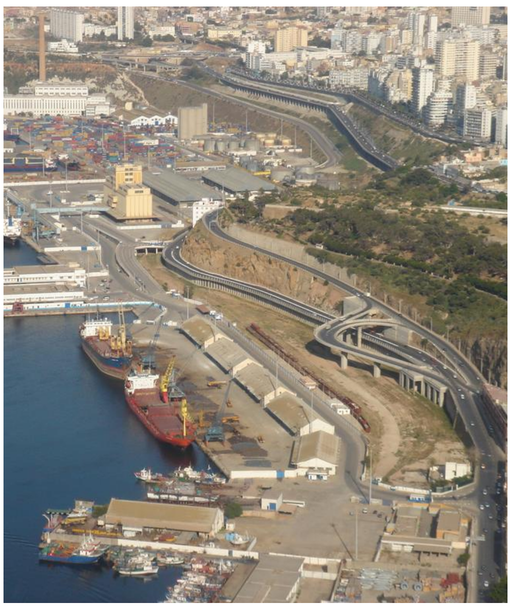
Special Economic Zones in Algeria
Promoting Growth and Mitigating Economic Instability

David | Newbrander



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Special Economic Zones:
Promoting Growth and Mitigating Algerian Instability

Algeria's high youth unemployment rate, reliance on hydrocarbon exports, and unattractive business climate are sources of economic instability. These factors increase regional political instability, incentivize migration to Europe, and heighten the potential for radicalization of the population. Special Economic Zones (SEZs) allow for incremental economic liberalization without risking political instability. This report argues that Algeria should create a Hybrid Export Processing Zone, a type of SEZ focused on private sector investment, in the Armez region to promote job creation, diversify the economy, and attract foreign investment. Such a zone would reduce Algeria's vulnerability to economically motivated civil unrest that has the potential to erupt into civil war.

Introduction: Algeria Immune to the Arab Spring?

> *"Algeria is poised between its fear of returning to chaos and violence if the army and the regime loosen up and its underlying socio-economic difficulties that cry out for political and economic reform."*[1]
>
> – Bruce Riedel

The Algerian regime faces opposition from Berber and Islamist groups. However, unlike Tunisia, Egypt, and Yemen, a large, unified opposition has failed to mobilize despite widespread political, social, and economic grievances.

The lack of sustained protest in Algeria led several scholars to question whether Algeria was immune to the Arab Spring.[2] Nevertheless, Algeria has seen some and is likely to see greater unrest. Approximately 130 Algerians committed suicide by self-immolation in 2011 because of socio-economic grievances, while sporadic small-scale protests broke out in January 2011 after food prices increased.[3] Protests continued throughout the year—there were 11,000 cases of low-level protests, strikes, and self-immolations in 2011. Yet, protests failed to garner widespread support due to a fragmented opposition, a violent history of civil unrest, and the regime's response.

- *A Fragmented Opposition*. Internal disagreements during the 2011 uprisings weakened the National Coordination for Democratic Change, a coalition of opposition parties, human rights organizations, youth associations, and independent trade unions.[4] National anti-regime protests mobilized a mere 2,000 protesters, fewer than individual protests by graduate students against university reform.[5] Protests by Berber groups have been ongoing for decades, but have achieved only limited gains.

- *Devastating Civil Unrest in the 1990s*. In 1991, the military voided an electoral victory by the Islamic Salvation Front. This intervention triggered a devastating decade-long civil war between the government and Islamic opposition groups, particularly the Armed Islamic Group. As Malek Serrai explained: "we already lost 200,000 people [in the civil war,] we cannot again go through this kind of problem."[6] The memory of the civil war dampens popular enthusiasm for renewed unrest.

- *Government Repression*. The regime responded to protests in 2011 with a mix of repression, limited political reform, and economic appeasement. Police stepped in to prevent protests from gaining momentum as they did in other North African countries. Police arrested over 1,000 protestors in January 2011 and responded with overwhelming numbers: 26,000 police were dispatched to quell the February 12 protest.[7] "Young men armed with knives attacked some protestors. Police used new tactics, kicking people with steel-toe boots to avoid camera lenses."[8]

- *Government Appeasement.* The regime also appeased potential protesters by ending the 19-year long state of emergency and implementing limited reforms such as increasing representation for women in parliament and allowing limited press freedom.[9] Most importantly, the regime used its wealth from oil and gas exports to buy off its citizenry. The government spent almost $23 billion on: (1) additional food subsidies, (2) higher salaries and benefits, (3) cash transfers to regions with a strong opposition presence, and (4) interest-free loans for young entrepreneurs to start businesses.[10]

