express consent of the governed takes the form of a literal social contract, called the Agreement of Coexistence, which all residents must sign in order to reside in Próspera. This Agreement of Coexistence explicitly commits residents to "knowingly and voluntarily" consent to the governance institutions of the Próspera ZEDE. Próspera is currently represented by a Technical Secretary, whose policy and managerial decisions and rulemaking require the review and approval of a local Council of Trustees. For instance, Ch. 3, Section 2, Article 12 of the ZEDE Organic Law describes the power and authority of the Technical Secretary as encompassing everything from legal representation of the ZEDE, to "managing the administration" of the zone, to "enacting legislation" within the zone, to "issuing resolutions" and "developing plans" for the zone (La Gaceta, 2013). This effectively gives the Technical Secretary near total control over all aspects of the ZEDE's governance, as the National Lawyers' Guild pointed out in a report (2014). This seemingly insignificant point is an illustrative example of how the Próspera legal team worked within the confines of the ZEDE Organic Law to apply international best practices as closely as possible.

It is intuitively clear that having power centralized in one singular figure is not conducive to catalyzing generalized prosperity, which is the ultimate goal of the Próspera ZEDE. As such, the Próspera ZEDE legal team worked with CAMP to develop an alternative

solution that introduces both democracy and a true quasi-legislative body in the Council of Trustees (discussed further below). This was possible because Ch. 3, Section 2, Article 12 of the ZEDE Organic Law also gives the Technical Secretary the power to “appoint ad hoc secretaries to assist in the administration of the ZEDE,” as well as to “establish trusts” (La Gaceta, 2013). Using the combination of these two powers, the Próspera Charter and Bylaws created the Council of Trustees, each of whom is technically an ad hoc secretary, to manage the policymaking process. This simultaneously solved the problem of agglomeration of power by the Technical Secretary, introduced democratic compliance, and powerfully improved the policymaking process in the jurisdiction. This is but one of many examples of how the Próspera team worked within the unique contours of the ZEDE law to create best-practices based governance institutions. (avoid writing in a defending from future critiques tone)

Under the ZEDE Organic Law, local public policies are crafted as “rules” by Próspera’s Technical Secretary, with the approval of its Council of Trustees (and, in most cases, also with the review and approval of CAMP). Actual consent of the governed to these rules is secured in Próspera through the use of “Agreements of Coexistence” in which natural person or legal entity residents (both physical or e-residents) contractually agree to being governed by Próspera, to secure a minimum level of general liability insurance, and to resolve all civil disputes by private arbitration in exchange for competent municipal services, access to e-governance services, and, in the case of physical residents, legal stability guarantees by Próspera that future rules will not adversely impact them.<sup>12</sup> Natural person e-governance fees that must be paid when entering into a physical residency contract range from \$260 for Honduran nationals to \$1,300 annually for non-Hondurans. E-resident fees for any person or entity as well as legal entity e-governance fees are \$130.00 annually. Agreements of

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<sup>12</sup> Legal stability guarantees are reserved to physical residents to encourage permanent residency, as additional consideration for greater tax liability exposure, and to protect residents who, as a class, have the greatest stake in Próspera public policy. See ZEDE, 2020 and Próspera, 2019.



coexistence for temporary income earners require payment of an e-governance fee of \$10 for each ten-day period. No fee is charged to visitors under their agreement of co-existence.

The reasoning behind these Agreements of Co-existence is straightforward. Honduras has a history of governmental oppression and land appropriation, forcing citizens into circumstances they would have never chosen voluntarily (Edelman & León, 2013). In particular, Honduras has been accused of using their expropriation power to forcibly take land for the purposes of creating a ZEDE in other areas of Honduras, which would mean citizens are being forced into a new governance regime they did not voluntarily choose. As such, Próspera ensures up front that any resident of Próspera has expressly and voluntarily consented to the governance structures therein prior to joining the jurisdiction. It is, in the purest sense, a mechanism for ensuring consent of the governed within the jurisdiction.

### **3.2. The Composition of the Próspera Council of Trustees**

The ZEDE organic law authorizes the Technical Secretary to “[e]stablish trusts for the provision of all services, revenue management, procurement, property management, and other functions” (La Gaceta, 2013). Accordingly, as promulgated by the Technical Secretary, the Próspera Charter establishes a Council of Trustees as a public trust vested with governance authority alongside the Technical Secretary.

There are nine seats on Próspera’s Council of Trustees, one of which is filled by the Technical Secretary. To reinforce the governance power-sharing between the Office of the Technical Secretary and the Council of Trustees, the trustees holding the remaining eight seats on the Council have also been appointed as “ad hoc” Technical Secretaries pursuant to the Technical Secretary’s authority to “appoint ad hoc secretaries” under the ZEDE organic law, which is not conditioned on such ad hoc secretaries having Honduran nationality (La Gaceta, 2013).

The Council of Trustees includes members designated Council Treasurer and Council Secretary. The Council Treasurer is responsible for financial tracking, reporting and

overseeing audits. The Council Secretary certifies the official record of proceedings, acts as revisor of rules for publication, and must be present for quorum of the Council to exist in all but emergency circumstances. Council members serve seven-year terms. Currently, seven of nine Council seats have been filled. The Technical Secretary and Council of Trustees currently meet publicly on every 2<sup>nd</sup> and 4<sup>th</sup> Thursday of each month.<sup>13</sup>

The composition of the Council of Trustees is designed initially to align incentives with the rapid development of Próspera consistent with the vision of its promoter and organizer, but it will eventually transition to invite robust democratic engagement by residents. One seat is reserved for the Technical Secretary who is appointed by CAMP. The promoter and organizer is entitled to appoint the occupants of four seats. Any resulting conflict of interest can be resolved by outside expert review for commercial reasonableness (Próspera, 2018).

During a transitional phase, landowners are entitled to appoint the occupants of the remaining four seats; however, once urban population density is reached, residents will have the right to appoint occupants of those four seats. Moreover, once the population of Próspera reaches 1,000 natural person residents, CAMP is entitled to appoint an ombudsman to oversee compliance with governing law and the “Resident Bill of Rights,” which is a guarantee of liberties for residents that is closely modeled after the Bill of Rights of the United States; and so long as there are at least 1,000 natural person residents in Próspera, residents have the right to replace the ombudsman by referendum (Próspera, 2018). Further, once the natural person population of residents in Próspera reaches 10,000, then all rules will be subject to repeal by referendum of natural person residents.

This last point is crucially important. While Próspera has worked hard to ensure that the incentives of all council members are aligned with the prosperity and wellbeing of the residents of the jurisdiction, no system is perfect. If, by some series of unfortunate events, a

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<sup>13</sup> All meeting minutes and publications can be viewed at <https://pzgps.hn/>.

counterproductive rule were passed by the council, approved by CAMP, and not found to violate the Charter and Bill of Rights, then residents still have one inviolable fail-safe option to effectively veto that rule via a direct popular vote. Equally as important, it shields direct proactive legal action from the negative influences of a potential mob mentality and all of the incentives at play when proactive referenda are introduced. Professor Tom Bell calls this “corrective democracy,” and it is a crucial governance innovation introduced in Próspera (Bell 2018).

Furthermore, once high population density is reached, residents will have the right to nominate the Technical Secretary, subject to approval by CAMP (Próspera, 2018 Section 4.03(3)). Lastly, if a charter amendment referendum has not been sooner authorized by the Council of Trustees, Próspera’s charter may be amended by referendum at the initiation of the ombudsman at any time after 2054 (Próspera, 2018).

The focus of this structure is the proper alignment of incentives. No matter how strongly worded or tightly constructed a constitution and bill of rights may be, public choice theory shows that special interest groups and internal incentives will not always be aligned with the well-being of the residents of the jurisdiction in question, which in turn leads to a whole host of bad outcomes—from logrolling and pork barrel legislation, to short term focus and excessive special interest group influence (Buchanan & Tollison, 1984). At its core, this is the result of the misalignment of incentives between legislators and those who they represent. Legislators have a strong incentive to take actions which maintain their position of prestige and power as a legislator, shifting their focus to being re-elected—an incentive which can corrupt, in small and sometimes unnoticeable ways, even the most implacable of legislators.

The structure of the Próspera Council of Trustees was specifically designed to solve this dilemma described by public choice theory. Four of the nine Trustees are appointed by the “Promoter and Organizer” (P&O) of the ZEDE—in this case, Honduras Próspera Inc. As mentioned previously, the Próspera ZEDE began as a total greenfield site, devoid of any

residents at the time of ZEDE formation. The Promoter & Organizer currently owns all of the land within the jurisdiction, and expects to maintain a high level of land ownership in order to internalize the positive externalities of good governance. However, the process of land appreciation via catalyzing general prosperity takes considerable time—decades or more.<sup>14</sup> Furthermore, the Promoter & Organizer can only profit from its landownership and jurisdiction formation efforts if the jurisdiction does, in fact, become prosperous. The appointment of four councilmembers by the P&O ensures this long-term view has a strong presence on the council without the short-term incentives created by democratic influences (Katz, 2014). However, recognizing the importance of democratic representation, five of the nine councilmembers will be elected—balancing short term and long-term incentives at the council level.

### **3.3. Rulemaking in Próspera**

As indicated previously, the first rule of Próspera was its original August 23, 2018 charter, which was promulgated by its Technical Secretary with the express approval of CAMP and later amended and restated. Under the current Próspera Charter, rules can be created in five different categories, with each controlling of the next in the following order: (a) charter provisions/ amendments; (b) statutes; (c) regulations; (d) ordinances; and (e) resolutions (Próspera, 2018). All local rulemaking requires promulgation by the Technical Secretary with the prior approval of two-thirds of the Council of Trustees (a lower threshold may apply temporarily in emergency circumstances). Such promulgation and approval may be accomplished by public in-person or electronic meetings or by electronic vote.

This two-thirds vote threshold is crucially important. With five of the nine council members elected, and four of the nine appointed, this two-thirds majority ensures that

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<sup>14</sup> Consider the decades it took Singapore to become prosperous, or the 20 years it took Shenzhen to reach developed country GDP levels.

neither the short-term-focused elected council members nor the long-term-focused appointed councilmembers can unilaterally enact rules without at least one or two members of the other group consenting. This is a forced conciliation measure, ensuring neither short term nor long term interests dominate the council, and ensuring neither the P&O nor the entire polity dominate the rulemaking process.

After promulgation by Próspera, CAMP review and approval is required for all Próspera rules (other than ordinances and resolutions). The Próspera Charter expedited this approval process (with CAMP's approval) by deeming all promulgated rules as approved by CAMP unless, after they are presented for CAMP's review, they are disapproved by CAMP within various deadlines (ranging from 15 to 60 calendar days after presentment) (Próspera, 2018). After approval by all relevant bodies, Próspera's rules are effective once published at <https://pzgps.hn/>. As of April 9, 2020, Próspera had promulgated 93 rules under the authority of its Charter.

This CAMP review process is an important facet of rulemaking in the Próspera ZEDE, and was extensively negotiated with CAMP. This aspect ensures constant oversight of the ZEDE by the central Honduran government, and permits third party validation and input in the rulemaking process. If CAMP vetoes a rule, it is amended per CAMP's guidance, voted upon again, and re-submitted for approval. This process acts as yet another check on the rulemaking powers of the Council.

Significantly, the Próspera Charter envisions the possibility of third parties establishing special districts within its boundaries by local rule (Próspera, 2018). Subject to certain minimum standards (to guard against the abuse of power), these districts are designed to operate under as much or as little of the general Próspera legal framework as they wish to adopt. The concept behind the special district authority is to enable entrepreneurs, perhaps future ZEDE promoters and organizers, to experiment with different governance models safely within the already established and tested Próspera "sandbox" environment.

Crucially, these districts must comply with the entirety of the Bill of Rights as well as a few other rights-protecting provisions of the Charter. While no special district has yet been initiated, the Próspera legal team envisions these as being an internally competitive force for the Próspera Council. If a special district is formed in which residents find the governance and rules superior, then residents can “vote with their feet” by shifting into that jurisdiction instead, consistent with the geographical locality necessary to make the Tiebout Theory function well as a mechanism to optimally distribute public goods (Banzhaf & Walsh, 2008). In this way, special districts apply further competitive pressures to the Próspera ZEDE to ensure an omnipresent alignment of incentives between ZEDE-level governmental action and the generalized well-being of the residents therein.

It should be noted that per CAMP regulations and Próspera Council regulations, expropriation of any land for the purposes of expanding the jurisdiction of the Próspera ZEDE is expressly forbidden under any circumstances (Próspera 2020).

### **3.4. Administration of Rules**

Relative to administering local public policy and rules, Próspera retains direct control over core criminal law enforcement and investigative services and delegates the handling and disbursement of its finances to the Próspera Trust.<sup>15</sup> However, in accordance with public-private-partnership best practices, Próspera outsources the administration of all other local public policies to a General Service Provider, which is currently North Bay GSP, Inc., the first Próspera ZEDE corporation (Próspera, 2019g).<sup>16</sup>

More specifically, the General Service Provider is responsible for furnishing standard municipal services, including e-Governance systems and associated registries of property, persons, and legal entities, as well as tax and fee assessment and collections in coordination

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<sup>15</sup> This is a second independent trust in the nature of an escrow, see Próspera, 2018, Sections 5.01, 10.01, 10.02.

<sup>16</sup> See also Próspera, 2018, Sections 2.04(15), 2.05, 3.09(5), 5.01(3), 7.01, 7.02, 7.03).

with the Próspera Trust escrow services (Próspera, 2019g). Próspera has also promulgated a Civil Penalty Statute under which the promoter and organizer and the General Service Provider have supplemented residency agreements with side letter commitments to avoid engaging in the civil law equivalent of criminal behavior (battery, assault, fraud) or be subject to paying substantial civil penalties (this civil penalty authority is necessitated during the current phase in which criminal law enforcement has not yet been established within the ZEDE) (Próspera, 2019j). Additionally, the General Service Provider is responsible for furnishing the default Arbitration Service Provider, currently Próspera Arbitration Center LLC, which serves as the core civil dispute resolution institution for Próspera. Próspera is currently contracting with Jacobs Engineering, a firm with extensive experience in city management, to manage and scale these operations (Jacobs, 2020).

### **3.5. Adjudication of Rules**

Under the ZEDE Organic Law, all commercial disputes arising within the jurisdiction of a given ZEDE are required to be resolved by private arbitration before resorting to the public court system (La Gaceta, 2013). In Próspera, this important legal requirement is addressed by Próspera's default Arbitration Service Provider, which serves by local rule both as the requisite private arbitration forum for commercial disputes mandated by the ZEDE organic law, and also as a general civil dispute resolution institution for Próspera residents as set forth in their standard residency agreement.

Currently, Próspera Arbitration Center LLC ("PAC") has been hired by the General Service Provider to furnish such arbitration services. The PAC is organized to provide a wide range of dispute resolution services through "Senior Judges" consisting of experienced retired Arizona State Supreme Court, appellate court, and trial court judges, "Judges" consisting of international legal scholars and accomplished litigators, and "Judicial Officers," who are dispute resolution professionals overseen by Senior and Judges. Some of these judges include:



- Judge John Gemmill, former Arizona Court of Appeals Judge
- Judge John Pelander, former Arizona Supreme Court Justice
- Judge Kenneth Mangum, former Arizona Superior Court Judge
- Judge Martin Klapper, Senior Partner at HopgoodGanim
- Judge Illya Shapiro, leading constitutional law scholar and head of the Robert A. Levy Centre on Constitutional Studies

Insofar as the PAC serves only as a “default” Arbitration Service Provider, the parties to any dispute are not contractually bound to use the PAC remain free to contract to use a different service. Unless the parties elect to bypass the default Arbitration Service Provider by contract, or otherwise opt for private arbitration or mediation conducted by the PAC (which involves an additional fee), the default Arbitration Service Provider is required by local rule to generate public precedent in the interpretation and application of Próspera law (Próspera, 2019e). This is a critical component of building out the rule of law within the Próspera common law legal system.

The precedential nature of the Próspera Arbitration Center’s rulings is another key governance innovation within Próspera. It is well known that arbitration is generally a faster and cheaper alternative to public courts, especially in a jurisdiction such as Honduras where the average time to resolve a case is 20 months. For many proceedings, the Próspera Arbitration Center is required by law to resolve a dispute in 60 days or less (IACHR, 2019).

The General Service Provider is required to operate the property, personal and legal entity registries in compliance with decisions of the default Arbitration Service Provider, and may suspend or revoke access to the same upon direction of a court, the arbitral tribunal or otherwise as a peaceful common law “self-help” enforcement measure to incentivize

compliance with Próspera rules and residency agreements (subject to judicial review by the default Arbitration Service Provider or ZEDE court system).<sup>17</sup>

### 3.6. A Deeper Dive into the Property, Personal and Entity Registries

Among the three registries furnished by the General Service Provider on behalf of Próspera, only the property registry is available in all of its functionalities to the general public. The property registry currently consists of a repository for all recordings relative to land titles within the boundaries of Próspera. To predictability and reliability, the land title registry division of the property registry is governed by Torrens principles adapted from New Zealand and Australian statute law. Accordingly, what is maintained in the registry will be presumptively dispositive of the condition of titles and related legal rights in Próspera. Personal property and vehicular registries are divisions of the property registry by local rule.<sup>18</sup>

The personal and legal entity registries are generally accessible only by and to existing residents of Próspera, and are also linked to the e-governance application processes necessary to become a resident of Próspera. The application process for residents (other than visitors) entails a background check that requires a copy of a passport or other official identification, proof of current national residency, as well as “know your customer” reviews of leading international criminal and sanctions databases. All residents of Próspera are assigned an identification number (designed to be compatible with the RTN numbering system of wider Honduras) when accepted for residency. If a resident is engaged in a “regulated industry”

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<sup>17</sup> See Próspera 2019e, *see also* Próspera Land Title Law 2019, <https://pzgps.hn/2-codification-codificacion-§§2-1-22-1-0-0-1-thru-2-1-22-5-12-0-135-land-title-law-2019/>; Próspera Entity Registry Statute (Section 4(e), <https://pzgps.hn/11-codification-codificacion-§§2-1-43-0-0-0-1-et-seq-prospera-entity-registry-statute-estatuto-del-registro-de-entidades-de-prospera/>); Próspera Personal Registry Statute, (Section 4(d)) <https://pzgps.hn/12-codification-codificacion-§§2-1-44-0-0-0-1-et-seq-prospera-personal-registry-statute-estatuto-del-registro-de-personal-de-prospera/>

<sup>18</sup> The land registry division of the property registry is currently available online at <https://prospera-sure.hn/>, accessible with the following credentials: username/password: public/publico.

and has opted to operate under the regulatory framework of Honduras, one of the various OECD countries reciprocally recognized in Próspera, or a petitioned-for/tailored Próspera regulatory rule (discussed in detail below), that fact must be disclosed by filing an appropriate informational statement in the relevant registry.<sup>19</sup>

The personal registry is predominantly a repository of residency agreements and related information for natural persons, including physical residency agreements, e-residency agreements, visitor agreements, and temporary income earner agreements, as well as associated general liability insurance agreements and public arbitration outcomes arising from the use of the default Arbitration Service Provider. The legal entity registry is, likewise, a repository of resident agreement-related information for legal entities; but it is also, importantly, an e-governance service whereby, for a reasonable fee, nearly all popular and internationally-recognized legal entities can be organized, maintained, and redomiciled within Próspera (after securing a relevant residency and liability insurance). This includes limited liability companies, corporations, statutory trusts, limited partnerships and more (Próspera, 2019). The privacy of retained applicant and resident data is maintained in accordance with Próspera rule; each resident's "regulated industry" election, permitting status, and public precedential arbitration outcomes arising from the decisions of the default Arbitration Service Provider will be made available to all residents, as well as the general public upon request.

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<sup>19</sup> For more details on industrial regulations, see ZNB Industrial Regulation Statute (Section 3(a)(iii)), <https://pzgps.hn/5-codification-codificacion-§§-2-2-28-0-0-0-1-through-2-2-28-0-0-0-7-znb-now-prospera-industrial-regulation-statute-znb-ahora-prospera-estatuto-de-regulacion-industrial/>, amended by Amendment to Industrial Regulation, <https://pzgps.hn/9-codification-codificacion-§2-2-41-0-0-0-1-enactment-of-amendments-to-znb-industrial-regulation-statute-§2-2-28-0-0-0-2ni-ii-and-7a-b-promulgacion-de-enmiendas-al-estatuto-d/>, Amendment to Industrial Regulation, <https://pzgps.hn/15-codification-codificacion-§§2-1-55-0-0-0-1-et-seq-promulgacion-de-enmiendas-al-estatuto-de-regulacion-industrial-del-znb-§2-2-28-0-0-0-0-2l-enactment-of-amendments-to-znbs/>, and PZ Roll Call Form-Amendment to Industrial Regulation Statute, <https://pzgps.hn/19-codification-codificacion-§§2-2-71-0-0-0-1-et-seq-enactment-of-amendment-to-znb-industrial-regulation-statute-§2-2-28-0-0-0-2ni-promulgacion-de-la-enmienda-al-estatuto-de-r/>.

### 3.7. Próspera's Tax and Regulatory Framework

Próspera's tax and regulatory framework is designed to optimize the conditions needed to generate prosperity based on international best practices. The tax system consists exclusively of three tax types established by local rule: (1) a flat income tax on income earned within Próspera only; (2) a retail value added tax on sales within Próspera; and (3) a land value tax on property within Próspera (ZEDE, 2013).<sup>20</sup> The regulatory system is best characterized as minimally prescriptive—most regulation in Próspera consists of legal accountability under the common law and measures intended to enhance the effectiveness of such accountability, such as mandatory liability insurance requirements, which is enforceable in the PAC or ZEDE court system by the promoter and organizer, General Service Provider and residents (Próspera, 2020c).

#### 3.7.1. The Nuts and Bolts of Taxation in Próspera

The General Service Provider currently furnishes personnel serving as Tax Commissioner. The tax system is presumptively based on the calendar year. Payment is due to the Próspera Trust on April 1<sup>st</sup> of each calendar year or as otherwise may be specified for the applicable tax year by notice of assessment from the Tax Commissioner. Significantly, on the latter of January 1, 2030 or the date the population of natural person physical residents exceeds 50,000, all tax revenues will be subject to an aggregate cap of 7.5% of gross domestic product, with any excess refunded to taxpayers pro rata in proportion to their contribution (La Gaceta, 2013). Similarly, to minimize the risk of indirect pressure to tax excessively, beginning on

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<sup>20</sup> For detailed tax information, see also Próspera Tax Statute, <https://pzgps.hn/8-codification-codificacion-§§2-1-38-1-0-0-1-through-2-1-38-12-12-0-136-prospera-tax-statute-2019-estatuto-tributario-de-prospera-2019/>, as amended by §2-1-51-0-0-0-1, <https://pzgps.hn/13-codification-codificacion-§§2-1-51-0-0-0-1-et-seq-enactment-of-amendments-to-tax-statute-2019-§§2-1-38-10-0-0-701-3-4-711-731-promulgacion-de-las-enmiendas/>

the latter of January 1, 2030 or the achievement of urban population density, Próspera will be subject to a debt limit of the greater of 105% of the nominal amount of the then-outstanding debt or 20% of the 5 year trailing average of annual GDP within Próspera (La Gaceta, 2013).

### ***3.7.2. Income Taxes in Próspera***

Próspera's statutory income tax is designed to be incapable of easy evasion or abuse, and is imposed in lieu of any income taxation otherwise authorized by the Próspera Charter or the Honduran national government. For natural person income, 50% of revenues (what would be called "gross income" under the U.S. Internal Revenue Code) earned within Próspera is deemed "presumed income" subject to the statutory tax rate of 10% (also capped at the same rate by the Próspera Charter) (Próspera, 2018). For legal entities, 10% of all revenues earned within Próspera is deemed presumed income subject to the statutory tax rate of 10%. The Próspera income tax is thus effectively a 5% gross income tax on natural persons and a 1% gross income tax on legal entities. To avoid double taxation, income tax paid by a legal entity is credited against the income tax that would be owed by that entity's owner in proportion to that owner's ownership interest. There is no withholding requirement for Próspera residents. But if income is earned within Próspera by non-residents, the payor must withhold on a monthly basis 10% of 50% of revenues earned within Próspera during the immediately preceding month (effectively 5% of gross income earned within Próspera in the immediately preceding month), and such amount must be deposited with the Próspera Trust within 15 days after the end of each month.

This particular Charter provision involved extensive negotiations with CAMP. In line with the broad economics literature, Próspera's initial intention was to create a strong Land Value Tax (LVT), and Value Added Tax (VAT), and nothing else. However, CAMP was concerned the lack of an income tax would create issues with the national government and

potentially result in Próspera being officially on the European Union's Tax Haven Blacklist. This was despite the fact that Próspera could demonstrate substantial revenues from the simple combination of a higher LVT and VAT, and the wealth distribution impacts of the VAT in particular along with the positive incentives created by the LVT (Maxwell and Vigor 2005). As such, at the behest of CAMP, Próspera adopted the income tax system described above.

### ***3.7.3. Retail VAT and LVT in Próspera***

The Próspera retail value added tax is 5% of the retail value add, which is deemed 50% of the final retail sales price (the rate of any VAT is capped at 5% by the Próspera Charter) (Próspera, 2018). This is effectively a 2.5% sales tax on all retail goods and services within Próspera. The land value tax rate is 1% of land value (the rate is capped at 2.5% by the Próspera Charter), which may be fixed by the Tax Commissioner based on the taxpayer's choice of any of the following methodologies: (1) recent sale of the property in question; (2) a recent professional appraisal supplied by the taxpayer at the taxpayer's cost; (3) the sales price specified by the taxpayer at the beginning of the relevant tax year in a standing option to sell the property which must be registered publicly in the Próspera property registry at the beginning of the relevant tax year and remain binding capable of acceptance by any third party without rescission for the entire tax year, subject only to a leaseback of improvements for 20 years (on such forms as the Tax Commissioner may provide); and (4) a default valuation based on a reasonable methodology adopted by the Tax Commissioner.

### ***3.7.4. Tax Exemptions and Credits in Próspera***

An exemption from any or all of these taxes can be requested if demonstrably necessary (and only to the extent necessary) for Próspera to compete with another tax jurisdiction, as determined either by local rule or the Tax Commissioner and set forth in a legal stability agreement. If granted, the exemption must be written in general and uniform terms to apply



and be available to all similarly situated taxpayers. Finally, under a variety of programs which Próspera may offer from time to time, marketable tax credits may be purchased by taxpayers directly from Próspera (or from holders of previously issued marketable tax credits), whereby between \$1.1 and \$5 of marketable tax credits can be bought for each \$1 paid to Próspera to purchase the credit (Próspera, 2018).<sup>21</sup> This provides for a mechanism by which the Próspera ZEDE can fund public works projects in the short term by providing a tax break in the long term for firms operating within the jurisdiction. Crucially, these marketable tax credits are legally allowed to be traded on the secondary market, potentially creating a market for these dependent on the expected future success of the jurisdiction.

### 3.8. How Próspera Regulates

Próspera's regulatory system consists of ten major public policies: (1) adoption of U.S. common law and uniform commercial code principles as the baseline source of legal rights and obligations (Próspera, 2019); (2) adoption of model U.S. business codes as the baseline source of legal entity formation and maintenance authority; (3) decentralized land use regulation; (4) codification of best practices in tenant eviction and mortgage proceedings (Próspera, 2019b)<sup>22</sup> (5) reciprocity for Honduran and major OECD country regulation of typically "regulated industries" or, alternatively, tailored local rule regulation or enhanced common law liability in such industries (Próspera 2019g); (6) optional permitting to confirm Próspera's exclusive regulatory jurisdiction (Próspera, 2019d); (7) ecological protection of

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<sup>21</sup> For more details about tax credits, see Próspera Marketable Tax Credit Resolution (Type 1), <https://pzgps.hn/prospera-marketable-tax-credit-resolution-resolucion-sobre-el-credito-fiscal-negociable-de-prospera/> and Próspera Marketable Tax Credit Resolution (Types 2 and 3), <https://pzgps.hn/resolution-approving-marketable-type-2-and-3-tax-credit-offerings-resolucion-por-la-que-se-aprueban-las-ofertas-de-creditos-fiscales-tipo-2-y-3/>.

<sup>22</sup> See also §2-3-29-0-0-0-1, et seq., Landlord Tenant Statute, <https://pzgps.hn/6-codification-codificacion-§§2-3-29-0-0-0-1-enactment-of-the-znb-landlord-tenant-statute-promulgacion-del-estatuto-de-arrendador-inquilino-del-znb/>, amended by §2-3-42-0-0-0-1, <https://pzgps.hn/amendment-to-prospera-landlord-tenant-statute-enmienda-al-estatuto-prospera-de-propietario-inquilino/>



Roatan's world class coral reefs (Próspera, 2019i); (8) hazardous condition and activity regulation; (9) labor regulations concerning minimum wages, employer benefits, and unions (Próspera, 2020d); and (10) mandatory minimum liability insurance requirements for regulated industries. These policies maximize individual freedom while enforcing the personal and social responsibility required by best practices as well as Honduran and international law.

### ***3.8.1. The Bedrock***

Inspired by the innovative “Ulex” code developed by Professor Tom Bell of Chapman University Law School, the “Roatan Common Law Code” is the name given to the Próspera rule adapting common law and uniform commercial code principles from certain of the American Law Institute’s restatements and the U.S.-based Uniform Law Commission’s model commercial codes (Próspera, 2019a). They establish liability for personal injuries, contractual breach, and property rights violations, as well as family law governing adoption and inheritance; all subject to interpretative first principles expressly favoring freedom of contract and self-responsibility. The business codes governing the formation and maintenance of legal entities are largely adapted from model legislation published by the American Bar Association. Taken together, the legal principles and mechanics adopted by the “RCLC” form the bedrock of the Próspera regulatory framework and should be very familiar to investors who do business in any common law country, such as the United States, Canada, the United Kingdom and Australia.

### ***3.8.2. Decentralized Land Use Regulation***

Inspired by the regulatory environment of Houston, Texas, land uses are not regulated by zoning laws in Próspera. Instead, the promoter and organizer is establishing a system of decentralized land use regulation by leveraging the RCLC and Próspera’s innovative Land Title Law. This decentralized regulatory system is premised on an initial framework of

covenants, conditions and restrictions that are recorded against title to all real property within Próspera. Included among this initial set of “CCRs” is authority for attaching and severing certain air space rights, pollution exclusion rights, and development rights in connection with the use of real property, separate title to which is recognized by Rule. (Próspera, 2019f). In essence, coordinated by Próspera’s e-governance platform, landowners and entrepreneurs will be able to buy, sell and trade the right to occupy or exclude the occupation of air spaces, the right to emit or exclude noises and other noxious pollutants, and the right to build or not to build to certain densities. Very much like development rights are currently traded in Manhattan, this will allow for voluntary trade and the market to coordinate the ultimate use of land within Próspera, subject to rules against trespass and nuisance under the RCLC, which will certainly tend to ensure the highest and best use of land will prevail.

### ***3.8.3. Commercial, Industrial and Financial Regulation***

The Landlord-Tenant Statute and Mortgage Foreclosure Sale Statutes are adapted from statutes of Texas and dozens of other U.S. states. The former statute is a default set of rules for eviction proceedings which require clear and fair notice for evictions, peaceful self-help, and remedies for abuse of process (Próspera, 2020b). As a default setting for leases, the parties to a lease can freely displace its provisions by contrary agreement.

The mortgage statute implements a non-judicial mortgage foreclosure process that the Federal Reserve credits with significantly increasing access to loanable funds (Pence 2003). Essentially, the statute provides that mortgages containing power of sale clauses will authorize the lender on breach to retain a trustee to conduct a public sale of the property without court action or engaging the default Arbitration Service Provider. The defaulting debtor can only respond by redeeming the debt, purchasing at auction or suing for fraud. The time frame for conducting the non-judicial sale is 45 days after notice, allowing the debtor an

opportunity to redeem the debt before the property is sold, up to 30 days after notice of default.

The Industrial Regulation Statute is the rule that implements reciprocity for Honduran and major OECD country regulation of what are deemed “regulated industries,” namely, the Finance and Insurance Industry, Energy Industry, Manufacturing Industry, Mining and Subsurface Industry, Waste Management Industry, Health Industry, Food Industry, Construction Industry, and the Agricultural Industry (Próspera, 2019g). Covered persons engaged in “regulated industries” are prohibited from engaging in any activity that could cause personal injury, breach of contract or property rights violations, as defined by the Roatan Common Law Code. If this prohibition is violated, any resident may seek injunctive relief in the default Arbitration Service Provider or ZEDE court system against the regulated person to remedy the prohibition, as well as seek treble damages for any resultant injury and litigation expenses. Any limited liability enjoyed by a shareholder, board member or officer of a legal entity is pierced to the extent of their investment or previous year’s compensation. However, the regulation provides two safe harbors from such exposure (reducing it to standard 1x common law liability).

The injunctive relief provision is worth focusing on in more detail. Within Próspera, any resident has the legal right to sue any other firm found to be violating its elected regulatory code and receive the damages and fines which would result from a ruling in the Próspera Arbitration Center in favor of the plaintiff. Essentially, every resident of Próspera has the legal right to enforce the legal and regulatory code of Próspera on all other firms. A loser-pays rule applies to prohibit frivolous or excessive litigation. This decentralized regulatory regime was created specifically to simultaneously prevent a large, economically costly regulatory force from forming at the governmental level as has happened in the US and elsewhere at great cost to the global economy, while also ensuring all rules, regulations, and statutes are being complied with to the highest degree possible (Coffey, McLaughlin, & Peretto, 2016). Of course, the Próspera ZEDE retains the right to enforce regulations as well,

but expanding the pool of potential enforcers to the entire population ensures that both regulations will be enforced and the incentive for budget-maximizing governmental entities to putatively enforce regulation is reduced because they are now in a competitive rather than monopolistic enforcement environment (Niskanen, 1994).

Under the first safe harbor, the regulated person can essentially elect to seek reciprocity for outside regulation by electing within Próspera to comply with the governing regulations of Honduras or any of the following “Best Practice Peer” countries: Australia, Austria, Belgium, Canada, Chile, Denmark, Dubai, Estonia, Finland, France, Germany, Hong Kong, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Singapore, Spain, Sweden, Switzerland, United Kingdom, and United States of America (which election must be filed in the relevant registry for public view and guaranteed in all relevant contractual undertakings within Próspera).

Under the second safe harbor, the regulated person can petition the Technical Secretary and Council of Trustees to adopt a rule creating a tailored regulatory environment, accessible to all similarly situated regulated persons, during the pendency of which enhanced liability exposure is suspended, and, upon promulgation, good faith compliance yields a complete defense to enhanced liability exposure. Under this same statute, only licensed members of certain professions, such as doctors or lawyers, may use those terms to market themselves irrespective of their regulatory election.

Próspera recognizes that officials and agencies of the Honduran national government and local governments, or even international agencies or bodies, may attempt to exert regulatory jurisdiction within its boundaries. Accordingly, as a complement to the Industrial Regulation Statute, Próspera has adopted a permitting resolution that allows regulated persons to declare their regulatory election and also clearly invoke the exclusive regulatory authority of Próspera within its boundaries (Próspera, 2019d). Such permitting is intended to minimize the risk of interference by outside agencies that wrongly claim regulatory

jurisdiction within Próspera. Permitting is thus prudent and highly recommended, but optional. Related fees for most permit types range between \$50 and \$200.

In addition to the Industrial Regulation Statute, special protection is given to the irreplaceable coral reef surrounding the Island of Roatan. The Coral Reef Protection Statute currently provides that any activity that tends to damage coral reefs is prohibited and subject to civil liability by suit brought before the default Arbitration Service Provider for the cost of remediation, injunctive relief, and litigation expense shifting (Próspera, 2019i). A committee of local residents and experts is being organized by Próspera to review international best practices and adopt a safe harbor regulatory framework for permitting coral-threatening or damaging activities. Similarly, the Hazard Precaution Statute regulates activities and conditions that represent an existential threat or risk to public health, safety and the political stability of Próspera, such as radiologics, biohazards, hazardous waste disposal, precursors to illegal drugs, and human cloning; subject to the right to secure a no-action letter from the General Service Provider or Próspera Council, or confirmation of an exemption from the Hazardous Activity Division of the default Arbitration Service Provider (decided within 60 days of an application) (Próspera, 2020e).

The Próspera Labor Statute implements governing Honduran constitutional and treaty obligations relative to international labor standards and human rights in the most efficient and fair manner possible (Próspera 2020d). The Labor Statute recognizes the right of employees to organize in a union and peaceably strike as well as the right of employees not to be unconscionably forced to join a union. Further, the statute requires a labor division to be established in the default Arbitration Service Provider to handle labor disputes. It establishes a minimum wage equal to 110% of the general Honduran minimum wage. It requires the employer to pay overtime equal to 125% of base compensation for hours worked by covered employees above 48 or days worked in excess of 6 in a week. And it requires employers to fund a trust account with an amount equal to 8% of a covered employee's salary, which the employee has the right to invest, retain for retirement and permanent disability,

or spend on medical, educational, housing and legal expenses. At the same time, family and small business employees, interns and entry level hires are deemed non-covered employees to mitigate the commonly recognized negative economic impact on overall employment from the minimum wage and enhanced compensation requirements.

These minimum wage provisions were not a result of central government pressure upon Próspera, but rather are voluntarily adopted provisions. Próspera chose to do this for a simple reason: anyone working in the Próspera ZEDE should be demonstrably and clearly better off working and living in the Próspera ZEDE than anywhere else in Honduras. This provision was a simple way to demonstrate and enforce that claim in law.

#### ***3.8.4. The Capstone: General Liability Insurance***

As the capstone of financial accountability to buttress the regulatory principles of the foregoing rules, Próspera also adopted the Financial Responsibility Statute (Próspera, 2020c). This rule requires residents and regulated industry persons to secure general liability coverage for awards of the default Arbitration Service Provider. To ensure the maximum cost associated with compliance is known in advance, the statute imposes a maximum premium for any mandatory coverage, such as a cap of \$260 per year for residents. The specific limits and coverage requirements are determined by the Financial Responsibility Resolution, and range from \$20,000.00 to \$3,000,000 USD annual loss limits depending on the industry involved (Próspera, 2020d). Such insurance can be purchased freely from any insurance company willing and able to do business in Próspera (to qualify to offer mandatory insurance within Próspera, insurance companies will need to maintain a minimum level of capital reserves and reinsurance to cover issued policies). The General Service Provider or, if none, Próspera, will offer liability insurance as the insurer of last resort; and is authorized to make the market by adjusting terms otherwise required by Rule, which can then be adopted by any other insurance company.

Recall that Próspera's regulations are enforced in a decentralized manner. This general liability insurance requirement is an express requirement that all residents and businesses have insurance able to cover adverse rulings as a result of that decentralized regulatory enforcement. It completes the other side of the regulatory enforcement equation: that enforcement is decentralized and therefore abundant, while the ability to pay is legally required for all residents and firms.

### **3.9. E-Governance System**

Próspera is implementing all of the above via an E-governance platform, to be known as E-Próspera. This system will electronically administer all of the ZEDE's various administrative and governance responsibilities, from registries to company formation and taxation. The system is based upon the Estonian government's E-governance system, and Próspera has brought Ott Vatter, the former Managing Director of Estonia's E-governance system, to build this software platform.

## **4. Distinctions between the Original and Amended Charter**

With a clear understanding of the amended charter as currently enforced in hand, we can now show and explain the differences between the two. The main improvements of the amended Charter were: the introduction of special districts, strengthening of the ombudsman and clarification of the ombudsman's role, the financial limiting mechanisms of income caps and debt caps pegged to GDP, clarifying the rules around potential conflicts of interest, and general "housekeeping" in the clarification of terms. Each will be discussed in turn below, with the exception of the special districts, which have already been discussed at length above.



#### **4.1. The Ombudsman**

While the ombudsman existed in the charter from the beginning, its role, funding sources, and specific duties were ambiguous. Furthermore, the examples from recent history show that in the Latin American context, if not properly structured, the Ombudsman role can be easily corrupted and abused (Uggla, 2004). As such, the role was amended to be democratically elected rather than appointed by Próspera, to avoid a situation wherein Próspera appointed an Ombudsman who might not pursue cases against Próspera. The amended charter gives the ombudsman the responsibility of producing a report on compliance with human rights on a yearly basis once the jurisdiction has residents, and grants the Ombudsman access to confidential documents in order to properly fulfill their role. The importance of this role and its careful structuring is paramount in the Honduran context, where corruption is endemic and human rights abuses are widely reported (Human Rights Watch, 2020).