Despite avoiding an Arab Spring uprising, President Bouteflika and *le pouvoir*, the military and security services leaders, remain vulnerable to civil unrest. According to University of Algiers professor Louisa dris-aït Hamadouche "the Algerian system's capacity for resilience has various sources: financial, security and historical. But like oil, these are non-renewable resources and will eventually run out."[11] The regime must address underlying political and economic grievances, but its policy responses have failed to do so. For example, the government loans to start new enterprises often disappear due to fraud, or are used for other purposes, like paying rent.[12] The minimum wage increase from 15,000 Algerian Dinars (DA) to 18,000 DA in January 2012 is insufficient to achieve economic security because of high food prices and declining purchasing power. The wage increase is "only a drop in the sea of social problems."[13]

The government's attempt to appease protesters in 2011, therefore, were effective in the short run, but failed to address the long-term issue of lagging private sector growth and job creation. As a result, Algeria faces economic, demographic, and political challenges that threaten national and regional stability. Unless President Bouteflika and *le pouvoir* address these vulnerabilities, they could face another regionally destabilizing civil war. As Lamina Maghraoui stated: "Nobody wants to bring Syria to Algeria, … but the more we protest, the more repression we see. If the regime doesn't change its attitude and the social suffering increases, there will be a reaction. It will be a revolt."[14]

Algeria remains vulnerable to economic sources of instability that could lead to an increase in political instability, migratory pressure to Europe, and radicalization of the population, increasing support for terrorist groups. Specifically, Algeria must address a high unemployment rate, an overreliance on the hydrocarbon sector, and an unattractive investment climate. To mitigate these problems, this report proposes creating a Hybrid Export Processing Zone, a type of Special Economic Zone (SEZ), in the Arzew region.

Regional Consequences of Increased Instability

Algeria's economic, political, and demographic troubles have several negative consequences for the country and the region. These consequences include heightening instability in Algeria, rising immigration to Europe, and increasing terrorist recruitment.

Instability in an Already Volatile Region

These sources of economic and political discontent could cause an economic crisis that triggers political upheaval and unrest. While Algeria avoided large Arab Spring uprisings in 2011 and 2012, it is doubtful that the regime could again fund such largess in welfare spending and benefits increases in response to protests if faced with an economic crisis, especially if oil prices simultaneously fell. Thus, the regime is susceptible to protests and civil unrest similar to the Arab Spring protests unless economic vulnerabilities improve. These protests likely will be violent. According to retired Algerian intelligence officer Mohamed Chafik Mesbah "I think it will be more violent than in Tunisia."[15] Algeria would likely to face a scenario similar to Syria where the security services are loyal to the regime.

The economic crisis that triggered a political crisis in the late 1980s and the Algerian civil war that raged throughout the 1990s bear many similarities to the current situation. Like today, the economy faced mounting inflation, significant unemployment, and a housing shortage.[16] When oil prices crashed in 1986, the government was forced to reduce its welfare spending, both in terms of eligibility for aid and amount of spending, while it pursued economic liberalization policies imposed by the IMF. The resulting economic hardship delegitimized the regime and led to widespread riots, which increased in size and frequency.[17] The regime cracked down in 1988, and the military killed approximately 500 protestors. The resulting fury against the military and the regime led to a brief period of political liberalization during which Islamist groups almost gained power. The military intervened, annulling the elections, and began a conflict against the Armed Islamic Group that sparked a civil war during which 100,000 to 200,000 died.

Finally, political unrest and civil war would have significant economic costs. The unrest in 2011, for example, led to a 97.1 percent decrease in new Chinese direct investment in Algeria.[18] The 1990s were plagued by civil war. Economically, they were a lost decade as GDP per capita declined only regaining its 1987 level in 2004.[19] The link between political unrest and economic growth creates a vicious cycle where upheaval decreases economic growth and opportunities, which in turn increases motivation for further unrest. Thus, as civil unrest spreads and intensifies, it further delegitimizes the regime economically.

Migratory Pressure

Poverty and unemployment are significant drivers of irregular migration to Europe.[20] Currently, migration from Algeria to Europe is limited in scope. Yet, more than 2,200 *harraga*, Arabic for illegal immigrants, were apprehended attempting to leave Algeria in 2008. A 2009 law penalizes leaving Algeria illegally with six months of prison.[21] Approximately 91 percent of these immigrants, who risked crossing the Mediterranean in non-seaworthy boats search of economic opportunity, were under the age of 35.[22] In recent years, the "number of highly-skilled migrants has grown because of high unemployment among university graduates and selective migration policies in North America and Europe, as well as the political situation in Algeria."[23]

Should Algeria face a severe economic crisis, these numbers would increase dramatically, especially if the economic crisis triggered political unrest. The Brookings Institute found that the Arab Spring created almost 2 million refugees and immigrants in 2011. According to EuroStat, asylum applications from Tunisians rose by 92.5 percent and from Libyans by 76 percent after the Arab Spring broke out.[24] Many of these refugees fled to non-European neighboring countries, but in 2011 alone over 58,000 refugees arrived in Europe.[25] In the first three months of 2011, 22,600 refugees arrived in Italy; comparatively, 147 sought refuge in 2010.[26]