#### **4.2. Financial Limitations**

As previously mentioned, the amended charter implemented total debt and total tax revenue limitations which are tied to per capita GDP. This was an intentional effort to keep taxation low and competitive with other jurisdictions, while also creating a bulwark against fiscal excesses by the Próspera ZEDE. These provisions take effect in 2030, or when the population reaches 50,000, whichever is sooner. Implementation of this provision is delayed because in the early years, the jurisdiction will almost certainly be running large deficits to overcome the startup costs associated with building new institutions and a new community.

#### **4.3. Conflicts of Interest**

Because of the unique relationship between the P&O and the Council of Trustees, stronger conflict of interest provisions were introduced. The operative text is: “A conflict of interest in relation to a proposed action may be resolved conclusively by demonstrating that the proposed action is commercially reasonable, equivalent to what would result from an arm’s length transaction, or otherwise consistent with the council member’s official duties and responsibilities.” It further allows residents to object to a council vote at any of the regular council meetings if they have evidence of a conflict of interest, but it will only be upheld if injury as a result of this undeclared conflict of interest can be specified. These provisions were meant to walk the fine line between ensuring conflicts of interests are properly highlighted and resolved without stymying all activity of the council in the process.

#### **4.4. Linguistic Housekeeping**

Upon requesting review of the charter by a number of international legal experts, many small wording ambiguities, phrasing ambiguities, and other linguistic issues which bear legal weight were illuminated. The amended charter resolved all of these small issues, which taken individually were not of paramount importance, but cumulatively could have created unforeseen issues in the future. This process also resulted in better grounding of the charter and the council in the express language and processes highlighted in the ZEDE Organic Law.

### **5. Lessons Learned**

The process of creating from scratch new governance structures was a years-long and expensive process. However, Próspera’s objective is and remains to create the best-governed and most prosperous jurisdiction on Earth, so this time and effort were warranted. Despite

Próspera's best efforts, some mistakes were made along the way which will be highlighted here.

First, Próspera underestimated the time and difficulty of obtaining intergovernmental agreements with Honduran agencies. Because the Próspera ZEDE is a part of the Honduran governmental hierarchy, it was necessary to create intergovernmental cooperation agreements with a number of agencies, including the Property Institute, the customs agency, the Honduran Revenue Administration Service, and many others. These took almost as long, if not longer, than creating the initial institutions. These delays were not a result of any ill will from the Honduran government, but simple confusion about how such processes should be carried out and what they should entail because Próspera was the very first organization to pursue the process.

Secondly, Próspera was surprised to find that firms and entrepreneurs were less enthusiastic about regulatory flexibility than was initially anticipated. While some who understood the concept fully found the concept worth shifting operations to Próspera, entrepreneurs are not public policy experts, and they often simply didn't know which regulatory environment was truly best for their industry. As such, the organization has adjusted its marketing and communication approach to more plainly explain and assist in the selection of a regulatory election for firms.

Finally, Próspera has been attacked on partisan political grounds in Honduras. As a special jurisdiction project, we underestimated the degree to which internal Honduran political dynamics would impact the project from a public relations perspective, and did not initially put adequate resources into properly enrolling the local community as a strong base of support to defend against partisan political attacks. While we did make some political inroads early on across the political spectrum, not enough weight and therefore resources were put toward this effort.

## 6. Conclusion

This paper was an attempt by the Próspera team to shed light on how the first ZEDE was formed, how its governance institutions were created, and the public policy reasoning behind it all. We hope that the information contained herein can inform future jurisdiction-building efforts and contribute to the overall literature on institution building from the perspective of those who have gone through the entire process of building new governance institutions from scratch.

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*A Follow-Up on the Economic Impact of Special Economic Zones in Honduras: Can Honduran ZEDEs and “Growth Hubs” Leapfrog Institutional & Economic Development?<sup>23</sup>*

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**Abstract**

The main cause of migration from Honduras to the United States is a lack of economic opportunities. The price mechanism provides signals for complementary production factors to be combined in the most efficient manner possible. The lack of (nonhuman) capital in Honduras induces workers to search for opportunities in other places where capital is more abundant. Conventional economic theory also suggests that nonhuman capital will flow to low-investment countries with poorly equipped workers. However, this is a conditional statement that would only be true under a business friendly institutional environment, which at present is not the case of wider Honduras. However, our model suggests that the institutional framework of the Honduran ZEDE has the ability to produce a business-friendly environment and, consequently, pull a large share of the Honduran people out of poverty.

**Resumen**

La principal causa de la migración de Honduras a Estados Unidos es la falta de oportunidades económicas. El mecanismo de precios proporciona señales para que los factores de producción complementarios se combinen de la manera más eficiente posible. La falta de capital (no humano) en Honduras induce a los trabajadores a buscar oportunidades en otros lugares donde el capital es más abundante. La teoría económica convencional también sugiere que el capital no humano fluirá hacia países de baja inversión con trabajadores mal equipados. Sin embargo, esta es una declaración

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condicional que solo sería cierta en un entorno institucional favorable a los negocios, lo cual, en general, en la actualidad no es el caso de Honduras. Sin embargo, nuestro modelo sugiere que el marco institucional de la ZEDE hondureña tiene la capacidad de producir un entorno favorable a los negocios y, en consecuencia, sacar a una gran parte de la población hondureña de la pobreza.

### Abbreviations

<b>DAFZA</b>	Dubai Airport Free Zone Authority (based in Dubai)
<b>JAFZA</b>	Jebel Ali Free Zone Authority (based in Dubai)
<b>FTZ</b>	Free Trade Zone
<b>GDP</b>	Gross domestic product
<b>HN</b>	Honduras
<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>SEZ</b>	Special Economic Zone
<b>TECOM</b>	Technology, Electronic Commerce and Media (TECOM), free zone authority (in Dubai)
<b>ZEDE</b>	Zone for Employment and Economic Development

## 1. INTRODUCTION

### 1.1. Progress Since Our Last Study

Last year, the authors of this paper published a study on the economic impact of so-called *Zones for Economic Development* (ZEDEs) in Honduras, a special type of special economic zone (SEZ). Our 2019 study discussed the success and failure of SEZs in China, Dubai, and India in the past. Then, it projected potential Honduran GDP per capita with and without ZEDEs. A Honduras *with* a successful ZEDE showed, for the region, tremendous potential. In effect, if done well, a SEZ can serve as a shortcut toward an investor-friendly tax code, regulatory regime, and judicial efficiency. In turn, this can lead to the rapid economic development of the region, turning previously impoverished and investment-ridden lands into hubs of prosperity. Nonetheless, much has changed since our first publication. As the inner workings of the ZEDE have become clearer (especially with the recent launch of Honduras' first ZEDE, Honduras Próspera) and its governance structure is now evident, its potential should also be reassessed.

In our original study, we assumed that (a) there would be one ZEDE and (b) part of the population would move into the ZEDE (in our study, we projected country-wide GDP per capita assuming 10%, 20% and 30% of the total population would be inside the ZEDE). However, the current prospect is that the Próspera ZEDE will also expand to new territories in a geographical sense. This goes far beyond the notion of a part of the Honduran workforce moving into ZEDE territory. In effect, as we will explain here, the ZEDE Constitutional Amendment and Organic Law allows for rapid growth by establishing multiple hubs. Some of these would operate under the same ZEDE management but are allowed to compete against each other in terms of regulations and infrastructure. They can, indeed, adopt the legal, regulatory and fiscal framework of an overarching ZEDE, such as the Próspera ZEDE.

A proliferation of so-called “growth hubs” might occur. In this paper, we define “growth hub” as the expansion and reach of the original ZEDE into other areas.

This model resembles, as we will also explain later, Dubai’s model to a certain degree. In Dubai, many free zones exist. Próspera’s growth hubs would be equivalent to the latter. Nonetheless, Dubai’s free zones are managed by only a few select free zone authorities (the equivalent of ZEDEs in Honduras). For example, the Technology, E-Commerce and Media Free Zone (TECOM) Authority manages ten free zones. Other free zone authorities, such as DAFZA & JAFZA, also administer various free zones. DAFZA is considered by many the most effective free zone administrator. If the Próspera ZEDE can match this administrative efficiency, and if competition emerges between growth hubs<sup>[1]</sup>, then the potential impact on the Honduran economy could be even greater than originally estimated. The situation might be even greater than initially estimated due to the global reconfiguration of supply chains brought by the COVID19 pandemic. In this paper, we consider that the Honduran ZEDE could impact even more positively than we originally estimated.

For instance, the COVID19 pandemic exposed the supply chain vulnerabilities of many countries around the world, including those of many U.S.-based businesses. The Próspera ZEDE appears to be well-positioned to take advantage of such a reshuffling of global production. Therefore, in this paper we review the new elements that have come to light over the past year (2020), what their impact will be on the Honduran economy, and how this might affect our initial projection of the ZEDE’s economic potential.

## **1.2. Ease of Doing Business within the Próspera Economic Zone**

We begin with the question: what are some of those new things that have come to light? According to a recent report by Ernst & Young (2019), Honduras Próspera allows for a giant leap on most of the Honduran Ease of Doing Business component scores, especially with regard to: (i) starting a business, (ii) (construction) permits, (iii) registering property, (iv)

getting credit, (v) taxes, (vi) cross border trade, and (vii) enforcing contracts. Enormous regulatory and institutional strides are made, almost overnight, within the Honduran ZEDE. According to the same E&Y study, these benefits would lead to a (potential) initial investment of almost 50% of total foreign direct investment Honduras received, on average, from 2012 to 2017. Especially worth highlighting are the immediate improvements in ease of doing business concerning labor laws, environmental protection laws and the judicial system.

Labor laws, although workers within the ZEDE command a 10% premium on the national minimum wage, are extremely flexible. The Próspera ZEDE, as well as Dubai's free zones, operates as a one-stop shop for bureaucracy. This simplifies and speeds up enormously the regulatory red tape involved in establishing and operating a business. However, the advantage of the Próspera ZEDE over Dubai's free zones, is the freedom of a business to adopt its own set of regulations. In practice, this can mean adopting the regulations of another country or any other set of regulations approved by the Próspera ZEDE Council. And, last, the Próspera ZEDE allows for default arbitration under a common law legal code<sup>[iii]</sup>, where arbitration awards have the legal equivalence of domestic court resolutions. This implies a rather staggering improvement in judicial efficiency (turnaround time) and lower total cost associated with legal processes. Some of these improvements are reflected in the following components of the Ease of Doing Business score:

**Table 1: Ease of Doing Business in the Próspera ZEDE compared to Honduras**

	Honduras	Próspera ZEDE <sup>[iii]</sup>
OECD Labor Restrictions Score (Scale 0-5)	2.4	0.5
Starting a business: number of steps	11	3



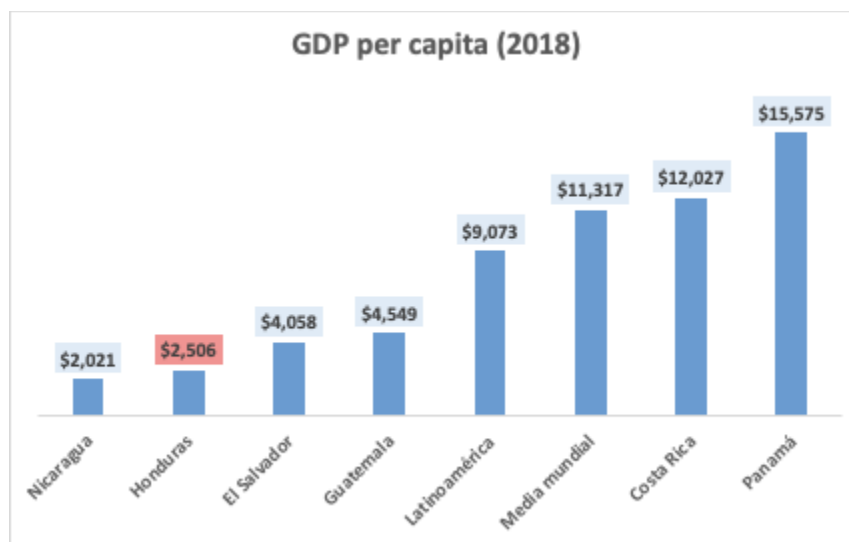
Starting a business: number of days	42	1
Obtaining permits: number of steps	17	1
Obtaining permits: number of days	32	1

Source: Honduras Próspera, Ernst & Young

There exists a strong relationship between ease of doing business and economic prosperity (Estevão et al., 2020). Even more interesting, the same study shows that reducing the difficulties of dealing with government bureaucracy is even more important than a more efficient financial system (Estevão et al., 2020). The components of the Ease of Doing Business Index most important for higher GDP are mostly related to regulatory issues (that is, red tape). Other studies confirm the importance of ease of doing business with regard to economic development (Besley, 2015).

### **1.3. The Potential of a Honduran ZEDE: Hondurans Prosper in Non-Honduran Institutional Contexts**

One reason for optimism regarding the success of the Honduran ZEDEs is the enormous leap in productivity and wages of Honduran immigrants in the United States: this leap might be an indication of how the institutional context of a worker (in this case, a Honduran worker) drives his/her productivity and affects his/her wage compensation. Honduras is one of the countries with the lowest income per capita in Latin America. Within the Central American region, as can be observed in the following chart, only Nicaragua has lower levels of income than Honduras.



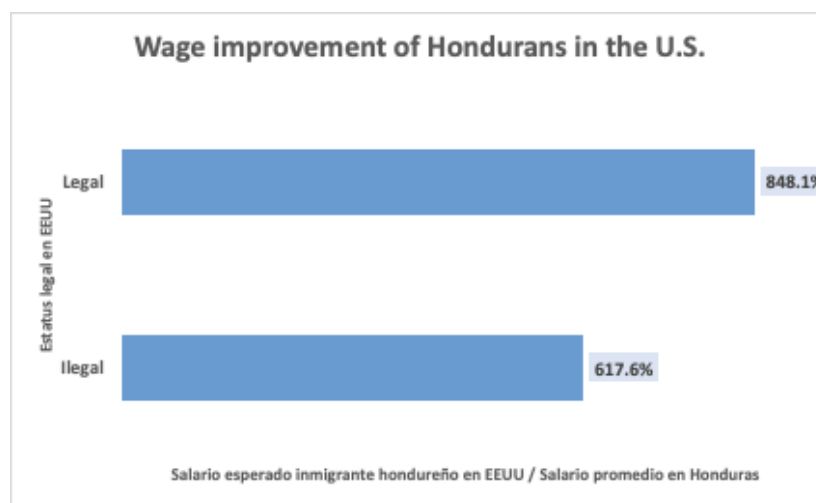
Source: World Bank, income levels in constant dollars.

There exist various causes as to why countries are unable to achieve higher levels of income per capita and economic development. Even though the ultimate causes of low levels of economic development can be very profound, the immediate causes, according to institutional economics, can be more easily identified: an institutional framework that thwarts or prevents free enterprise and the accumulation of capital.

The lack of (well-invested) capital prevents an increase in the productivity of labor<sup>[iv]</sup>. The development of human capital is, as a type of complementary capital, indeed disincentivized by a more general lack of capital. In these cases, an ambitious educational program could have the unwanted effect of triggering an outflow of talent from the country, because of the country's inability to provide jobs for the educated, due to a lack of complementary capital<sup>[v]</sup>. Therefore, low levels of education are not a cause of low levels of economic development, but a consequence, especially of an institutional scheme that is unable to provide sufficient capital in the economy. The institutional backdrop is key when it comes to developing economic well being. Hondurans thrive in institutional contexts

different from the one in their home country. This could be among the primary causes of the massive migration movements that spur from Honduras.

The average Honduran can employ their labor capacity in a much more beneficial manner in the United States than in Honduras. Therefore, it is often rational to migrate from Honduras to the United States, in some cases even illegally, despite the high risk involved with irregular migration. We can estimate, with data from Penn World Tables 9.1, the wage multiplier that an average Honduran worker might expect when they migrate to the United States.



Source: author's calculations with data from Penn World Tables 9.1 and Pew Research Center. The data from Pew Research Center refers to Latino immigrants. The data presented has been weighed according to human capital (lower in Honduras than even in the other Latin American countries)

The Honduran ZEDE has the ability to replicate, in the longer run, or even exceed, the successful institutional context that exists in the United States. As a result, Hondurans would no longer be compelled to migrate in pursuit of better labor opportunities<sup>[vi]</sup>.

## **2. The ZEDE In Its Current Shape: Comparisons to China & Dubai**

### **2.1. The Honduras Próspera “Growth Hub” Model: Resemblances with China & Dubai**

As mentioned in the introduction, as the ZEDE has taken shape and was officially launched, some surprising elements have crystallized. We can summarize some of the aspects of the Honduras ZEDEs as follows:

1. Honduras Próspera is the first Honduran ZEDE, but competition between ZEDE authorities is allowed and possible. The barrier to entry to form a ZEDE is, however, substantial, as the scope of ZEDEs is so broad that it takes a great effort to comply with all of its requirements. That said, there are already, at least, two additional ZEDEs in the making: Ciudad Morazán and Orquídea. It is likely that multiple ZEDEs will be competing against one another in the future.
2. Besides competition between ZEDEs, it is more likely that there will be competition between “growth hubs” (explain Why? Is it because of the relatively not so difficult yet not trivial costs of setting a ZEDE up? Be more precise. The reader will appreciate it). In this case, Honduras Próspera acts (or “can act”?) as an enabler of a network of economic zones (“growth hubs”, essentially subdivisions) across the country. If the Honduras Próspera provides, for instance, standardized legal services across growth hubs, this could (a) increase the number of people that live within a ZEDE drastically within short timeframes and (b) accelerate the economic impact of the ZEDE in the country. All this while leaving much of a growth hub’s autonomy to itself.
3. The process of forming new hubs under the Próspera ZEDE is transparent and open to the entire Honduran population. It is a voluntary process by which landowners or people ask to join the Próspera ZEDE’s legal framework. It is important to note that Próspera ZEDE cannot legally expropriate any land to expand the jurisdiction. This

could dramatically improve the lives of many Hondurans, as it serves, for instance, to bypass the failing judicial system by simply incorporating into the ZEDE. This would lead to a uniform legal system that could improve upon current judicial processes.

4. A growth hub can be authorized anywhere in the country, which means that the Próspera ZEDE and its governance could cover any of the areas as mentioned by the Inter-American Development Bank (IDB). IDB (2019) recommends the creation of “growth poles” outside existing trade routes that would diversify production in the Honduran economy both geographically as in terms of industries. This “growth pole” strategy can very well coincide and even thrive with the ZEDE’s ability to expand territory.

Now we will briefly discuss how this institutional arrangement could allow the Honduran ZEDE to mimic the success cases of China and Dubai. First, it is important to understand the difference between the China model and the Dubai model. In particular, it should be noted that many of China’s free zones have enjoyed a longer period of existence to be able to develop, whereas Dubai’s free zones are of more recent creation. That is, the first SEZ in Dubai, in its today’s shape, emerged in 1990, when the Dubai government created the Dubai Port Authority (a commercial company) to take over the management of the only free zone in Dubai. When in the mid-1990s it became clear the free zone would run out of land, new free zones were proposed. Various free zone authorities emerged, which can administer multiple free zones at once. Whenever land becomes scarce, free zone authorities have been allowed to expand territory by setting up new free zone areas. As a result, most of Dubai’s free zones originate from the past twenty years, signifying the immense development that Dubai has been through in a relatively short period.

On the contrary, many of China’s success stories originate from 1980 to 1984, that is, the Chinese free zones took longer to develop. Shenzhen, for example, was turned into a free zone in 1979-80. One of the key differences with Dubai is the ability to expand: a successful

free zone authority (equivalent of a Honduran ZEDE) in Dubai can incorporate new land quite easily, without any need for the land to be adjacent to the original SEZ. In the case of the Chinese SEZs, such adjacency is by definition necessary and there are clear limits to the supply of land under any given free zone management (in China, every special economic zone has their own management). In essence, this means that, while in Dubai a few efficient free zone operators (“authorities”) have gained a majority of market share, successful free zone authorities in China cannot acquire other free zones to manage. That is, a more efficient free zone authority cannot absorb less efficient free zone authorities.

In this sense, it must be noted that not every special economic zone in China is as successful as Shenzhen’s. For instance, even though improvements have been quite positive, Hainan (\$7,000 GDP per capita) pales by comparison to Shenzhen. The China model becomes even more complex when we consider the scale of Chinese economic zones. For instance, Zhuhai, a Chinese city in the Guangdong province, was designated a SEZ in 1980. Nonetheless, even within Zhuhai, there are a variety of other free zones (equivalents of Próspera’s “growth hubs” or “growth poles”<sup>[vii]</sup>, such as the Zhuhai Free Trade Zone (Zhuhai FTZ), which was founded in 1996 and has its own administrative committee. It appears that at least part of the Chinese success can be attributed to competition between free zones (especially smaller ones that thrive under the management of larger economic zones).

In light of this, an interesting empirical observation is that Chinese regions with multiple SEZs have experienced a better economic performance than regions with a single SEZ (Crane et al., 2018). Indeed, it might be the case that a country benefits from the competition between different zone authorities (administrations), which allows for trial-and-error of different approaches and styles, taking into account any local peculiarities. In fact, this has been one of the contributing factors to Dubai’s free zone success story<sup>[viii]</sup>.

It is important to note that the ZEDE and its growth hub model, which allows the incorporation of any land in Honduras into the Próspera ZEDE as long as both the landowner and the ZEDE come to a mutual agreement, mimics the Dubai model better than the China

model, and could even improve upon the Dubai institutional arrangement. More importantly, it appears that the Próspera ZEDE's institutional design allows for the expansion of efficient SEZ management and competition between “growth hubs” that incorporate into the Próspera ZEDE, combining the best of “both worlds” (Dubai and China).

Country	Number of special economic zones (SEZs)	Number of SEZ administrators
United Arab Emirates (Dubai)	45	3*
China	120**	120***

\*Currently, the three major free zone authorities are DAFZA, JAFZA and TECOM. TECOM, for example, manages more than 10 free zones.

\*\* This number includes the 6 original SEZs established between 1980-85, as well as 14 coastal cities, 15 free trade zones, 32 state-level economic development zones and 53 high-tech industrial development zones. It is likely that the number of economic zones is greater than 120.

\*\*\* We assume one administrative authority per economic zone. It must be noted that the administrative authorities are appointed by and large by the Chinese Communist Party. In China, various free zone authorities have been removed and replaced due to corruption, even in Shenzhen.

In addition, one of the key factors behind Dubai's success is zone specialization: the clustering of firms operating in virtually the same industry allows for facility sharing and resource pooling. The Próspera ZEDE's growth hubs could help cluster industry in certain areas of the country<sup>[ix]</sup>. This generates a network effect, which attracts additional investment and additional companies to move to the Próspera ZEDE's growth hub. In other words, growth hub creation (as a subset of the ZEDE), facilitates network effects, especially since growth hubs can be established in any given place within Honduran territory.



## **2.2. The Supply of land and the Próspera ZEDE**

A crucial factor in the potential success of the Honduran ZEDEs is their ability to incorporate new plots of land if both the landowner(s) and the ZEDE administrator (in this case, Honduras Próspera) reach an agreement. The current law allows for non-adjacent plots. This means that a ZEDE could have “subdivisions” across the entire country of Honduras. In this way, we conjecture that the Honduran ZEDEs avoid one of the most common problems that failed special economic zones have suffered: the problem of land assignment and the potential problems regarding corruption in assigning land<sup>[x]</sup>.

The existence of multiple ZEDEs would even imply that landowners are able to pick between various institutional designs that compete among each other. The institutional scheme designed by competing ZEDEs must be sufficiently attractive to:

1. Convince landowners to abandon their current institutional framework (that is, the institutional framework prevalent in today’s Honduras)
2. Convince landowners to stick with their ZEDE and not move to another ZEDE

In sum, we conclude that the Honduran ZEDE, as it emerged, combines the best of the Dubai and China model, enabling both the expansion of (the same) management to any region of the country, as well as enabling competition between ZEDEs but, more importantly, between “growth hubs” under the platform of one ZEDE. To our knowledge, only one ZEDE has created this capability so far: the Próspera ZEDE.

### **3. The Economic Potential of the Honduran ZEDEs**

#### **3.1 A Quick Overview of Our Initial Study**

Our initial study used two methods to project potential GDP per capita inside and outside the Honduran ZEDE. In our first attempt, we used GDP growth rates observed in the Chinese special economic zones from 1985 to 2017 (on average, 10.03% annual growth rate). This would lead to a \$35,000 GDP per capita in 2050. Moreover, in the first attempt, we also contemplated spillover and derived demand effects, using data from Guizhou and Tibet from 1985 to 2000, to estimate growth rates outside the Honduran ZEDE. While this would lead to a \$5,000 Honduran GDP per capita in 2050 outside the ZEDE, the difference with the base case (Honduran GDP per capita continues to grow at its current rate) is minimal, in line with existing academic literature. Last, we used three simple scenarios to estimate the average Honduran GDP per capita, by assuming 10%, 20% and 30% of total population to be within a ZEDE. This would bring average Honduran GDP per capita to \$8,000, \$11,000, and \$14,000 after 30 years, respectively.

In our second attempt, we used a dynamic regression model with the Global Competitiveness Index as independent variable. In this case, we assumed that the Honduran ZEDE would converge to the highest scores (general score) on the Global Competitiveness Index. It is assumed a third of the total Honduran population would end up within the ZEDE, and no spillover effects are assumed to the Honduran economy outside the ZEDE.

Method	Base case (no ZEDE) in Year 30	Average (country-wide) GDP per capita in Year 30	GDP per capita outside Honduran ZEDE in Year 30	GDP per capita within the Honduran ZEDE (or ZEDEs) in Year 30
China SEZ extrapolation	\$3,500	\$8,000 - \$14,000	\$5,000	\$35,000
Dynamic regression model w/ <i>Global Competitiveness Index</i>	\$4,000	\$6,000	\$4,000	\$14,000

Source: UFM Market Trends (2019), estimates are rounded.

### 3.1. A Follow-Up Study: What Is the Economic Potential of the Próspera ZEDE?

As a follow-up on our initial study, in which we used average growth rates in Chinese SEZs, we now take the success case of Shenzhen and model not only GDP growth, but also population growth. Shenzhen (historic) GDP growth rates have been collected from the Shenzhen Statistics Bureau and the Shenzhen Statistical Yearbook and Shenzhen (historic) population growth rates have been calculated from population figures obtained through PopulationStat. This provides us with the following growth rates:

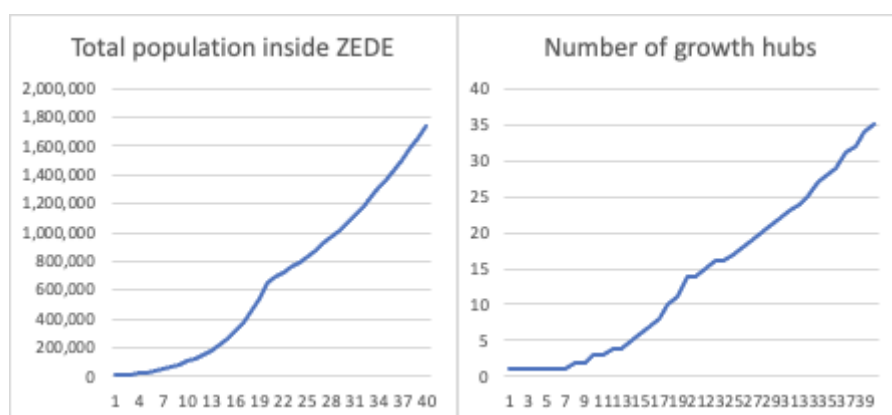
<b>Population:</b>	<b>Shenzhen</b> (historic data, Y1 = start of SEZ)	<b>Honduras</b> (forecast, Y1 = 2020)
<b>Year 1 to year 10</b>	+31.7%	+1.6%
<b>Year 10 to year 20</b>	+21.0%	1.3%
<b>Year 20 to year 40</b>	+3.2%	0.9%

Sources: PopulationStat & United Nations, *Department of Economic and Social Affairs*, Population Division. World Population Prospects: The 2019 Revision. (Medium-fertility variant)

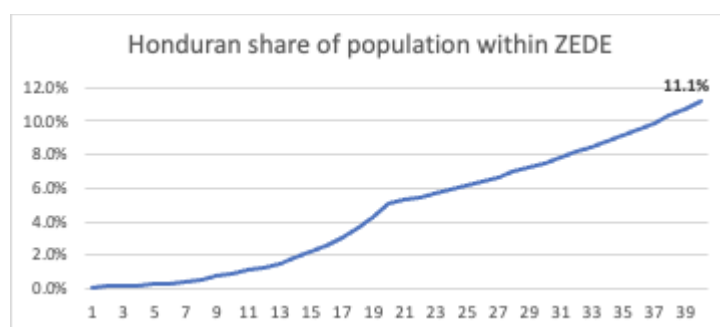
<b>GDP:</b>	<b>Shenzhen</b> (historic data, Y1 = start of SEZ)	<b>Honduras</b> (forecast, Y1 = 2020)
<b>Year 1 to year 5</b>	+55%	+3.5%
<b>Year 5 to year 10</b>	+35%	
<b>Year 10 to year 15</b>	+30%	
<b>Year 15 to year 20</b>	+20%	
<b>Year 20 to year 30</b>	+15%	
<b>Year 30 to year 40</b>	+10%	
<b>(Geometric) average growth</b>	+20.04%	

Sources: Shenzhen Statistics Bureau & Shenzhen Statistical Yearbook, Standard & Poors<sup>[xi]</sup>.

Moreover, we assume a starting population of 10,000 in the Próspera ZEDE, and a 50,000 population per growth hub. Applying the Shenzhen population growth rates, we would obtain the following results (from year 1 to year 40):



In terms of population share (ZEDE population as percentage of total Honduran population), this can be summarized as follows and is similar to our initial study of 2019:



However, even though the Próspera ZEDE would only account for 11.1% of Honduran population, it would account for 49.9% of Honduran GDP.

### **3.2. Monte Carlo Simulation: What is the ZEDE's Potential in a Best-Case Scenario?**

#### **3.2.1. Methodology**

Monte Carlo simulations are employed to model the probability of varying outcomes of a phenomenon that cannot be easily predicted because of the presence and large impact of random variables. It is a technique that can be used, in this case, to study the (both downward and upward) uncertainty regarding a forecasting model<sup>[xiii]</sup>. In other words, more than a forecast, our Monte Carlo simulation will show the potential of the Próspera ZEDE. It will show how sensitive the result (described in Paragraph 3.2) is to changes, especially in order to understand the Próspera ZEDE's prospects.

We have decided to vary the following input variables:

- GDP growth
- Population growth inside the ZEDE

Essentially, we have applied normal distributions to these two variables to the 40 years projected, with the means being the same as the optimistic scenario discussed in Paragraph 3.2 and gradually falling standard deviations as time passes:

Rate	Years	Mean	Standard deviation
GDP growth rate	Year 1 to year 5	55%	25%
	Year 5 to year 10	35%	20%
	Year 10 to year 15	30%	20%
	Year 15 to year 20	20%	10%
	Year 20 to year 30	15%	10%
Population growth rate (inside ZEDE)	Year 1 to year 10	30%	25%
	Year 10 to year 20	20%	20%
	Year 20 to year 40	5%	10%

This implies, for example, that there is a 13.6% chance that the GDP growth rate from year 1 to year 5 in our Monte Carlo simulation is between 5% and 30% and a 13.6% chance between 80% and 105%. This does not necessarily imply that every year will show extreme growth (as is the latter case), as the variation in the mean growth (and standard deviation of the mean growth) over the 40 years period reveals:

Outcome variable	Minimum	Maximum	Mean	Median	Standard deviation



40-year average ( <i>geometric mean</i> ) GDP growth rate	10.60%	23.82%	17.73%	17.75%	1.99%
Y1-Y10 average ZEDE population growth rate	-71.68%	124.35%	30.00%	30.00%	25.00%
Y10-Y20 average ZEDE population growth rate	-56.26%	103.57%	20.00%	20.00%	20.00%
Y20-Y30 average ZEDE population growth rate	-34.00%	50.831%	5.00%	4.99%	10.00%

Here we can also observe that even if our minimum growth rate is around 10%, population growth rate can reach, for example, 20%, which would in fact turn GDP per capita growth negative. This would thus represent the case of failure of the ZEDE to lift growth. Other possible failures might be seen in a large abandonment (move away) of residents from the ZEDE, which is exemplified by the minimum (an extreme) of -72% in the first 10 years. Other assumptions (input variables) remain the same (and are thus not varied):

Rate	Years	Level

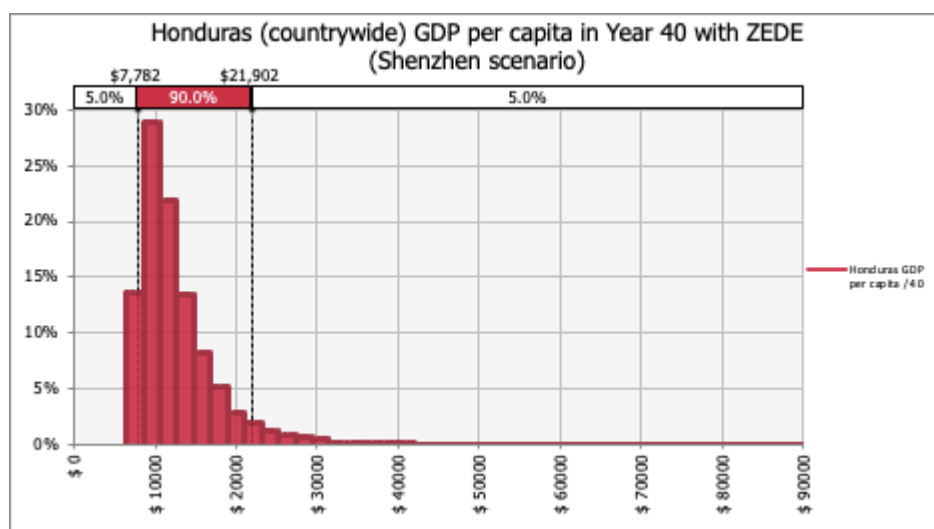
GDP growth rate of Honduras (outside ZEDE)	Year 1 to year 40	3.5%
General population growth (Honduras)	Year 1 to year 10	1.6%
	Year 10 to year 20	1.3%
	Year 20 to year 40	0.9%

As one is able to observe, in line with the literature, no *spillover effects* are considered. We then run a Monte Carlo simulation<sup>[xiii]</sup> of 100,000 iterations with the input variables discussed above. A summary of the results can be found below.

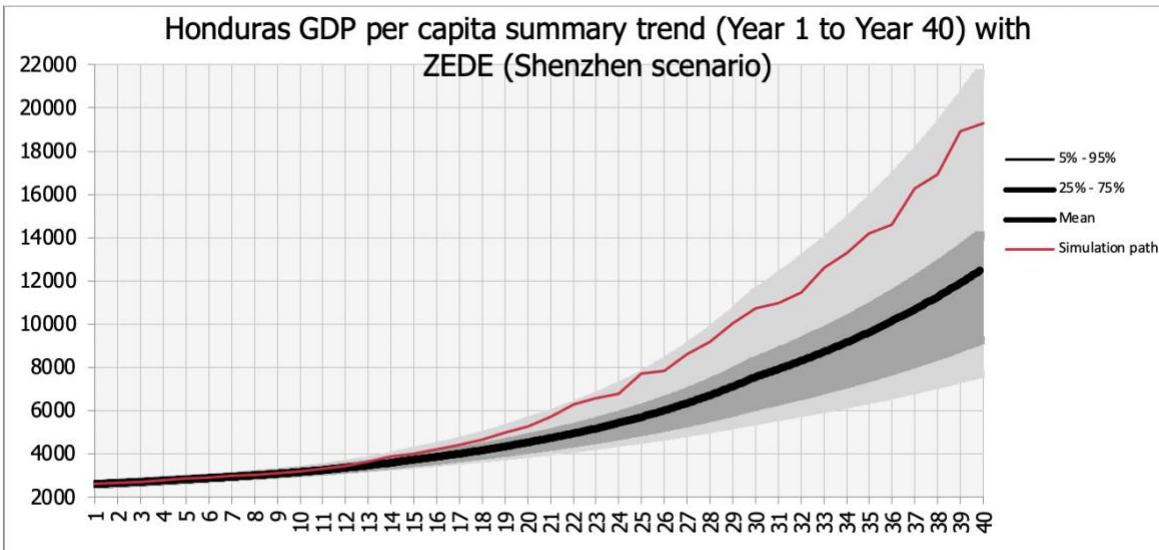
### 3.2.2. Results

Given the input variables and their respective standard deviations, there would be a 90% chance that (countrywide) GDP per capita in Honduras would fall between \$7,782 and \$21,902 dollars per capita. There would be a 5% probability of Honduran GDP per capita to exceed \$21,902: in this case, the Próspera ZEDE would be highly successful in promoting economic growth (high GDP growth rates) and highly successful in creating new and additional “growth hubs”, occupying a larger share of total Honduran population (high Próspera ZEDE population growth rates). In comparison, Chile, which is now considered the most developed country in Latin America, boasts a \$14,896 GDP per capita (2019) according to the World Bank. In other words, in roughly a generation, a successful Próspera ZEDE would be able to lift Honduran economic wellbeing to today’s Chilean standards, not only for Hondurans inside the ZEDes, but for a majority of Hondurans<sup>[xiv]</sup>. In fact, this would be sufficient for Honduras to be included in the “high income” group of countries, a classification used by the OECD.

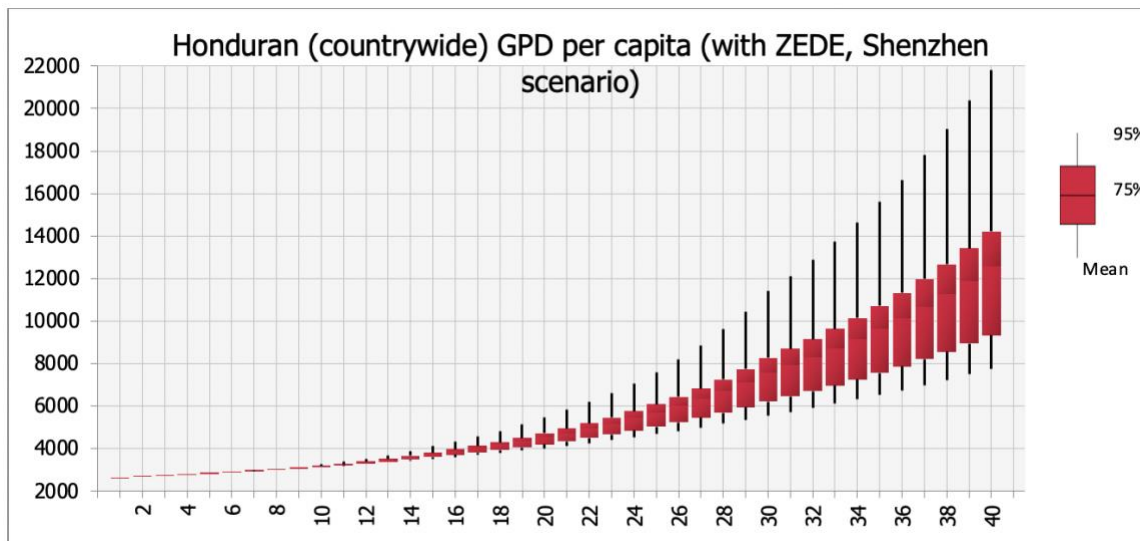
Below, you will find a visual summary of the Monte Carlo simulation.



It is interesting to observe the long-tailed relative frequency distribution, with a lot of upside potential. Whereas the downside is limited (the failure of the ZEDE to proliferate, attract investment, and lift growth), the upside is rather unpredictable but potentially high. Technically, we could state that the upside potential of the ZEDE is fat-tailed to the right (resembling a power law distribution), a characteristic it shares, for example, with exit values of venture capital investments.



In the above chart, we can see the variance in our Monte Carlo simulation with Shenzhen scenario inputs over time (from year 1 to year 40).



Another way to visualize the result of our Monte Carlo simulation (100,000 iterations) is through boxplots, as can be observed in the chart above.

	Minimum	Maximum	Median
Number of “growth hubs” (one ZEDE)	1	1202	27

The number of “growth hubs”, as a result from our simulation, is also interesting. The median number of growth hubs (27) is very close to the current number of special economic zones in Dubai (35), which we have mentioned earlier. The minimum (1) would entail a failure, as no new (viable) growth hubs would emerge beyond the initial one, launched in Roatán, Honduras.