The huge increase in refugees resulted in the deaths of over 1,500 irregular migrants seeking to cross the Mediterranean and caused additional tension in Europe among members of the Schengen Zone.[27] Increased immigration also is detrimental for the Algerian economy as an increasing proportion of emigrants are highly educated. Algerian immigrants, for example, are among the highest educated people group in the United States, averaging 13.3 years of education compared to 10.6 for U.S. and other foreign citizens.[28] Currently, migration from Algeria is manageable, but unless economic conditions improve, irregular migration will become a more serious problem for Europe and Algeria.

Radicalization and Increased Recruitment for Terrorism

Economic underdevelopment is a key root cause of radicalization and contributes to societal acceptance of terrorism. Radicalization occurs when populations become disillusioned as their prospects for the future grow increasingly misaligned with the reality offered by the government. Relative deprivation causes radicalization as expectations are created vis-à-vis more developed economies. The resulting heightened expectations increase perceived economic deprivation. These frustrations are felt particularly keenly in North Africa due to "a demographic explosion, growing expectations, weak state capacity, and diminishing opportunities for upward mobility."[29] Educated youth are particularly strong candidates for radicalization because they "have the highest political aspirations and expectations, and thus, it is they who are the most frustrated when their expectations are unmet."[30]

Radicalization, collective frustration and relative deprivation combine to form the support base for terrorism by creating a "climate of legitimacy and implicit support."[31] Terrorist organizations rely on the tacit support of their society to survive as well as to fill recruitment in the lower ranks. Without a suitable social climate, terrorism has no base from which to operate and will be unlikely to flourish. Several extremist groups, including Al Qaeda in the Islamic Maghreb, which is Algerian-led, benefit from Algeria's economic challenges.[32] According to documents confiscated from Al Qaeda, Algerians were one of the largest groups of anti-coalition fighters in Iraq.[33]

Sources of Economic Instability in Algeria

Migration, civil unrest, and terrorist recruitment stem from a variety of causes, but are all rooted in the lack of economic opportunity in Algeria—both the immediate problem of unemployment and the potential future economic crisis due to inadequate private sector growth, meager foreign investment, and an over-reliance on hydrocarbons.

Economic grievances, such as high unemployment, stagnating economic growth, high food and gas prices, and insufficient infrastructure, played a significant role in the Arab Spring protests.[34] Algeria's high youth unemployment, reliance on oil and gas revenues for export and fiscal spending, and inability to attract foreign investment are sources of ongoing economic vulnerability. If unaddressed, these problems will coalesce into a major economic crisis with significant political and societal implications.

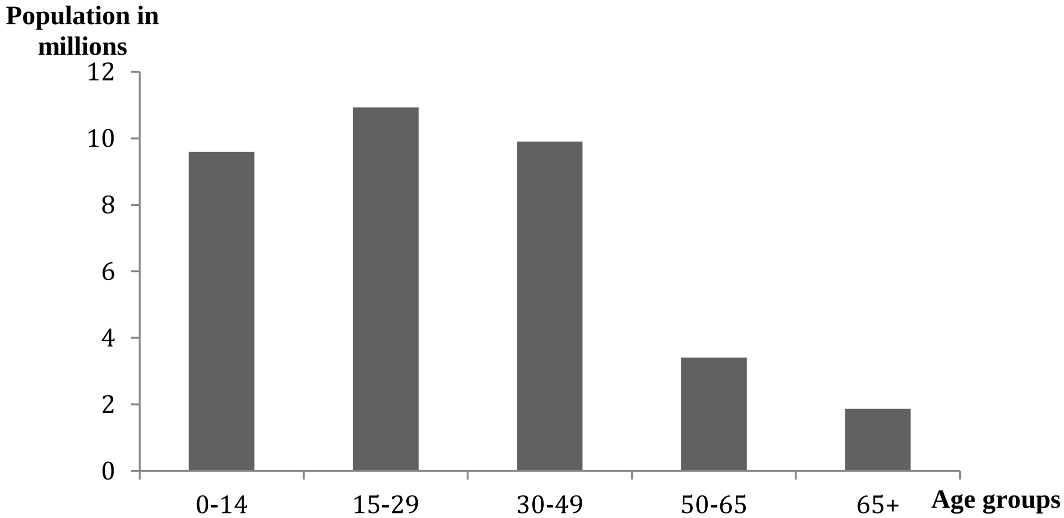
High Youth Unemployment Rates

One of Algeria's most significant challenges is a high unemployment rate. Unemployment and underemployment among educated youth increases frustration with the government and is a drag on the economy. Overall, the Algerian unemployment rate is roughly 10 percent, but it rises to 21.5 percent for workers between the ages of 15 and 25. High youth unemployment is especially worrying as 47 percent of Algeria's population is under the age of 25 (See Figure 1).[35] Demographic pressures will only fuel more unemployment among this age group. Approximately six million youth entering the job market by 2020 could overwhelm the labor market.