Method	Base case (no ZEDE) in Year 40	Average <sup>[xv]</sup> (country-wide) GDP per capita in Year 40	GDP per capita outside Honduran ZEDE in Year 40	GDP per capita within the Honduran ZEDE (or ZEDes) in Year 40
Shenzhen scenario + Monte Carlo simulation	\$6,300	\$19,296	\$6,300	\$57,048 ( <i>median</i> )

As can be observed in the table summary of our initial study, this implies an improvement in GDP per capita within the Próspera ZEDE of 62% compared to our initial simple average Chinese free zone growth estimate and of 307% compared to our dynamic regression model (which used the Global Competitiveness Index score as independent variable). It should be noted that our projection in this case is over a 40-year period, whereas our original estimates are projections over a 30-year period.

Nonetheless, in both cases, the Monte Carlo simulation shows greater economic potential than first estimated in our 2019 study, although probability-wise, even under a Shenzhen scenario with high levels of uncertainty (as is reflected in the standard deviations applied), lower values, or even values that would imply a failure of the ZEDE, can be observed.

## **4. Conclusions**

### **4.1. Will the ZEDEs Shape the Future of Honduras?**

The Honduran ZEDEs, in particular the Próspera ZEDE and its growth hubs, have the ability to shape the future of Honduras. As one of the poorest countries of the region, the ZEDEs are a way to introduce urgently needed market reforms to the country. It is very well possible that the Próspera ZEDE's growth hubs will proliferate across the country, if the first growth hubs are successful and thus able to exemplify the potential of the Próspera ZEDE, especially since the institutional design avoids all the pitfalls committed in, for example, India.

A particular challenge to the region is the deficient legal system, with a general lack of judges (few judges with high caseload), long legal turn-around times, low court quality, and unreliable enforcement<sup>[xvi]</sup>. This made it necessary to expand the reach of the Honduran ZEDEs (which is not customary in other parts of the world). This could hugely contribute to the future success of the Honduran economic zones.

It appears the Honduran ZEDE regime, with the launch of Honduras Próspera, has delivered on almost every key factor that is required for economic success, especially when it comes to judicial efficiency, regulations and land assignment. The Honduran ZEDE, although scarcely touted, could set a new standard for special economic zones not only in the Central American region, but in the world.

## 4.2. What Could Go Wrong? Risks to Be Considered

The potential of the Próspera ZEDE to drive economic growth in the country is vast, as we have shown in the Monte Carlo simulation. Nonetheless, risks exist, which could negatively affect the development of the ZEDEs. We will briefly discuss some of the risks that we consider most important:

### 4.2.1. *A reversal of the institutional environment*

Latin American countries often stand out because of their institutional instability. Therefore, there exists a risk that the legislation that facilitates the creation of ZEDEs (and, ultimately, growth hubs) will be repealed or modified substantially at a future point in time.

If and when the ZEDE population exceeds a level of 100,000 residents, there will be a referendum aimed at evaluating the possibility of introducing certain amendments to the ZEDE legislation. Fortunately, there exist strong constitutional safeguards, which will make it highly difficult to modify the legislation behind the special economic zones. A qualified majority of two thirds is required in the Honduran congress to modify the constitutional articles that underpin the ZEDE legislation. As a result, a significant change in rules is rather unlikely.

### 4.2.2. *Rigidities imposed by the Honduran government*

As we have commented in our initial study on ZEDEs published in 2019, the decentralization of authority and administrative functions is an indispensable prerequisite for a well-performing SEZ. The Honduran ZEDEs have a high probability of success due to their high degree of decentralization and autonomy relative to the central Honduran government.

When the ZEDEs begin to attain success, it is possible that the central Honduran government might take an “interest” in the growth hubs and aim to recoup some of its authority, after ceding most of it to the ZEDEs.



#### **4.2.3. Access to electricity**

Honduras harbors one of the worst electric power systems in Central America. According to the Ease of Doing Business Index, published by the World Bank, the Honduran electric power system occupies position 138 (of 190) in the world. The electric power supply in Honduras is unpredictable, with above average power outages<sup>[xviii]</sup>.

This might be a problem when it comes to investments which require considerable amounts of electricity (such as heavy industry) or investments in which the stability of the electric power supply is crucial (certain types of tourism or even virtually the entire tourist industry).

It is possible that the ability of the ZEDEs to build infrastructure leads to a more stable supply of electricity, but this will undoubtedly remain a challenge.

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[i] As we will discuss later, industrial clustering is a clear possibility under the current ZEDE set-up, which would lead to network effects, economies of scale and resource sharing.

[ii] This is done through the Próspera Arbitration Center (PAC). More information can be found here.

[iii] As provided by Próspera ZEDE.

[iv] Capital should not only be accumulated, but must be accumulated in profitable investments in order for capital formation to be sustainable. To achieve this, it is necessary that the market feedback mechanism is allowed to work (this prevents the accumulation of capital that generates little added value). Therefore, it is crucial to avoid subsidies on the accumulation of capital or public investments (by definition, public investments are made based on political rather than economic considerations).

[v] The return on labor specialization (human capital) is only positive when there exists a place to put to work such specialized skills. For instance, it does not make sense to train nuclear engineers in a country without nuclear power plants to employ them.

[vi] The ultimate causes of migration can be manifold. The ZEDE can only diminish and, in the most optimistic of cases, end *economically motivated* migration.

[vii] The city of Zhuhai currently houses four special economic zones.

[viii] It appears part of the success in Dubai is due to the administration's transparency and easy access to information. The Honduran ZEDE Próspera appears to have made a promising start in that regard, given the ample information and resource center on their website.

[ix] Again, an interesting take can be found in the Inter-American Development Bank's report (2019) on Honduras.

[x] An interesting case study regarding this aspect are the special economic zones in India. Also see Moberg (2015).

[xi] "We expect GDP growth to (...) hover around 3.5% in the next couple of years." (S&P Global)

[xii] Other methodologies might be considered. We used *this* specific methodology because, first, we consider that transaction cost economics are unable to explain the economic development of poor countries (poor to rich) and, therefore, consider a transaction-cost based comparative static analysis not a good fit for our study. Moreover, our main objective was to explore the economic potential of a successful special economic zone for Honduras as a country. Similarly, public choice modelling would not properly capture the effects of FDI, which we assume is the greatest benefit of introducing SEZs. Both techniques might be more apt for developed countries, because they analyze "what is" instead of "what can be."

[xiii] An easy, nontechnical description of the Monte Carlo simulation method can be found here.

[xiv] It would be interesting to study the dynamics of within-country inequality, as has happened in China, which has led to massive migration toward free economic zone areas from non-free economic zone areas. The key advantage of the Honduran ZEDE is its ability to expand geographically on a voluntary basis, without any need for government approval or initiative (as is the case in China).

[xv] This is the result (year 40) of the simulation path; if we would continue to do iterations ad infinitum we would end up with a mean (as depicted in Chart X) of \$12,562).

[xvi] The World Bank expresses the same challenge as follows: “It [the Honduran government] recognizes that Honduras’ ineffective legal framework and judicial institutions negatively impact the investment climate and worsen conditions for the poor.”

[xvii] According to the World Bank, businesses in Honduran endure, on average, 2.4 days a month some type of interruption in the supply of electricity. Even Nicaragua, the poorest country in the region, has less power outages on average than Honduras.

## Medical Countermeasure Manufacturing Zones: A Proposed Tool for the Pandemic Response

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### ABSTRACT

Widespread and lingering shortages of medical countermeasures (MCM) continues to hinder the COVID-19 pandemic response. Shortages of personal protective equipment (PPE) have placed healthcare workers, emergency responders, and members of the public at inordinate risk of contracting the disease; a lack of medical supplies, including vaccines, has crippled some hospitals' abilities to provide necessary care. The source of these shortages is a failure to invest in public health resiliency, including an overdependence on the global supply chain. To help solve this problem, this paper proposes the creation of a new special jurisdiction—Medical Countermeasure Manufacturing Zones (MCMZ). Industries operating in or reshoring production of MCM to these zones would 1) benefit from special tax incentives and 2) gain priority consideration in public purchases, including those made for the Strategic National Stockpile (SNS). Priority purchasing consideration provides the strong demand signal industry requires in order to reshore production. Lastly, these producers would be required to sell to U.S. purchasers before exporting their goods during a declared public health emergency. Making products in the United States and guaranteeing sale of that PPE to U.S. purchasers would help to strengthen the MCM supply chain and ensure that supplies are available in times of public health crisis. This paper takes a United States-centered approach to emergency response, proposing a new type of federal-level special jurisdiction in the United States, called Medical Countermeasure Manufacturing Zones (MCMZ). This model, as we later conclude, could be replicated in other countries in order to grow domestic MCM production and promote greater public health resiliency.

**Keywords:** Public Health; Medical Countermeasures; Foreign Trade Zones; Manufacturing, United States.

### RESUMEN

La escasez generalizada y persistente de contramedidas médicas (MCM) continúa obstaculizando la respuesta a la pandemia de COVID-19. La escasez de equipo de protección personal (EPP) ha puesto a los y las trabajadores(as) de la salud, los servicios de emergencia y el público en un riesgo excesivo de contraer la enfermedad. Igualmente, la falta de suministros médicos, incluidas las vacunas, ha

mermado la capacidad de algunos hospitales para brindar la atención necesaria. La fuente de esta escasez es la falta de inversión en la resiliencia de la salud pública, incluida una dependencia excesiva de la cadena de suministro global. Para ayudar a resolver este problema, este documento propone la creación de una nueva jurisdicción especial en Estados Unidos: las Zonas de Fabricación de Contramedidas Médicas (MCMZ). Las industrias que operen o reubiquen la producción de MCM en estas zonas 1) se beneficiarían de incentivos fiscales especiales y 2) obtendrían consideración prioritaria en las compras públicas, incluidas las realizadas para la Reserva Nacional Estratégica (SNS). La consideración de compra prioritaria proporciona la fuerte señal de demanda que requiere la industria para repoblar la producción. Por último, estos productores deberían vender a compradores estadounidenses antes de exportar sus productos durante una emergencia de salud pública declarada. Fabricar productos en los Estados Unidos y garantizar la venta de ese PPE a los compradores estadounidenses ayudaría a fortalecer la cadena de suministro de MCM y garantizaría que los suministros estén disponibles en tiempos de crisis de salud pública. Este documento adopta un enfoque centrado en los Estados Unidos para la respuesta de emergencia, proponiendo un nuevo tipo de jurisdicción especial a nivel federal en los Estados Unidos, denominada Zonas de fabricación de contramedidas médicas (MCMZ). Este modelo, como concluimos más adelante, podría replicarse en otros países para aumentar la producción nacional de MCM y promover una mayor resiliencia de la salud pública.

**Palabras clave:** Salud Pública; Contramedidas médicas; Zonas de Comercio Exterior; Fabricación, Estados Unidos.

## 1. INTRODUCTION

By the time it arrived on U.S. shores, the novel coronavirus (COVID-19) confronted a neglected public health and medical infrastructure. The shortages it triggered were predictable and predicted, as was the burden they would impose on frontline workers and healthcare systems across the country. Critics have condemned a lack of preparedness as the root of the issue, citing a lack of sufficient stores and an inability to import and distribute the needed additional medical countermeasures (MCM). What needs further development are solutions that prepare the United States for the next pandemic or other public health emergency. Reshoring manufacturing should be part of that vision.

The Food and Drug Administration (FDA) defines MCM as “products used to diagnose, prevent, protect from, or treat conditions associated with chemical, biological, radiological, or nuclear (CBRN) threats, or emerging infectious diseases.” MCM include biologic products, such as vaccines; drugs, such as antibiotics; and devices, including personal protective equipment (PPE) as well as diagnostic tests and ventilators. Both domestically produced and imported products are regulated by the FDA to ensure quality and safety. The existing pandemic response infrastructure, including the Strategic National Stockpile (SNS) and Centers for Disease Control’s (CDC) Strategy for Optimizing PPE Supplies, do not offer a sustainable solution for the next pandemic. This is because the existing infrastructure is focused on managing supplies, not creating new ones.

At its establishment in 1998, the SNS was conceived as “an unprecedented national stockpile of drugs and vaccines for civilian use in case of a bioterrorist attack.” Its purpose has since expanded to include measures to respond to CBRN threats; pandemic influenza; and natural disasters. However, the SNS was never intended to provide for the needs of state, local, territorial, and tribal governments simultaneously, nor to serve as the primary source for pandemic response resources (Gerstein, 2019). Considering the problems of product expiration and the substantially different needs imposed by CBRN threats,

pandemics, and natural disasters, stockpiling with the goal of fully providing for all needs across all potential public health emergencies is unfeasible. As such, the shortages of MCM—most notably PPE—stem less from a failure to stockpile as from an inability to acquire a sufficient number of quality products when they are needed.

The Centers for Disease Control and Prevention (CDC) Strategy for Optimizing PPE Supplies iterates three capacity levels containing strategies to ensure supplies are adequately matched to need. These strategies have nothing to say about production, importation, or distribution of supplies. Rather, the CDC provides guidance on how to selectively limit the provision of care in order to eliminate competition for limited supply. The presumption underlying this agenda is that, under emergency circumstances, acquiring additional supplies is so unlikely as to not be worth considering (CDC, 2020). “Steps for acquiring necessary supplies” are not offered. This is not a failure of the CDC, whose jurisdiction does not encompass the medical supply chain. The agency can only offer mitigation techniques. Medical facilities and providers, and other frontline workers, would do well to heed CDC guidance, but policymakers should be concerned with the systematic failures which undermine the opportunity to wage an adaptable response to a public health crisis.

As long as the focus of the United States’ pandemic response emphasizes existing ways of sourcing MCM, it will always suffer from the pitfalls associated with global supply chains concentrated in a few countries. Increasing the supply of MCM, both for everyday and pandemic-event use, requires reshoring manufacturing of MCM. Since manufacturing benefits from collocation with research and development (R&D) and other similar activities, special jurisdictions can be an effective way of offering incentives for reshoring production to clusters wherein actors from across the MCM industry can operate in close proximity and thereby gain efficiencies and increase innovation.

This paper is structured in five sections. Section II draws upon the historically broad conception of public health to lay out the public health justification for domestic



manufacturing of MCM. Section III discusses some of the weaknesses in global supply chains, especially as it relates to MCM. Section IV proposes the Medical Countermeasures Manufacturing Zone (MCMZ) special jurisdiction, and places the need for an MCMZ in the context of the “industrial commons,” which describes the ecosystem of clustered industrial actors in a certain region. Part IV also discusses some potential attributes of MCMZs related to tax incentives and government contracting to help guide policymakers interested in designing such zones. The paper concludes with a brief summary of the arguments and ideas offered throughout, and suggests how this model can be adapted to other countries with similar problems.

## **2. PUBLIC HEALTH JUSTIFICATION**

Although the global supply chain disruptions experienced in the first months of the pandemic averted catastrophe, U.S. purchasers, and the front-line workers they supplied, were confronted with the reality of a system that was not set up to adapt quickly to crisis. Despite the valuable role that medicines and protective equipment play in the epidemiological tool kit, the early response overemphasized quarantine, isolation, and widespread shutdowns. These strategies continue to play an outsized role in the U.S. pandemic response plan. In the United States, citizens have been asked to limit time interactions for ten months through numerous primaries and a general election, multiple national and religious holidays, and one and a half school semesters. The insurmountable difficulty of maintaining social distancing has demonstrated that these policies, though necessary, are not sufficient to control the spread of COVID-19, nor to protect the health and wellbeing of frontline workers (Soo, K., 2020; Williams J., 2020). Access to physical supplies is also essential (Honein, et al. 2020). The United States must develop a strategy to create and deliver more masks, medicine, and other countermeasures, so that its people can survive this crisis.

## **2.1. The Need for PPE and MCM**

Demand for PPE is estimated to exceed 21.9 million units weekly in the United States (“Shortage Index,” 2020). The sources of need include hospitals and clinics, but the vast majority of facilities without sufficient supplies are non-hospitals, including homeless shelters, dental clinics, nursing homes, and social services. In fact, non-hospitals account for approximately 80 percent of need. The individuals who work within these facilities must have access to PPE in order to safely provide the services that their clients rely upon in order to maintain their health and wellbeing. In October 2020, and for the third month in a row, 70 percent of all facilities were entirely out of at least one type of PPE (“Shortage Index,” 2020). Part of the issue stems from a lack of NIOSH/FDA approved medical-grade PPE. Whereas face coverings may generally be widely available, the kind needed by frontline workers to assure the highest level of protection remain hard to acquire and expensive. Frontline workers and industries have struggled as a result.

The lack of PPE and MCM at the front lines of the pandemic response has led to horrific outcomes in healthcare and other essential service fields. Shortages of masks and gowns, including reports of doctors and nurses reusing PPE, have come to epitomize the COVID-19 pandemic (Morning Edition, 2020). Healthcare workers have died as a result of this lack of protection (Clark, C., 2020; Karlamange, S., 2020; Gee, A., 2020). When New York City experienced a surge in cases in May 2020, a lack of ventilators threatened to trigger medical rationing (Johnson, M., 2020). Lacking swabs to use for COVID-19 testing, Boston doctors organized former classmates and “an army” of 3D printers to produce their own supply. Overall, the scarcity of swabs has “hobbled” testing in the United States (Mfuson, et al., 2020). So unbalanced are supply and demand for N-95 respirators that an informal market for these supplies has emerged (Clark, D.B., 2020). There is a clear need

for concerted efforts to establish MCM supply chains that can respond quickly and effectively to crisis-level demand.

In recent months, the United States have started to deploy additional MCM in the form of vaccines. Both Pfizer and Moderna—the manufacturers of the two FDA-approved vaccines—are operating at maximum capacity to produce these vaccines (Lupkin); hospitals, pharmacies, and other authorized distributors are operating at maximum capacity within the limitations of their staffing and supplies to deliver them. Vaccines comprise components: mRNA, lipids, potassium chloride, monobasic potassium phosphate, etc. They come in glass vials and are stored in “extreme cold” storage. As with other MCM, a robust vaccine supply chain requires secure and diversified sources for not just the final product, but the component parts as well.

## **2.2. Toward a Broader Conception of Public Health**

Public health is an interdisciplinary field that intersects with medicine and with policy. It aims to promote the health of a population as a whole by dealing with the factors of disease, including hygiene, epidemiology, and disease response, as well as the nonmedical factors of health (also referred to as the “social determinants of health”). One way of conceptualizing public health is to think of illness as something that can be prevented: primary prevention is proactive, aiming to avoid the contraction of disease (i.e. strategies to avoid spreading COVID-19); secondary prevention aims to identify and respond quickly to new cases (i.e. COVID-19 testing and contact tracing); and tertiary prevention seeks to mitigate the effects of a disease that has already been contracted (i.e. reducing the severity of COVID-19 symptoms and avoiding death). MCM plays a role in each of these stages.

In its capacity as advocate for disease prevention, the field of public health ought to be concerned with how the nation shapes and manages the medical supply chain. That the nation has allowed the vast majority of MCM production to offshore demonstrates the lack

of coordination between the public health and manufacturing sectors. It is not that public health officials are unaware of the problem: in early 2020, the U.S. Department of Health and Human Services (HHS) published a report highlighting the problems with the current MCM supply chain under pandemic circumstances (Office of the Assistant Secretary for Preparedness and Response, 2020). It is clear now that HHS was right. The result of a lack of communication between the manufacturing and public health sectors has been an inability to provide a domestic response to material needs during a public health crisis.

At the turn of the last century in American politics, Congress considered some of the first legislation intended to reform the systems which affected public health and wellbeing, including the non-medical factors of health. The proposals of this time understood public health in a way that contemporary politics is only beginning to rediscover. Leadership in the early 1900's "did not simply envision that the sick should be able to purchase medical care," but rather, "viewed poor health as...a problem of the underlying economic structure" (Fairchild, et al., 2010). Though neglected, this viewpoint remains no less pertinent in 2020: when the pandemic hit, insurance could not save the hospital system from collapse; the trade and manufacturing sectors had to do that by ensuring that hospitals and providers were equipped to provide necessary care safely. Moving forward, the United States needs to readopt the early 20<sup>th</sup> Century's consideration of strategies outside of medicine and money to bolster the nation's defenses against deadly diseases.

The United States' pandemic response problem is contained within its narrow conception of health. Preparedness has similarly been too narrowly conceived. Public health, trade, and manufacturing must work together for the nation to achieve effective pandemic preparedness. Growing the domestic manufacturing sector would enable the nation to scale supply to meet demand during future public health emergencies. Strategic contracts with manufacturers could also sustain spending on the SNS to ensure that stockpiles are sufficiently maintained and consistently replenished.

In addition to providing a more responsive and resilient MCM supply chain, reshoring manufacturing of MCM to the United States could bring about other positive health effects in areas in which factories were reopened. These factories would provide jobs and economic stability to local communities, which can serve to improve health outcomes (“Employment,” 2020). The added benefit of domestic MCM manufacturing is renewed investment in an early idea of health promotion: an economic structure more supportive of individual and societal wellbeing.

### **3. GLOBAL SUPPLY CHAINS CAN HURT THE PANDEMIC RESPONSE**

#### **3.1. Dependence on Foreign Imports**

The United States’ pandemic response has been limited by its excessive reliance on MCM produced overseas. Imports account for an overwhelming percentage of the U.S. supply of many types of MCM. For example, China accounted for over 15 percent of U.S. imports of medical ventilators and over 70 percent of medical protective articles, including masks, in 2019 (U.S.-China Economic and Security Review Commission, 2020). Over 70 percent of active pharmaceutical ingredients (APIs) used in the United States are produced in foreign countries, with over 30 percent made in India and China alone (Kota & Mahoney). It is notable that the Peter Institute for International Economics encouraged nations to scale up domestic MCM production, and the European Union (EU) Chamber of Commerce has specifically urged EU member nations to diversify their supply chains away from China (Brown, C., 2020; Crossley, G., 2020).

The United States’ dependence on imports for MCM puts public health at the mercy of foreign governments. In February 2020, the Chinese government commandeered all production of medical supplies for domestic use, limiting even U.S. companies from exporting their Chinese-produced goods (Pinghui & Xin, 2020). Twenty-four EU nations imposed similar export restrictions in March (Bayer, et al., 2020). Without U.S.

manufacturing to scale up MCM production, these gaps often went unfilled. The Congressional Research Service posits that China’s attempts to secure sufficient MCM to provide for the needs of its citizens during the pandemic “likely exacerbated medical supply shortages in the United States and other countries, particularly in the absence of domestic emergency measures that might have locked in domestic contracts, facilitated an earlier start to alternative points of production, and restricted exports of key medical supplies” (Sutter, et al., 2020). The same policies which facilitated a steep rise in Chinese MCM production also contributed to sharp decreases in exports of these critical supplies. One expert writes:

In a dark irony, most of the world’s face masks—now ubiquitous in China as a precaution—are made in China and Taiwan, and even for those made elsewhere, some component parts are Chinese-sourced. Shortages have led China to declare the masks a “strategic resource,” reserving them for medical workers. U.S. hospitals are “critically low” on respiratory masks, according to medical-supply middlemen. Lack of protective gear could increase vulnerability to the virus, and the one place on earth suffering from production shutdowns is the one place where most of the protective gear originates. (Stoller, M., 2020).

Furthermore, there is evidence that China prioritized certain trade partners over others when exporting MCM. Whereas the United State accounted for 40.9 percent of China’s export market for N95 respirator masks—the greatest single holder of market share—in 2019, in 2020 the EU usurped the United States, claiming 34.6 percent of Chinese N95 mask exports compared to the 25.5 percent exported to the United States (Sutter, et al., 2020). Because of the United States’ dependence on China, China holds a great deal of leverage to determine American’s access to lifesaving supplies. The current crises—public

health and economic—which affected the wellbeing of individuals worldwide, “provides the chance to rethink fundamental assumptions about our country's economic and social system,” including the role for public health to lay in shaping policies and practices that promote good health (Fairchild, et al., 2010). Defensive policy decisions may have been rational in light of the dire state of public health within the nations which enacted them at the time. But the fact remains that the United States’ reliance on foreign nations undermined its own ability to effectively respond to the pandemic.

### **3.2. Limitations Inherent to the Global Supply Chain**

Even if trade had continued as usual during the pandemic, scaling issues and long shipping times might have undermined the speed and deftness of the U.S. public health response to the crisis. The Crimson Contagion Functional Exercise Series, conducted by HHS between 2018 and 2019, tested the nation’s ability to respond to a flu pandemic. The After-Action Report (2020) concluded, among other findings, that “Global manufacturing capabilities will not be sufficient to meet demand, resulting in an inability to import adequate quantities of medical countermeasures” in the event of a pandemic. Stockpiles are inherently limited and would be difficult to restock because both complete products as well as components and materials would have to be imported. Importation can become functionally impossible if any point of the supply chain is disrupted.

To counter this threat, HHS recommended that the United States “Promote growth of the domestic medical countermeasure industrial base with a focus on bolstering input supply chain development (raw materials) and enhancing rapid manufacturing supply” (Office of the Assistant Secretary for Preparedness and Response, 2020). A stronger domestic manufacturing sector would shorten the distance between suppliers, producers, and



purchasers, as well as grant the nation greater control over the end-to-end supply chain that cannot be guaranteed when it spans across nations.

To the extent that supplies exist, their availability is limited by long transportation times. Air travel is by far the fastest mode of transportation across the Pacific Ocean, but it is also the most expensive and can handle only relatively small volumes. Ocean freight is cheaper and can handle larger loads but can take up to a month from port to port (Gronkvist, 2018). Loading and unloading the cargo may account for an additional week of transit time. When needs are immediate, that is too long to wait. Moreover, the global supply chain has made it difficult for U.S. producers to compete in the domestic market. The depletion of the domestic manufacturing sector has negatively impacted public health in the United States in a number of ways. Extremely low production costs overseas, disincentivizes the production of American-made goods, even at times of heightened demand.

Lastly, the role that the U.S. manufacturing sector could play in promoting healthier American communities is undermined by a global supply chain that incentivizes the production of goods offshore. Reshoring manufacturing would also help domestic producers to the healthiness of their communities, through both their production practices and the quality of their products (West & Langsang, 2018). At the same time, reshoring would recreate manufacturing jobs, which would help to address the widespread poverty and poor mental health that arose in many working-class communities as a result of the loss of industry. Poverty and poor mental health have proven to exacerbate the adverse impacts of events like the COVID-19 pandemic (Reeves & Rothwell, 2020). What manufacturing jobs may not be able to offer in work-from-home flexibilities during the pandemic, they may have made up for in providing families with financial safety nets and, indeed, access to supplies that could protect them and others from the virus. When the United States overlooks reshoring, it not only undermines pandemic preparedness but misses an opportunity to promote greater environmental stewardship, worker protections, quality standards, and to reenforce the economic factors that promote wellbeing in local communities.

#### **4. MEDICAL COUNTERMEASURE MANUFACTURING ZONES**

In response to the great reliance that the United States has on foreign suppliers—and in particular China—for MCM, this paper proposes a new type of special jurisdiction to incentivize the reshoring of production of MCM to the United States. Defined by alternative rules that apply with the special jurisdiction, but not the areas outside that jurisdiction, a Medical Countermeasures Manufacturing Zone (MCMZ) would mimic other special jurisdictions already in use (Foreign Trade Zones Act, 1934). MCMZs would be created by the federal government, which would bestow a number of unique privileges upon entities operating within the MCMZ. In this way MCMZs are like other special jurisdictions in both origin and operation.

How MCMZs differ is in their ability to create synergies from the agglomeration of entities engaged in similar activities. Unlike Foreign Trade Zones (FTZs), for example, which are agnostic as to industry, MCMZs would be designed specifically for use by those manufacturing MCM, PPE, and other goods deemed essential to ensure public health preparedness (Foreign Trade Zones Act, 1934).

##### **4.1. Rationale for a Special Jurisdiction**

At first it seems unclear why a special jurisdiction would be necessary to encourage reshoring production of MCM. Certainly, the federal government could provide lower taxes or longer contract awards to companies manufacturing MCM anywhere in the United States. What is the need to tie these incentives to a special jurisdiction?

#### ***4.1.1. The Case for an Industrial Commons***

The short answer is that place matters. When located near each other, different companies from the same industry—even companies in the same industry but specializing in different subsets of that industry—interact in ways that drive innovation, boost efficiencies, and achieve greater success. This concept of an “industrial commons” is what makes special jurisdictions potentially so helpful for improving pandemic responsiveness (Pisano & Shih, 2009).

The industrial commons refers to local or regional “Concentrations involving a particular industry...on the presumption that they will gain an advantage in learning or in hiring workers with relevant skills and knowledge, and by being near suppliers and complementary businesses” (Shih & Chai, 2015). Think Detroit for automobiles, Silicon Valley for computers, the Raleigh-Durham Research Triangle for pharmaceuticals, Pittsburgh for autonomous vehicles, and Boston for biotech. The physical proximity of entities within these industrial commons generates a mass of workers moving between firms and bringing their creativity and expertise with them. This energy can supercharge companies (Shih & Chai, 2015). As one expert notes:

The potential sources of agglomeration advantages include cheaper and faster supply of intermediate goods and services, proximity to workers or consumers, better quality of worker-firm matches in thicker labor markets, lower risk of unemployment for workers and lower risk of unfilled vacancies for firms following idiosyncratic shocks, and knowledge spillovers. (Greenstone, et al., 2010)

There’s good evidence confirming the sound intuition that being physically closer to other experts and workers in one’s field generates more success for everyone than if those individuals were scattered. The Internet has been remarkable, especially during the pandemic, at permitting individuals to communicate and collaborate almost as effectively

virtually as in-person. But only almost. Nothing can replicate a chance interaction with a potential collaborator while waiting in line at the coffee shop, or the efficacy of negotiating a solution around a physical table (Pisano & Shih, 2009).

For example, a study of the professional networks in two different research clusters in Denmark—a vibrant life sciences cluster and another a stagnant wireless telecommunications cluster—demonstrates the value of place-based clusters (Shih & Chai, 2015). The thriving life sciences cluster in Copenhagen drew heavily on Danish university students and local talent, cultivating unique local expertise that stayed and flourished in the area. The slack telecommunications cluster, in North Jutland, started strong—Denmark pioneered the development of mobile phones—but began to lag after a series of acquisitions by foreign entities and a weakening pipeline of local talent dispersed expertise (Shih & Chai, 2015). Another study of over 800,000 inventors between the years of 1971 and 2007 found that upon moving to an innovation cluster—the backbone of the industrial commons—an inventor significantly increased the number of patents they produced (Moretti, 2019). Moreover, clustering increased the overall efficiency of both an industry and the rate of innovation within the cluster’s home country. According to the same study, the total number of computer science patents in the United States would be more than 13 percent lower if those inventors had been evenly distributed across the country (Moretti, 2019).

#### ***4.1.2. The Unraveling of the Industrial Commons in the United States***

Unfortunately, the United States has seen a hollowing out of its industrial commons spanning at least the past generation. U.S. manufacturing has dropped from nearly 27 percent of gross domestic product (GDP) in 1990 to 11 percent of GDP today (Kota & Mahoney; FRED, 2020). This decline in manufacturing has been driven by offshoring in pursuit of cost cutting (Kota & Mahoney). Such offshoring has devastated the United States’ industrial commons by degrading manufacturing clusters across the country. The ease of

offshoring and the allure of its cost savings makes it difficult for companies to keep their production in the United States. In the case of one study by the Massachusetts Institute of Technology (MIT), 150 start-ups utilizing MIT research relied on domestic skills and financing until it came time to scale production. Then those start-ups were pushed to move production overseas, especially to China (Reynolds, et al., 2014). Even worse, the long-time reassurance—that high-value activities like innovation and research and development (R&D) would stay in the United States even as lower cost manufacturing went overseas—has proven incorrect. In 2000, prior to China’s accession to the World Trade Organization (WTO), U.S. corporate R&D expenditures in China were \$506 million (U.S.-China Economic and Security Review Commission, 2020). From when China joined the WTO in 2001 until 2018 the U.S. trade deficit with China exploded, and the United States lost 3.7 million jobs (75 percent of which were in manufacturing) to China (Scott & Mokhiber, 2020). Unsurprisingly, R&D has since begun to leave too. As U.S. manufacturing went offshore to China, U.S. R&D expenditures in China ballooned more than 631 percent to \$3.7 billion by 2017 (U.S.-China Economic and Security Review Commission, 2020). The tendency for R&D to follow production offshore has not been limited to manufacturing. The same has been true in the pharmaceutical industry (U.S.-China Economic and Security Review Commission, 2020).

The success of the industrial commons derives from its comprehensiveness. Manufacturing, design, and R&D must all be part of the equation in order for companies to see the gains that the industrial commons offers. But when manufacturing moves offshore, R&D follows, leaving behind no commons at all, but instead a wasteland of U.S. headquarters missing innovative vitality that they may not even realize they could have.

#### ***4.1.3. MCMZs as Industrial Commons***

Special jurisdictions offer an opportunity to rebuild the industrial commons by helping to cluster manufacturing and R&D in certain regions and communities. By their nature,

special jurisdictions involve placing limits on to whom benefits are conferred, and where those entities may be established. In the case of the industrial commons, geographic boundaries are essential because the benefits of the industrial commons only presents itself upon the agglomeration of industrial actors.

By offering a number of special privileges to companies operating in, or relocating to, an area designated as an MCMZ, the United States can not only improve its access to PPE, essential medicines, and other MCM, but also catalyze innovations that are thwarted by distance. An MCMZ focused on PPE manufacturing might be located in parts of the southern United States to draw upon the region's history and expertise in textile manufacturing (Thomas, D., 2020). Ideally, the MCMZ would not just be focused on PPE manufacturing or pharmaceutical production, but instead bring players from these and other related industries together to draw synergies from their physical closeness. Just like in the Danish life sciences cluster, employees taking new jobs with different firms in the cluster would bring with them ideas and expertise that further drive innovation and efficiencies.

The location of MCMZs might even be determined by a competitive application process, with localities competing for the designation and its attendant benefits. The competition for Amazon's second headquarters (HQ2) demonstrated the desire of countless cities to boost their economies with the kind of big investment Amazon promised (over 238 jurisdictions threw their hat in the ring to win the location of HQ2). Yet, the fact that HQ2 was ultimately awarded to communities in New York City and near Washington, D.C. demonstrated the shortcomings of relying upon a single large corporation to be a catalyst for local economic development (Gruber & Johnson, 2019). A similarly competitive process facilitated by the federal government, whose priorities were more holistic than a private sector actor, might motivate experts in MCM research, development, and manufacturing to design for themselves the clusters that make up a healthy industrial commons. The federal benefits associated with designation as an MCMZ would incentivize this collaboration.

To expand the diversity of locations that aspire for MCMZ designations, the determination process may include state and local matching investments, partnerships between industry and area universities, or assessments of affordability or expansion potential. MCMZ designations are ultimately most capable of producing the full span of their benefits if they do not merely double down on established, high-performing cities, but look more broadly (Gruber & Johnson, 2019). Communities throughout the South and industrial heartland possess potential as innovation and manufacturing hubs, yet are often overlooked (Dizikes, P., 2019). A federally run competition for MCMZ status might help to facilitate growth in underdeveloped parts of the United States by prioritizing the creation of MCMZs in these areas.

#### **4.2. Potential Attributes of MCMZs**

There are any number of ways to design an MCMZ program in order to incentivize reshoring and the creation of an MCM industrial commons. Below, two possible and probable attributes of MCMZs are considered: tax reduction on corporate income, investment, and research; and greater length of, and priority consideration for, government contract awards. Tying these incentives to a specific geographic location could encourage the creation of clusters that support a healthy industrial commons. While not an exhaustive or exclusive list, these attributes are among the most effective tools that the federal government may have available to incentivize reshoring and encourage manufacturing sector growth in the parts of the United States where such growth is most needed.

##### ***4.2.1. Lower Taxes on Income, Investment, and Research***

Favorable tax treatment has consistently been a favorite tool of policymakers designing special jurisdictions. Since 1934, FTZs have provided a reduction in tariffs to companies operating within them (Foreign Trade Zones Act, 1934). More recently, Opportunity Zones



provide tax deferral and incentives to those investing in an economically distressed area. With regard to MCMZs, policymakers could consider tax incentives involving multiple aspects. Policymakers might consider reducing the corporate income tax on producers of MCM operating within the MCMZ. They might also consider providing increases for existing tax credits, or the creation of new tax credits, for investment and other R&D activities that occur in the MCMZ.

Policymakers might also consider linking an MCMZ program with the existing FTZ program. Collocation of MCMZs and FTZs would provide duty free access to certain inputs in the manufacturing of MCM. Such collocation would be especially beneficial for companies seeking to export MCM from the zone. Although the purpose of MCMZs are to reshore production to the United States, collocation would not necessarily undermine that aim. Certain inputs or raw materials for different MCM may not be available in the United States, or impossible to reshore. In those situations, collocation with FTZs would further the aim by giving manufacturers less expensive access to those goods, thus making it easier to produce MCM in the United States rather than near the source of those overseas inputs.

#### ***4.2.2. Longer Duration of, and Priority Consideration for, Government Contracts***

A unique feature of MCMZs would be its ability to offer a federal contracting preference to those companies manufacturing MCM in the zone. Federal contracts are an effective way to send a strong demand signal to private industry assuring manufactures that there will be a market for their products. Combined with domestic content requirements, such as the Berry Amendment for PPE and textile products, federal contracting can be an effective way to incentivize reshoring. But a weak demand signal can be just as useless in this regard as no demand signal.

For this reason, long-term, or multi-year, contracts are the most effective ways to use the government's contracting power to incentivize reshoring. Yet, almost all of the federal contracts for PPE issued since the start of the COVID-19 pandemic have been short-term: 90 to 120 days. Short-term contracts fail to give industry the certainty that investments in the United States will pay off. Why pay the expense to move a factory from China if after three months no one is around to buy what it produces? This is why industry experts recommend three to five-year long contracts for PPE as one of the most effective means by which the government can incentivize the reshoring of PPE (Glass, K., 2020).

Throughout the pandemic, experts have called for long-term contracts as one of the best policies available to incentivize reshoring of MCM (Adler & Breznitz, 2020). The United States government is the world's largest purchaser of goods and therefore is able to use that immense procurement volume to move markets in strategic directions (Collins & Erickson, 2020). In addition to awarding longer-term contracts, the federal government could also generally give priority consideration for contracts to manufacturers within the MCMZ. The federal government already gives contract preferences to meet specified public policy aims via contracting preferences for veterans or small businesses (Williams, J.T., 2012). Although some might see a contracting preference for a business within an MCMZ as unusual—since the entity in the MCMZ would not necessarily have special status based on its owner's background or size—the federal government does have an existing and geographically based contracting preference: the Buy American Act.

In fact, domestic contract requirements, like the Buy American Act or the Berry Amendment, are already preferences that help incentivize reshoring and limit offshoring. Policymakers could build upon the existing statutory architecture of domestic content requirements to add requirements for longer-term contracts as well as priority consideration for those contracts, when the business being contracted is in an MCMZ. Most relevant to MCMZs and the pandemic response is the Berry Amendment, which requires the Department of Defense to purchase only textile products, clothing, and footwear that are

made entirely in the United States from materials of entirely U.S. origin. Its requirement that the components be U.S. made makes the Berry Amendment one of the strongest of the domestic content requirements in U.S. law (Manuel, et al., 2016). Since the Department of Defense is the agency currently managing pandemic-related procurement, PPE purchases are required to be compliant with the Berry Amendment (Muhammah & Reece, 2020).

According to a survey by the Department of Commerce, two-thirds of companies providing textiles to the U.S. government said that the Berry Amendment had a positive impact on their business (Office of Technology Evaluation, 2017). Of course, those companies' success is in part a result of the business they receive thanks to the Berry Amendment requirement (which limits the amount of competition firms face for federal textile contracts). But, that's the point. If policymakers believe that reshoring MCM is vital for the country's pandemic response—and the evidence seems to suggest that it is—it is necessary for policies to preference those producing in the United States over those producing overseas. The Berry Amendment's popularity with domestic producers demonstrates its success for domestic industry, and combined with the additional attributes discussed above, can be leveraged as part of a contracting strategy designed specifically to target and foster MCMZs as pandemic-fighting industrial commons (Muhammad & Reece, 2020).

## **5. CONCLUSION**

At this point in the COVID-19 pandemic, the death rate is at record highs, shortages of MCM continue, and little ambiguity remains regarding the insufficiency of the global MCM supply chain to respond to U.S. demand during a pandemic. While there are important benefits to trade, undeniable drawbacks emerge where reliance upon global supply chains conflicts with the ability of the United States to respond quickly to demand surges during a pandemic.