Youth unemployment only exacerbates Algeria's existing poverty, where one in four citizens lives below the poverty line.[36] Due to labor market mismatch, college graduates are three times more likely (21.4 percent) to be unemployed than non-graduates (7.3 percent).[37] Unemployment has significant social costs, decreasing the ability of youth to marry and reducing incentives for further education.

The majority of Algerians find employment through "personal or family connections," known as *wasta* in Arabic. Only 15.7 percent of jobs are filled by "competition or examination," compared to 40.6 percent filled by *wasta*.[38] The dichotomy between merit and *wasta* frustrates many Arab youth and increases discontent. As one law student explained: "Even with a diploma, you can't get a job. You need connections."[39]

Figure 1: Population by Age Group, 2010 in millions[40]

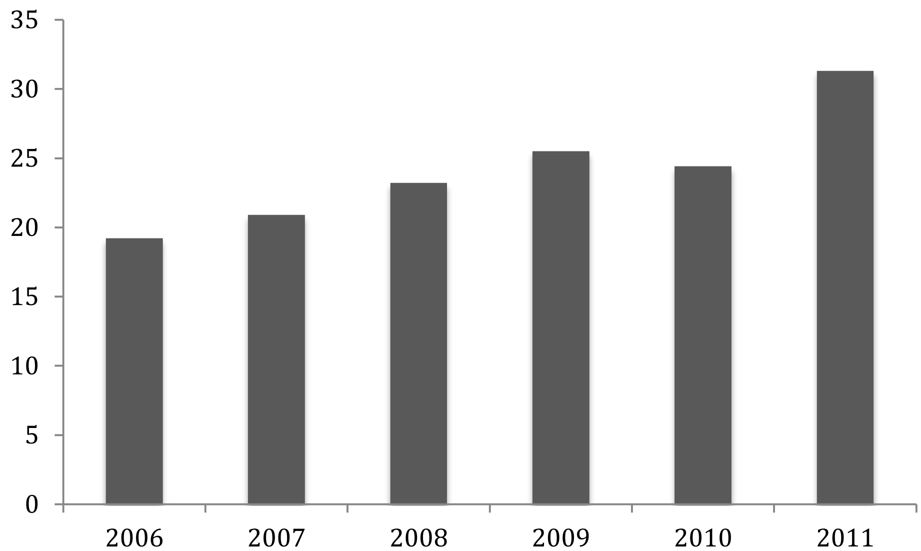


Lack of Economic Diversification: Reliance on Hydrocarbons

Algeria is a key African producer of natural gas and sweet, light, crude oil. Not only is Algeria the fourth-largest oil exporter in Africa with 12.2 billion barrels of oil reserves, but its oil is also highly desirable because its low viscosity and mineral content make it easier to refine and transport.[41] Algeria is the eighth-largest gas exporter, and is the third-largest exporter of natural gas to Europe, providing approximately 15 percent of European gas imports.[42] These hydrocarbon exports are the lynchpin of Algeria's economy, accounting for 97 percent of total exports, but only employ approximately two percent of the labor force.[43] Indeed, hydrocarbon sales generate 60 percent of government budget revenues and constitute 36 percent of GDP.[44] Hydrocarbons' overwhelming dominance among government revenue sources has several implications.

- *Unsustainable welfare spending.* Algeria funds its social welfare services largely with hydrocarbon revenues. According to a leading British think tank, "45% of government expenditure in the non-hydrocarbon sector is paid for by oil and gas revenues. Oil and gas exports pay for nearly 80% of imports of goods and service[s], and other net payments by the non-hydrocarbon sector."[45] Non-hydrocarbon exports, on the other hand, only pay for less than 1 percent of imports.[46] Hydrocarbon revenues have allowed Algeria to amass $56.7 billion in its sovereign wealth fund, the Fund for the Regulation of Receipts (FRR).[47] Economic rents from oil exports are channeled into the FRR, which provides liquidity should oil prices fall and pays for the annual fiscal deficit. The FRR financed the aforementioned cash transfers and salary increases that appeased discontented citizens. This spending, however, is not sustainable (See Figure 2). "If this level of spending continued until 2016, the FRR would drop to half its 2010 level."[48] Additionally, spending at a higher rate than GDP growth risks higher inflation, which is harmful to export industries.[49] In 2012, Algerian inflation jumped from 4.5 to 9.1 percent, harming the economy and threatening Dutch disease.[50]

Figure 2: Government Expenditure as a Percent of GDP[51]



- *Potential for political and economic crisis.* Should oil and gas prices decrease or reserves dry up, Algeria would face a political and economic crisis. Reduced social welfare spending would trigger a political crisis. Because the non-hydrocarbon sector is only able to achieve anemic growth at best, it is therefore incapable of covering the fiscal deficit from welfare spending on its own.