Offshoring U.S. manufacturing has undermined preparedness and left the nation vulnerable during a pandemic-level crisis.

The simplest solution is to reshore MCM production, and as this paper argues, to do so using a new type of special jurisdiction designed to foster not just domestic manufacturing of medical countermeasures, but an industrial ecosystem to go with it. This action would not only advance pandemic preparedness by establishing a rapid and scalable domestic supply chain, but also contribute to overall public health by creating jobs and bringing wealth back to depressed communities. While there are a variety of ways for policymakers to design such a zone, this paper contemplated a handful of possible options for MCMZs. But regardless of what they look like, medical countermeasure manufacturing zones offer a fresh answer to the thorny questions that policymakers, for more than a generation, have asked about the difficulty of sparking a manufacturing renaissance in the United States.

The aim of this paper has been to articulate the broad and theoretical case for MCMZs as part of the pandemic response and manufacturing policy tool kit, and urge others in the special jurisdiction, public health, and manufacturing communities to continue to think about, and expand upon, the concepts introduced here. Though focused on the United States, the model presented here is above all an argument in favor of utilizing tax and trade strategies to grow a domestic medical countermeasure manufacturing base that can support any nation through times of heightened need. Using this model, virtually any country could encourage collaboration between their public health and manufacturing sectors, in order to promote greater resiliency and innovation among both.

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## Special Economic Zone: A Path to Increase Brazil's Economic Position with Chinese FDI

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### Abstract

This paper examines the creation of a Special Economic Zone (SEZ) in the city of Pouso Alegre (in the state of Minas Gerais, Brazil) as a way to attract Foreign Direct Investment (FDI) from China. The author's hypothesis is that Minas Gerais would receive more FDI if the right incentives were put into place. SEZs are such a tool to foster Pouso Alegre's economic and social development. This paper analyzes the micro and macro environments of the zone's strategic planning to understand the endeavor's viability and what this says about Pouso Alegre city's choice. The paper also presents Brazil's and Minas Gerais' economic backgrounds to showcase the investment opportunities already in place. This paper highlights how the economic measures necessary to implement the SEZ are a formidable route to reduce bureaucratic obstacles and promote international investment from places like China.

**Keywords** Special Economic Zone; Economic Development; Foreign Investment; Minas Gerais; Brazil; China.

### Resumen

Este artículo examina la creación de una Zona Económica Especial (ZEE) en la ciudad de Pouso Alegre (en el estado de Minas Gerais, Brasil) como una forma de atraer Inversión Extranjera Directa (IED) de China. La hipótesis del autor es que Minas Gerais recibiría más IED si se implementaran los incentivos adecuados. Las ZEE son una herramienta de este tipo para fomentar el desarrollo económico y social de Pouso Alegre. Este documento analiza los entornos micro y macro de la planificación estratégica de la zona para comprender la viabilidad del esfuerzo y lo que dice sobre la elección de la ciudad de Pouso Alegre. El documento también presenta los antecedentes económicos de Brasil y Minas Gerais para mostrar las oportunidades de inversión que ya existen. Este documento destaca cómo las medidas económicas necesarias para implementar las ZEE son una ruta formidable para reducir los obstáculos burocráticos y promover la inversión internacional desde lugares como China.

**Palabras clave:** Zona Económica Especial; Desarrollo económico; Inversión extranjera; Minas Gerais; Brasil; Porcelana.

## 1. INTRODUCTION

It is intriguing that Brazil, a highly regulated country full of potential investment opportunities, has not taken advantage of Special Economic Zones (SEZ) to improve its economic positioning while reducing the economic regime's inflexibility. Additionally, Brazil has unique resources that are not receiving adequate domestic investment due to either financial constraints or lack of technology. Furthermore, Brazil's economic and political instability entails a high regulatory risk level for foreign investors<sup>24</sup>. This limits international financial investment. Overall, the country seems to be missing a chance to experiment with special jurisdictions and regulations which can increase prosperity, just like many countries around the world have already done. One of these countries is China.

China had enormous economic development in the past four decades due to testing economic policies in delimited areas, one by one. In a way, its experimentation was done as if it followed the Chinese saying "crossing the river by feeling the stones". Today, the government has learned from multiple policy experiments, even expanding the successful ones to the national level. The success of the initial four SEZs in Shenzhen, Xiamen, Shantou, and Zhuhai has led to the implementation of dozens of SEZs across the country. Despite Brazil giving its back to SEZs, China has proved to be a valuable commercial partner, even in moments of uncertainty. From 2008 to 2018, China's investment in Brazil amounted to USD 59.4 billion<sup>25</sup>. Currently, there are several Chinese-led successful projects in action across Brazil, ranging from energy to industrial machinery production. Because Brazil has an extensive territory, and each of its regions boasts unique characteristics, Brazilian states

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<sup>24</sup> "Foreign Investment in Brazil." Santandertrade.com, 2009, [santandertrade.com/en/portal/establish-overseas/brazil/foreign-investment](http://santandertrade.com/en/portal/establish-overseas/brazil/foreign-investment).

<sup>25</sup> "OEC - Brasil (BRA) Exportação, Importação, E Parceiro Comercial." oec.world. <https://oec.world/pt/profile/country/bra/>.

have different needs and comparative advantages. Therefore, a one-size-fits-all solution for implementing SEZs would not work. For a country as diverse and large as Brazil, the Chinese experience of approaching investments with a regionalist strategy, understanding the needs and resources of specific states might be one that works.

This paper focuses on the state of Minas Gerais (MG), where Pouso Alegre is located, due to its significant economic and logistical advantages, its current positive growing trade with China, and the availability of natural resources frequently sought by Chinese companies. It is in this city where the Xuzhou Construction Machinery Group (XCMG) has decided to locate the Chinese lead, Pouso Industrial Park. Currently, some of Minas Gerais' biggest impediments for growth and further development are economic regulation, trade, and business tariffs. Hence, this paper argues for a robust and diversified approach to Special Economic Zones in Minas Gerais in order to mitigate these roadblocks. The creation of this SEZ can increase cash flow for the state and profitable opportunities for international companies and strengthen relations with China, the state's biggest trade partner.

Although Minas Gerais has relevant natural resources for Chinese companies (namely, minerals and renewable energy), the government could create a more favorable environment from the regulatory perspective, with tailored experiments for different regions within Minas Gerais, considering their comparative advantages.

This paper aims to study the viability of creating a SEZ in Pouso Alegre, a prosperous city in southern Minas Gerais, with China's Special Economic Zone expertise and its regional presence with Pouso Alegre Industrial Park. It concludes with recommendations on how to implement an Export Processing Zone in the state aimed at attracting more Chinese investment.

To elaborate on the project feasibility analysis and justify the city's choice and SEZ type, this article is divided into five macro sections: Special Economic Zones; Economic background; SWOT Analysis; Implementation of the new SEZ in Pouso Alegre; and Conclusion takeaways. The second section focuses on a historical perspective of SEZs and an

explanation of the concept. It also includes a discussion on the Chinese experience in the area, which elucidates China's background and unique know-how of using FDI to construct SEZs. The third section analyzes the Brazilian panorama, provides an overview of Minas Gerais State and Pouso Alegre City's Economic Potential. The strategic factors presented are based on economic, social, and political aspects. The fourth section elaborates a SWOT analysis of the city of Pouso Alegre. Lastly, the fifth section elucidates the process of creating the SEZ, justifies the choice for the specific type of SEZ here proposed for the city—an Export Processing Zone. Finally, the sixth section concludes with takeaways from the analysis.

## **2. SPECIAL ECONOMIC ZONES**

The implementation of Special Economic Zones (SEZs) englobes public policy strategies, including various aspects of the region's social, environmental, and cultural life. A SEZ may have very different characteristics. Their structure and types are still a matter of intense academic discussion.<sup>26</sup> Generally, the main goal when creating a Special Economic Zone in a given country is not only to promote industrialization and structural transformation but also to attract foreign investment to achieve economic and social development. As per the definition of Thomas Farole, Senior Economist at the International Trade Department of the World Bank, SEZs can be generally described as:

...demarcated geographic areas contained within a country's national boundaries where the business rules are different from those that prevail in the national territory. (...) a business environment that is intended to be more

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<sup>26</sup> Lotta Moberg. "The Political Economy of Special Economic Zones." *Journal of Institutional Economics* 11, no. 1 (2015): 167–90. doi:10.1017/S1744137414000241.



liberal from a policy perspective and more effective from an administrative perspective than that of the national territory<sup>27</sup>.

The *Special* in Special Economic Zone derives from these extraordinary rules: extensive tax exemptions that tend to attract foreign and national investments. In doing so, they allow the economy within the Zone to flourish, with spillover effects. For example, new industries will employ several local citizens, the capital flow will enable the local progress, and logistical facilities will be improved, helping entrepreneurs move their products. The exceptions within the SEZ will depend on the type of SEZ, on whether the investment will be private, public, or a partnership, and on which sector of the economy will be contemplated. As per the table below, SEZs can increase FDI, foreign exchange, and exports:

Table 1: Potential Benefits Derived from SEZs

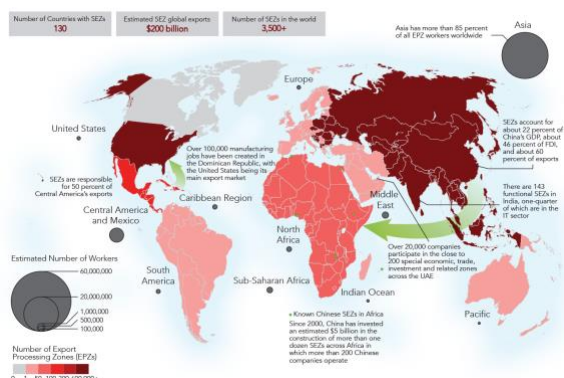
	Direct benefits	Indirect benefits
Foreign Exchange earnings	■	
FDI	■	
Employment generation	■	
Government revenue	■	
Export growth	■	
Skills upgrading		■
Testing field for wider economic reform		■
Technology transfer		■
Demonstration effect		■
Export diversification		■
Enhancing trade efficiency of domestic firms		■

Source: Douglas Zeng, China's Special Economic Zones and Industrial Clusters: Success and Challenges, 2012

<sup>27</sup> Thomas Farole and Akinici Gokhan, "Special Economic Zones Progress, Emerging Challenges, and Future Directions," 2011, <https://openknowledge.worldbank.org/bitstream/handle/10986/2341/638440PUB0Exto00Box0361527B0PUBLIC0.pdf?sequence=1>.

A SEZ is frequently implemented in a location with some comparative advantage. This can be an abundant natural resource, a connecting area between highways and a cargo port or airport, or any component that can be exploited and refined. That advantage, along with local, geographical, and social assets, will influence the type of SEZ chosen. A given area can become more than one type of zone since they are not mutually exclusive.

Historically, Export Processing Zones (EPZ) were the first type of SEZ created to attract foreign investment in Europe. As shown in the map below, today, SEZs are present in Africa, Asia, the Americas, and Oceania. However, they are no longer limited to seeking FDI. SEZs can be used as small experiments for new public policies, as a way to foster systematic economic reforms, and as a complementary solution to encourage local employment.



*World's Special Economic Zones.* Source: Parag Khanna, "Special Economic Zones".

Globally, there are more than 5,400 SEZs, according to the 2019 World Investment Report. They have been studied and discussed already for 50 years. SEZs prosperity and development depend on their proper implementation. Currently, the most famous and economically successful Special Economic Zones are the ones located in China. These and other zones

provide for worldwide excellent learning opportunities, which can be adapted to the national context, with careful and technical planning<sup>28</sup>.

### **2.1. Chinese Experience**

China was a closed and isolationist economy until Deng Xiaoping rose to power in 1976. To boost the economy, Deng Xiaoping implemented a series of far-reaching economic and political reforms. But Chinese growth mainly started when the government, focusing on increasing national production, began to allow controlled private initiative. In 1988, it was established that the private economy would be complementary to socialist doctrine. The state should protect the private sector's rights and interests by guiding, overseeing, and controlling the economy, a decision has proven to be a serious commitment to the country's economic growth. Finally, in 1993, it formalized the change from a “centrally planned economy” to a “market planned economy” and transformed State Enterprises into State-Owned Enterprises (SOEs), with independent operations and separate liabilities for profit and loss.

China started to shift from a mystery to foreign investors to an appealing destination for investment in the future. The reforms and the opening-up policies helped create the conditions that allowed China to become one of the fastest-growing economies in the world for decades and lift hundreds of millions of people out of poverty. Within this context, the SEZ's potential enhanced the demands for reforms, leading to more openness and internationalization.

Xiaoping's idea was to create SEZs as small-scale experiments within their territory. The government would then control their progress, constantly evaluating the next steps without threatening the national economy. There are valuable takeaways in the Chinese model, however, the conditions that made SEZs in China unique are hardly replicable

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<sup>28</sup> UNITED NATIONS, “World Investment Report - Special Economic Zones,” 2019.

elsewhere given the directives of the government: First, China showed the strength of a growing global economy and the focus on innovative models. Participating in the global economy was strategic and essential to China's growth, and SEZ was a great way to attract FDI. China needed to be inserted in the international scenario, which, in turn, forced the country to improve its productive sector, requiring a more skilled and efficient labor force. All those changes were boosted by the economic and technological development zones, free-trade zones, and high-tech industrial development zones implemented at the time. Second, envisioning a higher purchasing power and a better standard of living for the Chinese population the government focused on increasing productivity and maximizing economic incentives. Third, even with the adoption of a more open system, the Chinese Communist Party was still the ruling power in any instance, especially to continue to make the necessary adjustments. In other words, the Chinese government built the SEZs and provided the infrastructure that consequently attracted international companies and Foreign Direct Investment.

Hong Kong city is another compelling real-life case for a Special Zone, being a Special Administrative Region, and Deng Xiaoping noticed the economic success of this Chinese special administrative region governed by British laws and regulations. Much more open than the rest of Asia in general and China in particular, Hong Kong became an international hub for world companies and a pole of FDI.

In 1979, when the Chinese Central Government decided to create four Special Economic Zones in four coastal cities (Shenzhen, Xiamen, Shantou, and Zhuhai), the main goal was to attract foreign investment and make use of China's large reserve of labor. Despite the fact that the best implementation cases in the world were in China, not all the 2,543 Chinese zones were successful. Located right across Hong Kong's strait, Shenzhen is the most famous case; it developed from a village with 30,000 residents into a city of 1.2 million residents with the highest per capita GDP in China.

The implementation of modernizing policies, such as SEZs, while taking China to a new level in the world market has also brought benefits to the Chinese population that are tangible to social inclusion, unemployment reduction, and Chinese per capita income growth. It is undeniable how this growth has in many ways been beneficial for many Chinese people. Today, many have better social conditions, increased life expectancy, higher purchasing power, and better employment rates.

- After profitably carrying out several SEZs nationally, China saw the possibility of investing in SEZs around the world. It started exploring creating SEZs in Africa. The Chinese government approved seven African SEZs to receive special funding as part of the global initiative's project, and six of them began construction in November 2009. But the Chinese government knew that SEZs should have different implementation processes. Therefore, Chinese officials considered favorable outcomes and issues from previous international implementations before creating new ones in Africa, resulting in more constructive relations.
- The Chinese government gave Chinese companies incentives to be the ones in charge of building and operating these zones for profit. However, these companies must compete for the government's subsidies. Additionally, it is their responsibility to invest their own money, decide the best location, and negotiate with the host government. As with many Chinese policy innovations, the zones are treated as an experiment, with a variety of approaches encouraged.<sup>29</sup>

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<sup>29</sup> Deborah Brautigam and Xiaoyang Tang, "China's Overseas Special Economic Zones: Aims and Objectives," December 5, 2011, <https://deborahbrautigam.files.wordpress.com/2013/04/2011-brautigam-chinese-investment-in-special-economic-zones.pdf>.

- In June 2019, as a result of this cooperation between China and different African countries, China announced more SEZs, strengthening the existing Overseas Economic and Trade Cooperation Zones<sup>30</sup>. These movements exemplify China's interest in investing in various countries through SEZs, directly improving its economy and strengthening its international status. Chinese interest is often corresponded with by the recipient countries. Experts such as Douglas Zeng see the benefits of these models and recommend expanding these initiatives further, especially by Latin America employing domestic policies that favor skills improvement, technological adaptation, knowledge transfer, and innovative product development to materialize the benefits of China's investment

### **3. ECONOMIC BACKGROUND OF THE SEZ'S PROPOSED LOCATION**

#### **3.1. Brazilian Panorama**

Brazil is the top destination for Chinese investment in Latin America. Since 2009, China has been Brazil's largest trading partner and the leading destination for Brazilian exports. According to data from the Brazilian Ministry of Industry and Foreign Trade and Services (MDIC), in 2017 Brazilian exports to China totaled USD 64.2 billion, while imports of Chinese products totaled USD 34.7 billion, resulting in a Brazilian surplus of USD 37.3 billion.<sup>31</sup>

As previously mentioned, obstacles when doing business in Brazil are excessive bureaucracy, high taxes, and heavy tariffs. These hinder not only Chinese investors as well as foreign and domestic ones. According to data from the World Bank, Brazil is one of the most bureaucratic countries in the world. It ranks number 124<sup>th</sup> (out of 190 countries) in the

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<sup>30</sup> Aeabc, "China to Develop More Special Economic Zones in Africa," AEABC, June 9, 2019, <http://aeabc.org/china-to-develop-more-special-economic-zones-in-africa/>.

<sup>31</sup> CEBC, "Comercio Bilateral Brasil- China 2018: Anos Recordes Balança Comercial," January 2019, [http://www.cebc.com.br/arquivos\\_cebc/cebc-alerta/Ed%20108\\_2018\\_edi%C3%A7%C3%A3o.pdf](http://www.cebc.com.br/arquivos_cebc/cebc-alerta/Ed%20108_2018_edi%C3%A7%C3%A3o.pdf).

Doing Business Index in 2019. On the other hand, China has been improving its position, ranking 31<sup>st</sup> in the same world ranking.<sup>32</sup>

Brazil has one of the most complex taxation systems in the world.<sup>33</sup> It has over 60 types of taxes. According to the World Bank, Brazil ranks 184th among 190 countries in the Paying Taxes indicator<sup>34</sup>. In 2018, a Brazilian citizen worked, on average, 153 days to pay the tax amount due. Recently, the population has been pressing for a revision and simplification of the system, which would immensely reduce the tax burden and represent a great victory for business. In 2019, a proposal was sent to the House of Representatives, and it is currently under revision. The 25th world's largest exporter in the world, Brazil is a competitive player in the commodity market, specifically in mineral extraction and agribusiness. These are areas in which Minas Gerais State excels. However, Brazil still has a long way to go to becoming an open global economy, despite its recent growth years. Creating special jurisdictions would result in more trade and promote access to international consumer markets and further FDI, all positive aspects for a country developing into a robust world economy. That said, Brazil's political risk has been a concern in the past for foreign investors, as government instability can harm profit and economic expansion. Simultaneously, heavy taxation also discourages new international capital flow. However, these taxes would not hinder SEZ, given the special concessions within zones for alternative taxation rules.

In economic aspects, Brazil's records and forecast trends display positive indicators. A strong GDP, coupled with growth expectations, assures Brazil's position among the top 10

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<sup>32</sup> "Ease of Doing Business in Brazil," Tradingeconomics.com (Trading Economics, October 8, 2019), <https://tradingeconomics.com/brazil/ease-of-doing-business>.

<sup>33</sup> "The Challenges of Tax Compliance in Brazil." International Tax Review. International Tax Review, September 25, 2017. <https://www.internationaltaxreview.com/article/b1f7n98fwr4lj/the-challenges-of-tax-compliance-in-brazil>.

<sup>34</sup> "Paying Taxes - Doing Business - World Bank Group," [www.doingbusiness.org](http://www.doingbusiness.org), <https://www.doingbusiness.org/en/data/exploretopics/paying-taxes>.



in the GDP world ranking. In recent years, despite political and financial crises, Brazil has been experiencing a significant increase in its consumer market due to the swift change in the Brazilian social pyramid. Many Brazilian citizens moved from class D (total family income up to two minimum wages of around the USD 350) to class C (up to four minimum wages of around the USD 1,400). This social mobility has raised the purchasing power of class C and the middle class in general. Also, Brazil offers excellent operating conditions and a growing and young population. This would be appreciated by Chinese SEZ investors. A strong labor market is a key factor for decision-making concerning the Chinese SEZs outside of China.