  Falling hydrocarbon prices and depleted oil and gas reserves in Algeria are likely. New hydrocarbon finds, especially in North America and Australia, may lead to a decrease in oil prices.[52] A recent study examining resource depletion predicts that Algeria will face severe energy sector challenges within 5 to 20 years. The study assumes 10-20 percent overall growth in oil reserves due to new finds and that prices will remain around $100/barrel. The authors calculate that "hydrocarbon exports would turn negative in 2033." The fiscal balance for the government is projected to be negative beginning in 2019. Additionally, the trade balance is projected to plummet to -33 percent.[53] New reserve findings may slow the process, but will not solve the problem.

- *Vulnerability to hydrocarbons to shocks.* Reliance on hydrocarbons leaves the Algerian economy susceptible to oil price shocks. Recent terrorist attacks on oil pipelines and gas plants highlight the vulnerability of oil and gas infrastructure.[54] An attack on pipelines or a refinery would be detrimental to Algerian hydrocarbon exports and serve as a further economic shock.

Algeria must encourage growth in the private, non-hydrocarbon sector. While growth in other sectors will increase domestic consumption for oil and gas, in the long run, diversification is the only viable strategy for continued economic growth and strength. The current profits from high oil prices provide an ideal basis from which to fund this diversification effort.

Unattractive Business Environment

Algeria's private sector growth is severely hampered by government inefficiencies that result in a lack of attractiveness to foreign investors. Reform is necessary for Algeria to improve its business environment.

Algerian bureaucracy hinders the creation of small and medium enterprise (SMEs) in the non-hydrocarbon sector because "[e]nergy development is the only sector of Algeria's government that operates efficiently."[55] Instead, "influence-peddling [is] still an integral part of business" and corruption is widespread.[56] Yet, even Algeria's hydrocarbon sector has trouble attracting business partners because of frequent delays and high tax rates for foreign oil producers. For example, in 2011 Algeria filled only two of ten offered permits for oil and gas exploration.[57] Additionally, the 2010 Complementary Finance Law requiring 51 percent Algerian ownership of any foreign investment dampens foreign enthusiasm for investing.

In the medium term, Algeria's economic growth in the non-hydrocarbon sector will "largely depend on the authorities' structural reform agenda to further strengthen and develop the financial sector, enhance the business climate and competitiveness, promote private investment and support economic diversification."[58] Algeria, however, has a long way to go. It is the second-worst ranked Middle Eastern state on Heritage's Economic Freedom Index, scoring particularly poorly on government involvement in the economy, regulator efficiency, and trade freedom.[59] It also ranks 152nd out of 185 countries for ease of doing business. Algeria improved access to credit for starting a new business through loans and by access to personal credit reports.[60] Nevertheless, investors still face difficulty accessing reliable electricity, registering property, paying taxes, and enforcing contracts.[61] This lack of attractiveness for foreign investment hampers economic growth in the private sector and increases Algerian reliance on hydrocarbons.

Additional Sources of Instability in Algeria

Algeria faces a number of additional challenges and potential sources of instability. These challenges include political factors such as high levels of corruption, limits on the freedom of assembly and association, limited transparency, the need for judicial reform, and the behind-the-scenes dominance of the security sector in politics.[62] Demographic challenges, such as population growth, exacerbate other economic and political sources of instability. Algeria's population has almost doubled since 1980. Not only has this population explosion caused a generational gap and increased societal strain, but it also will deplete water supplies, force reliance on food imports, cause overcrowding, and strain infrastructure and educational, political, and economic systems.

Should these factors coalesce, Algeria is likely to face an economic crisis that triggers a political crisis. To decrease the potential for an economic crisis, Algeria must pursue economic policies centered on creating jobs, attracting foreign investment and diversifying the economy.

Economic Liberalization Models

Algeria must pursue policies to liberalize the economy in order to attract foreign investment, create jobs, and diversify the economy away from hydrocarbon exports. There are two ideal types of economic liberalization for Algeria to choose from. Each approach to liberalization has different political implications.

- *Rapid Liberalization*. This approach, championed by the IMF, structurally overhauls the entire economy at the same time. In the past, the IMF has attached conditions to countries undergoing economic stress as a policy tool to achieve economic liberalization. It adopted a one-size-fits-all approach to liberalization. The proposed policies included privatization of state enterprises, tax reform, liberalization of inward foreign direct investment, and fiscal discipline.

  Today, the IMF still grants conditional aid, but has relaxed its universal approach in response to harsh criticism. Critics argued that the universal approach failed to allow for the cultural, historical, and regional context. As a result, its policy recommendations adopt a case-specific approach. The policy recommendations generally follow similar prescriptions as in the past, but there has been increasing flexibility. For example, the IMF acknowledged that capital controls might be useful at times.[63]

- *Incremental Liberalization Model*. The incremental approach was successful in Korea, Taiwan, Singapore, Hong Kong, and China, leading to strong growth rates for these countries and increased foreign direct investment.[64] For example, in 2010 Taiwan's SEZs accounted for $11.5 billion of investment.[65] The Chinese model of economic development is one example of incremental liberalization. It includes two main stages: "bringing in" of Western technology and ideas, and the eventual "going out" of competitive Chinese exports and economic philosophy to markets around the world.[66] The first phase involves gathering technology and human capital necessary for growth. As a means of accomplishing these goals, China created four SEZs. In these SEZs, they ignored national protectionist policies and adopt liberal terms of trade. These regions succeeded in attracting foreign investment, and quickly blossomed into flourishing Export Processing Zones, encouraging the Chinese government to implement additional SEZs.

  Within these SEZs, trade restrictions, barriers to foreign investment, and other factors inhibiting economic development were lowered sharply or abolished completely. The result was robust economic growth that encouraged the government to develop over one hundred SEZs, to diversify the industries within the SEZs, and eventually to ensure that the industries became export-competitive—achieving the second stage of development.[67]

Political Implications of the Two Development Strategies

Regimes adhering to the IMF model of the late 1980s usually did so out of necessity rather than out of choice, and faced no small number of political problems along the way. The rapid model of economic liberalization increases political instability during the transition to free market capitalism. Rapid liberalization "turned out to be suicidal for the governments that launched it, notwithstanding the scars … would remain for a long time."[68] For highly authoritarian governments, maintaining subsidies is a key strategy for keeping constituents politically quiescent and generally supportive. Subsidies are not economically sustainable due to their high cost, so when the IMF grants conditional loans requiring that governments drop subsidies, leaders are forced to choose between alienating their constituencies and alienating the IMF, between economic growth and political survival. Governments in Poland, Russia, Bulgaria, Estonia, the Czech Republic, Albania, and Latvia all abandoned rapid liberalization in favor of gradualism "after unfavorable elections results for the … governments."[69] A recent study on IMF liberalization and civil conflict concluded that: "the IMF-guided process of liberalization generates new losers at a rate with which a state with weakening powers is incapable of contending. It is as these actors see the opportunity costs of conflict-initiation decline that the risk of civil war onset rises"[70] Thus, the alienated constituencies are more likely to rebel against the regime and civil war becomes more likely.

The model of economic liberalization that China charted in the late 1970s offers a more politically feasible alternative for economic growth than the massive overhauls proposed by the IMF during the 1980s. The Chinese model allows for an interim period in which a state will gradually wean itself from the subsidies and protectionist trade barriers while experimenting with liberalization in a limited number of regions. The benefits of this model are twofold: (1) the state avoids the political chaos of sudden, massive reductions in subsidies and tariffs; (2) the state can prove to itself and its citizens that liberalization is a helpful economic change.

The Chinese model takes the same end goal of liberalization and changes the nature of the game, adding a longer time frame with the incremental strategy, easing the burden and dramatically decreasing the resulting political instability. In essence, the debate boils down to two approaches to the same goal of liberalization: the IMF model argues that the high initial cost of one-time liberalization will eventually pay for itself despite the resulting political instability, while the Chinese model argues for incremental liberalization as a strategy to minimize political repercussions during the process of liberalization.

While the IMF model may be successful in maximizing economic growth in the long run, it is not politically feasible in highly authoritarian countries such as Algeria. The plan depends on a favorable political system whereas the incremental approach is practicable in authoritarian countries. Thus, the model of incremental growth is better suited for Algeria given political exigencies. Algeria's experience with IMF conditionality in the 1980s and 1990s is but one example of how devastating an attempt at rapid economic liberalization can be for an authoritarian regime.

Policy Solution: Special Economic Zones in Algeria

Algeria is in desperate need of private sector growth, especially in the non-hydrocarbon sector. However, "Algeria is unlikely to grow substantially through private sector growth unless there is a change in the current system. There remains too much control from above and too little scope for individual initiative."[71] This required change must be achieved gradually to avoid political instability. If applied correctly, the incremental liberalization model can create the economic liberalization and opportunities for growth Algeria needs. This paper proposes creating a SEZ that will provide increased jobs, diversify the economy, and allow Algeria to improve the business climate in the Special Economic Zone.