### **3.2. Minas Gerais Overview**

The state of Minas Gerais (MG) is the third richest state in Brazil, behind only the Sao Paulo (SP) state in first and Rio de Janeiro (RJ) state in second place. In Brazil's Southeast Region, these states collectively act as the industrial, agricultural, livestock, and service hubs. Minas Gerais is located in a privileged geographical position, with access to large consumer markets such as Sao Paulo and Rio de Janeiro. Neighboring the Center-West and Northeast Regions, it is the leading business corridor in Brazil. Also, MG has the most extensive road network and the second-largest rail network in Brazil.

Another focal point of MG's attractiveness is its easy access to Brazil's most important cities and ports. The state has forty-four airports and the largest road network in Brazil, 2,500 km or around 16% of the country's total. Minas Gerais used to have approximately 8,700 km of the railroad network, but now 6,200 km are unused and without any maintenance. Yet, this railroad carries the potential for future economic development with the right infrastructure improvements.

In southern Minas Gerais, Pouso Alegre's city acts as a strategic trade point, as it has been historically the main connecting area between Minas Gerais and Sao Paulo state. The

historic trade settlement that later became Pouso Alegre originated from the commercial exchange between the two states. Pouso Alegre is also one of the main trade routes between the two states and within other regions in MG.

### **3.3. Pouso Alegre Potential**

Pouso Alegre is a prosperous city, having the main road interchange in southern Minas Gerais, cut by five highways, three state roads, and two federal roads. Pouso Alegre is only 110 km from the interstate that directly connects major consumer city centers. The city is strategically located 400 km from Belo Horizonte (capital of MG), 286 km from Sao Paulo city (capital of SP state), and 386 km from Rio de Janeiro city (capital of RJ state). These logistic and geographic considerations played an important role in picking the city to receive the XCMG Industrial Park. Industrial Parks are manufacturing and production areas planned and zoned for industrial development. In the combined efforts between the two countries, China supplies the financial investment, while Brazil provides a local labor force and a large consumer market. XCMG Pouso Industrial Park was the first Chinese machinery-oriented construction in Brazil, representing an exciting opportunity for all parties involved.

In June 2014, financed by FDI from Xuzhou Construction Machinery Group (XCMG), the Park started operations to encourage bilateral cooperation. The facilities link the industry, research & development areas, storage, distribution systems, nearby suppliers, and financial services. The XCMG Park has bridged investments from China and local companies, leading to economic and trade expansion. The Park is exclusive for XCMG, that is, it is not open to any other company interested in investing in MG.

In the past six years, the agreement has grown into a much larger partnership. In January 2020, the XCMG group decided to open an investment bank, the first investment

bank in Brazil with 100% foreign capital, to further enable business in the area and sector.<sup>35</sup> The creation of the Pouso Industrial Park has also overcome some of the impediments that prevented economic growth in Brazil and Minas Gerais; since its special jurisdiction allowed for reduced bureaucracy and taxes.

Receiving substantial Chinese FDI has led to positive spillover effects in neighboring regions. XCMG Brazil has taken part in nearly 200 social welfare activities and projects ranging from disaster relief, education, and poverty alleviation.<sup>36</sup>

Many national and international companies, such as the Indian ACG Worldwide, the multinational Unilever, and the Swiss Aryzta, are attracted to the Pouso Alegre region because of logistical accessibility and strategic location. Yet, no company uses today the entire logistics chain advantage. These advantages bring about a significant opportunity that any company could take in the new proposed SEZ.

#### **4. SWOT MATRIX**

The fact that XCMG has implemented an Industrial Park in Pouso Alegre is per se a strong indicator of the valuable investment opportunity the city exhibits as a destination for FDI. As the paper proposes a more robust and open type of SEZ in Pouso Alegre to attract more

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<sup>35</sup> “Grupo Chinês Anuncia Investimentos Em Minas Gerais,” [agenciaminas.mg.gov.br](http://agenciaminas.mg.gov.br) (Agencia Minas, January 7, 2020), <http://agenciaminas.mg.gov.br/noticia/grupo-chines-anuncia-investimentos-em-minas-gerais>.

<sup>36</sup> XCMG. “XCMG Pouso Industrial Park in Brazil Becomes China’s First Construction Machinery-Oriented International Economic and Trade Zone.” [Prnewswire.com](https://www.prnewswire.com/news-releases/xcmg-pouso-industrial-park-in-brazil-becomes-chinas-first-construction-machinery-oriented-international-economic-and-trade-zone-300966761.html), November 29, 2019. <https://www.prnewswire.com/news-releases/xcmg-pouso-industrial-park-in-brazil-becomes-chinas-first-construction-machinery-oriented-international-economic-and-trade-zone-300966761.html>.

Chinese investment and other Chinese companies to Minas Gerais, the SWOT Matrix will be used to explore the city's strategic factors.<sup>37</sup>

The Strengths (S), Weaknesses (W), Opportunities (O), and Threats (T) matrix is based on the internal context for S and W, on the one hand, and the external environment for O and T, on the other. SWOT is a guideline for understanding the current reality to decide how to proceed with a strategy. It is a framework used to analyze from a company department to entire organizations, sectors of the economy, regions, countries, and continents<sup>38</sup>.

The internal context (S and W) will consider Pouso Alegre and all factors that can directly impact or influence a new type of SEZ construction in the city. Strengths are positive aspects, which are critical for a successful SEZ construction. In short, they include all the competitive advantages, resources, and valuable assets that the city has to offer. Weaknesses are vulnerabilities and potentials that must be improved to provide adequate conditions for this undertaking such as excessive taxes and bureaucracy.

As for the external environment (O and T), where the city can influence but not directly impact, nearby towns and the surrounding region will be contemplated. Opportunities represent possibilities to invest and capitalize that have not been addressed, such as a new market niche, new customer demands, or loss of competitors. Threats, contrarily, are the roadblocks that could harm a SEZ's progress in Pouso and may affect the project's financial viability. Once the threats have been identified, they can be simply monitored or may require a counteraction.

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<sup>37</sup> \* All data used represents the most currently available indicator.

<sup>38</sup> Skye Schooley, "SWOT Analysis: What It Is and When to Use It," Business News Daily, June 23, 2019, <https://www.businessnewsdaily.com/4245-swot-analysis.html>.

#### **4.1. Strengths**

Pouso Alegre is an excellent place to do business, ranking 29th among the country's best cities to make investments. In the state of Minas Gerais, Pouso Alegre is second only to the capital, Belo Horizonte, according to the annual study carried out by Urban Systems that has 42 indicators and four focus areas: economic development (maturity and growth of the city), human capital (related to professional qualification and training of labor), social development (a social reflection of the development of the town) and infrastructure (essential for business development).<sup>39</sup>

The business development in the region has attracted large pharmaceutical and logistics industries to Pouso Alegre, also due to the municipality's strategic location. Minas Gerais is the corridor of Brazilian cargo flow; within the state, Pouso Alegre has a uniquely well-located position, making it one of the six MG's dry ports - a Bonded Area and Inland Customs Unit (as shown in the map below). Bonded Areas are a type of SEZ closely related to Free Trade Zones as these commercial hubs receive and store (free of charge) products for exchange in the bonded warehouses. The central difference is that a Free Trade Zone is exempt from customs laws and regulations while a Bonded Area is not.<sup>40</sup>

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<sup>39</sup> "Melhores Cidades Para Fazer Negócios," Urban Systems (Revista Exame), <https://www.urbansystems.com.br/melhoresidadesparanegocios>

<sup>40</sup> Douglas Zhihua Zeng, "Special Economic Zones: Lessons from the Global Experience" (Private Enterprise Development in low-income Countries), <https://bityli.com/WhNmD>



*Ports and Dry Ports in the Southeast Region.* Source: Davyson Demmer and Fabio Alves, “Why Minas Gerais,” INDI

These logistic and geographic considerations played an important role in why the city was picked to receive the XCMG Industrial Park. Yet XCMG is not the only significant foreign company in the city. The Indian pharmaceutical multinational ACG Group opened a unit in Pouso Alegre in early 2019, and today it is the largest empty capsule manufacturing plant in Latin America and the most advanced in the world<sup>41</sup>. Brazilian companies also see the attractive logistics and distribution accessibility of Pouso Alegre. For example, in the second half of 2019, Cimed - the fourth largest national pharmaceutical industry - built a sizable facility near the Federal highway BR 381 road connecting Belo Horizonte to São Paulo city.<sup>42</sup> For six years, the presence of XCMG and other foreign industries has transformed the lives of Pouso Alegre’s citizens, allowing greater international exchange and cultural assimilation, making the city a place where foreigners can easily adapt to life and work.

<sup>41</sup> “Inauguração Da Nova Planta Da ACG Capsules,” India Brazil Chamber of Commerce, March 14, 2019, <https://www.indiabrazilchamber.org/post/inaugura%C3%A7%C3%A3o-da-nova-planta-da-acg-capsules>.

<sup>42</sup> “Notícias CD,” Grupo Cimed, <https://cimedremedios.com.br/noticias/>.

Many characteristics favor foreign investment in Minas Gerais state, particularly in the Southern region. For example, MG's qualified labor force is much cheaper than that of neighboring São Paulo or Rio de Janeiro states. In fact, the base minimum wage in MG for 2020 is between BRL 100 to 200 lower per month than in SP state, resulting not in worse conditions for employees but rather in greater purchasing power within MG. Plus, according to the survey conducted in 2018 by the Brazilian Institute of Geography and Statistics (IBGE), Pouso Alegre was the wealthiest economy in Southern Minas, at the time with a representative GDP of USD 1.335 billion.<sup>43</sup> The value of the land for the SEZ future installations in this area is also another beneficial element. It is possible to acquire vast tracts of land for a reasonable price in Pouso Alegre and nearby areas, as prices are much more competitive than in São Paulo's cities.

#### **4.2. Weaknesses**

The city's fast industrialization, accompanied by rapid population growth, entailed a lack of sufficient and corresponding urban planning, generating an inadequate infrastructure in some city sectors. The United Nations Educational, Scientific, and Cultural Organization (UNESCO) indicated Pouso Alegre among the 30 safest cities for young people in Brazil in 2017, with the available indicators of 2015.<sup>44</sup> However, the city fell from number one in the country, in 2013, to 24<sup>th</sup>, two years later. Although the figures are outdated, they show an increase in violence. This is a widespread tendency in other metropolises in Brazil. Violence is

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<sup>43</sup> "Produto Interno Bruto Dos Municípios - Pouso Alegre," Instituto Brasileiro de Geografia e Estatística - IBGE, 2017, <https://cidades.ibge.gov.br/brasil/mg/pouso-alegre/pesquisa/38/47001?tipo=ranking>.

<sup>44</sup> "Relatório Vulnerabilidade Juvenil - Violência," Forum Segurança (UNESCO, 2017), [http://www.forumseguranca.org.br/wp-content/uploads/2018/10/FBSP\\_Vulnerabilidade\\_Juveni\\_Violencia\\_Desigualdade\\_Racial\\_2017\\_Relat%C3%B3rio.pdf](http://www.forumseguranca.org.br/wp-content/uploads/2018/10/FBSP_Vulnerabilidade_Juveni_Violencia_Desigualdade_Racial_2017_Relat%C3%B3rio.pdf).



still an issue that needs to be addressed as it is a strong indicator of riskier investments, particularly among foreign investors used to lower crime rates.

#### **4.3. Opportunities**

The logistical and environmental potential are excellent opportunities that have not been fully seized in the region. There are currently no projects that explore the potential of ecological tourism, despite all the forests surrounding Pouso Alegre. Moreover, the region has excellent air quality and it is full of rivers and woods - circumstances favorable to attract foreigners and tourists, who would come at a greater flow to the city if it becomes a prosperous Special Economic Zone.

Yet, as stated above, no company uses today the entire logistics chain advantages, creating a major opportunity for any company in the new SEZ. Some benefits are storage in bonded areas and easy access to other states, without paying state taxes, to ship the production from nearby ports.

#### **4.4. Threats**

In order to initiate the implementation of a new SEZ in Pouso Alegre, there must be direct approval from the Minas Gerais state government. In this context, the main threat that could arise would be the local political struggle. The more scarce, specific, or essential the opportunity is, the more interested politicians will struggle to influence decision-making, create obstacles, and stop projects from approval when they fail to impose their agenda. In this example, the scarce resource would be the contribution of Chinese capital - the FDI that will be implemented with the specialized know-how to create a SEZ. Hence, the city that will receive the resources gains a considerable advantage by becoming a hub of economic attraction.

Nothing prevents new foreign investments from happening in other locations later. But one must consider that projects such as this SEZ are not focused on the short term. The priority of a SEZ should be global social improvement through commercial expansion and growth through economic development. With this goal in mind, it would be possible to envision a more competitive and efficient economic environment in the future, created by greater mobility of international capital.

## **5. IMPLEMENTATION OF THE NEW SEZ IN POUSO ALEGRE**

Even though Brazil is a federal republic, individual states do not hold as much power to change legislation and make economic policies as they see fit. Establishing a SEZ in Minas Gerais would be an effective way to cut through red tape and reduce taxes as the Special Zone would have special taxation exemption and specific legislation. After careful consideration of all legal, economic, and political aspects in play, at the federal (Brazil), state (Minas Gerais), and municipal (Pouso Alegre) levels, this paper suggests that a viable route seems to be creating an Export Processing Zone (EPZ) in Pouso Alegre. One industrial project of a company interested in the EPZ and an economic feasibility study denote the location being suitable for exports. Creating it is possible under federal law. There is already a National Council of Export Processing (CZPE).

Export Processing Zones are a type of SEZ dedicated almost entirely (around 80%) to produce goods for exportation. To create one, it is necessary to provide a series of documents and fill an administrative request with the CZPE to implement an EPZ in Minas Gerais. The requirements for the enterprise are proof of land and availability of funds. The authorities also require a report stating the presence of minimum infrastructure; an indication of the legal model to be adopted; declaration by the competent environmental agency; and a term of commitment from the State or municipality's legal representative.

Another positive factor for such creation is that the state's current government is pro-free market. It has worked to reduce excessive bureaucracy and it actively supports the creation of the Chinese bank by XCMG. Plus, the federal government guarantees for 20 years the right to an EPZ, as prescribed by the Brazilian EPZ regime.

An additional challenge faced by this type of SEZ to function is that the investment comes from the federal government in Brazil. Having part of the project financing coming from China via FDI could considerably minimize this issue for two reasons: First, part of the value would already be made available by the Chinese investment; And, second, the Brazilian government would be pressured to expedite its share of the investment. In this way, Brazil would be nationally committed to delivering not only to MG but also to China, its most significant international commercial partner.

Beyond the FDI to build the EPZ, a spillover effect is expected to expand to multiple cooperation areas, as was the case with the XCMG's bank, created because of the Industrial Park's success. However, unlike Pouso Park, the EPZ will not be restricted to one company, that is, other industries and businesses would be attracted.

## **6. CONCLUSION AND DISCUSSION**

Doing business in and with Brazil is not a simple task. Even though the country receives plenty of FDI and has abundant natural resources, political and government matters do not facilitate financial transactions and efficient economic growth. Nevertheless, China has been steadfast in its investments in Minas Gerais, making it one of the top destinations among Brazilian states for Chinese FDI.

This paper argued that Minas Gerais and Pouso Alegre have the potential and capacity to receive and coordinate more Chinese FDI. Minas Gerais's geographic characteristics make it a strategically competitive area. Its logistical facilities enable a fast

flow of products and outlets to all the country's larger consumer markets. Nevertheless, taxation and bureaucracy often come into play, preventing this free movement of foreign capital.

To mitigate both issues, the paper proposed creating an Export Processing Zone in Pouso Alegre. Many are the compelling reasons behind this suggestion, including how the state has the third-largest consumer market in Brazil. The paper used a SWOT analysis to raise relevant points and possible improvements that the state and municipal government could carry out for the EPZ to thrive. XCMG Industrial Park's success, cheaper land, and labor are excellent strengths that favor the city. On the other hand, the present infrastructure could be upgraded to meet the minimum infrastructure report requirements for the EPZ request. Furthermore, the EPZ could foster the use of the whole logistical chain present in the city.

Given that China has a record of directing the flow of FDI to locations where it has implemented a SEZ, carrying out an EPZ in Pouso Alegre will be a profitable strategy to systematize and increase foreign capital flow in Minas Gerais.

In summary, a Chinese-sponsored EPZ in Brazil would be appealing to both countries, which are often looking for more prominent bilateral partnership opportunities, according to the New BRICS Development Bank seminar regarding the negotiation of a Sino-Brazilian free trade agreement<sup>45</sup>. If the Chinese market purchases the products from the EPZ for a reduced amount - given the tax incentive - this agreement can expand Minas Gerais - China's cooperation and efficiently guide Chinese foreign direct investment in Brazil. In conclusion, the Export Processing Zone in Pouso Alegre would be an instrument to promote Pouso Alegre, Minas Gerais, and Brazil's economic growth with Chinese FDI.

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<sup>45</sup> "Guedes Fala Em Livre Comércio Com China: Veja Principais Produtos Negociados," globo.com (G1, November 12, 2019), <https://g1.globo.com/economia/noticia/2019/11/13/guedes-fala-em-livre-comercio-com-china-veja-principais-produtos-negociados.ghtml>.

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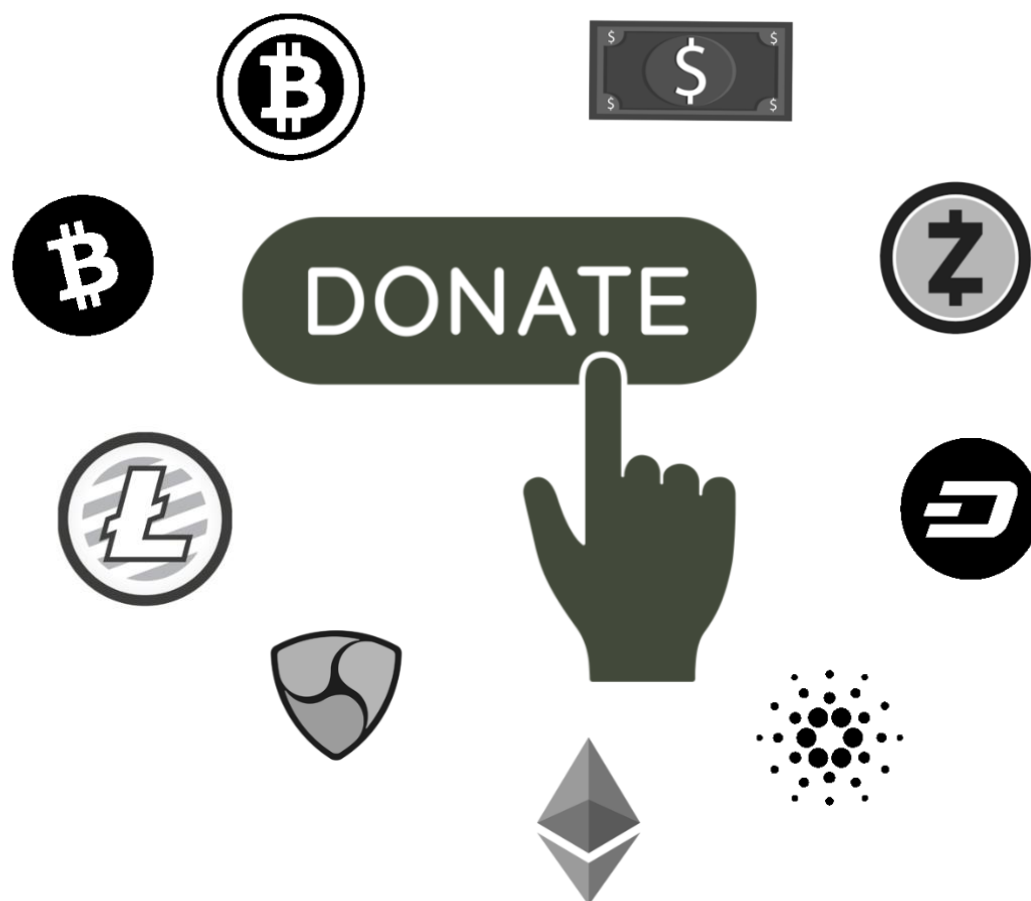
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