In order for this policy to be successful in the long term, Algeria must continue to invest in human capital—especially education, build strong linkages between the SEZ and the rest of the economy, and seek to increase the number of SEZs. Over time, Algeria can permit more SEZs and increase economic liberalization. As Algeria incrementally liberalizes the economy and grows economically, political reform becomes more feasible.

Finally, there are several direct benefits for the Algerian economy and government and many indirect benefits. Besides economic growth and export diversification, Algeria would gain increased foreign direct investment, higher government revenues, and increased employment opportunities.[72] SEZ employment leads to worker skills improvement, technology transfer and regional development.[73]

Question #1: What type of SEZ is best suited for Algeria?

Previous attempts to create SEZs in Algeria were unsuccessful because they failed to adopt an appropriate type of SEZ given the country's strengths and requirements. In 2008, China and Algeria agreed to create the Jiangling Economic and Trade Cooperation Zone to assemble cars in Algeria.[74] However, just a year later, construction came to a halt when an Algerian official announced the suspension of the project. The failure of Jiangling shows that the Chinese model of SEZ development in Africa is inappropriate for Algeria for several reasons:

1. The process of investment generally involves importing the necessary infrastructure, technology, and capital from China instead of from the domestic economy.[75]

2. Chinese firms control ownership of the SEZ, but over time, some of the investors choose to relax their control and gradually allow African partners to hold a larger share of the investment, ideally culminating in African majority ownership after 50-99 years, depending on the contract.[76] This system disproportionately benefits the Chinese partners.

3. Chinese SEZs generate fear that they are merely a clever way for China to capitalize on favorable tariff rates from African countries. For example, Chinese exports might be taxed at a higher rate than the same good from a developing African country. This can also lead to the creation of a small enclave economy, depending on the industry within the SEZ.[77]

4. The SEZ results in a lack of quality employment for locals. Chinese companies typically import Chinese workers. At best, locals can hope for low-paying unskilled jobs and often face mistreatment, which can lead to dangerous protests and strikes.[78]

Construction of the Jiangling SEZ likely stopped in 2009 because the Algerian government passed a law stating that at minimum "51% of investment projects in Algeria must be owned by Algerians."[79] It is unclear what prompted this change in policy, but the four problems mentioned above provide insight into why this decision may have been reached. The decision may also have been influenced by Chinese corruption and fraud while constructing the East-West highway. While working on that project, Chinese companies "gave bounced checks to at least 15 Algerian subsidiary enterprises" and "reportedly [upheld] over US$4.2 million in wages."[80] This example of a failed Algerian SEZ offers valuable lessons for similar projects in the future.

Algeria should implement a Hybrid Export Processing Zone (EPZ). An EPZ focuses on manufacturing goods for export. In the case of a Hybrid EPZ, however, the SEZ is divided between sections reserved exclusively for export-oriented industries and sections open to all industries. Similar to other forms of SEZs, the Hybrid EPZ is in a delineated area, often fenced in, and has a separate customs area with streamlined procedures. Producers are eligible for certain benefits due to their physical location within the SEZ.[81] Goods produced within the EPZ are marked with the host nation's certificate of origin, and therefore can make use of beneficial tariff policies or import/export regulations between the host country and other countries.

The Hybrid EPZ is well suited for Algeria because it provides significant job creation and export diversification. Even if the overall number of workers in the EPZ is not large, in many countries SEZ employees account for less than one percent of the labor force, the overall effects of job creation are amplified through indirect job growth.[82] As supporting industries expand to meet the new demand created by the SEZ, a large number of jobs are created. Globally, EPZ indirect job creation is estimated between 9.6 and 77 million jobs.[83] Given Algeria's large population and high unemployment, industries will likely first manufacture goods with relatively high labor intensity. These goods will provide export diversification. The Hybrid EPZ allows for strong linkages between the SEZ and the local economy. Recent studies have found that zone success depends on the "degree of integration to economy and trade and investment reform agenda." While it is important to keep the SEZ separated from the local market, the SEZ must be integrated into the local economy. Local labor involvement is one important factor in this integration.

The Hybrid EPZ is better suited for Algeria's needs than the traditional EPZ or the Free Trade Zone (FTZ). The traditional EPZ focuses almost exclusively on manufacturing for export, where as the Hybrid EPZ is more flexible and more attractive for investors (See Table 1). The Hybrid EPZ allows investors to export goods abroad and to sell a limited quantity in the domestic market. The FTZ's primary goal is to support trade through duty free areas with warehouses and distribution facilities for re-export.[84] The Hybrid EPZ provides larger job creation than the FTZ while providing opportunities for access to domestic and export markets.

Table 1: Selective Overview of Special Economic Zone Typology[85]

Type	Development Objective	Size	Typical Location	Eligible Activities	Markets
Traditional EPZ	Export Manufacturing	< 100 Hectares	None	Manufacturing, processing	Mostly Export
Hybrid EPZ	Export Manufacturing	< 100 Hectares[a]	None	Manufacturing, Other Processing	Export and Domestic
Free Trade Zone	Support Trade	< 50 Hectares	Ports of Entry	Entrepôt, Trade-related	Domestic, Re-export

Question #2: What are the general guidelines for an Algerian SEZ policy?

As Algeria navigates between attracting investors and protecting the domestic economy, several issues must be addressed.

- *Local vs. Foreign Labor.* To maximize job creation in Algeria, the government should consider implementing regulations concerning what percentage of labor must be local. This regulation mitigates the problem of Chinese companies importing all of their labor.

- *No Local Ownership Requirements.* Algeria should drop the 51 percent Algerian ownership in new direct investment requirement for the SEZ. Algeria may impose a lower percentage requirement, but preferably would drop this requirement completely. Saudi Arabia abandoned its requirement in 2000 and relies on tax incentives to promote joint ventures.[86] The Saudi case may provide an example for the Algerian regime to copy.

- *Streamlined Bureaucracy*. The government should ease the burden on investors and create a "one-stop-shop" for all government bureaucratic affairs related to the SEZ. Under the current bureaucratic system, it "takes 14 procedures and 25 days to start a business."[87]

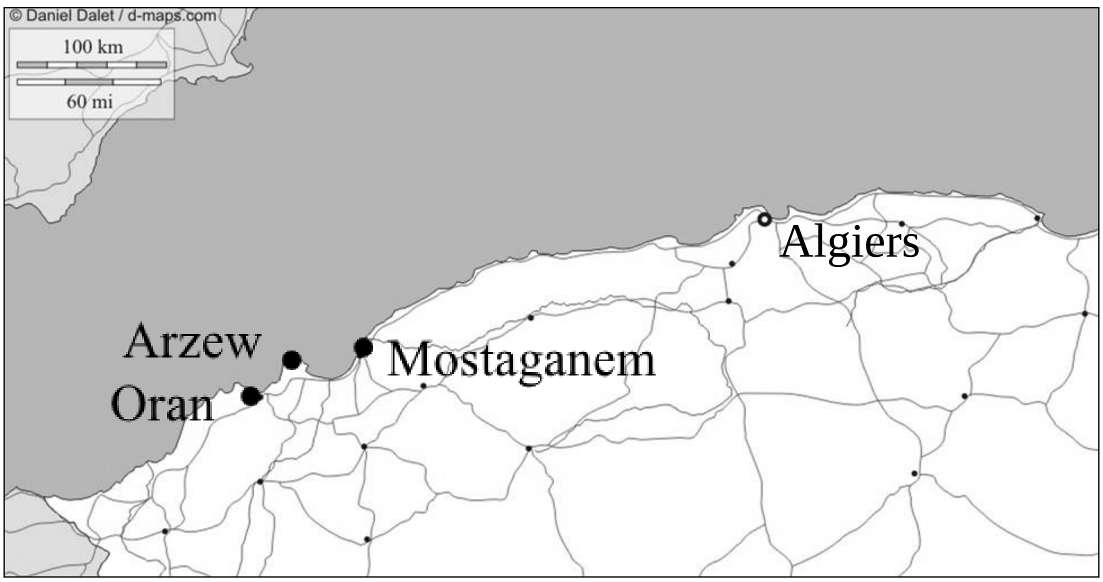
- *Credibility Mechanism.* Algeria also must provide a credibility mechanism for committing to the Special Economic Zone model. In the past, attempted SEZs failed due to government policy changes, such as the 51 percent rule that halted the Jiangling zone in 2009. Companies will be hesitant to invest in Algeria if they are uncertain how regulations will change and affect their investments.

  One possible avenue is to structure the SEZ under bilateral investment treaties (BITs), which provide some protection for foreign companies. Algeria has already signed BITs with almost 50 countries.[88] The contracts between the companies and the government for investing the SEZ must also include a conflict resolution mechanism.

Question #3: Where should the SEZ be located?

A prime location for the SEZ is in the region surrounding Arzew between the cities of Oran and Mostaganem. This site has several benefits. First, the proximity to Spain provides the SEZ with low transportation costs to Europe. Second, Oran is connected to the East-West highway that spans Algeria and provides ease of transport within Algeria. Third, Arzew already has a major port, shipping 40 percent of Algeria's hydrocarbon exports.[89] Fourth, a significant challenge to starting a business in Algeria is access to electricity. A power plant outside Arzew currently provides electricity to the oil and gas refineries.[90] Fifth, Arzew is close to Oran, one of Algeria's largest cities, and therefore will have a large pool of labor from which to draw. Sixth, Mostaganem hosts several universities, allowing students to move easily from school into skilled labor positions in the SEZ. Finally, indicative of the suitability of this area, Mostaganem was selected to host the abortive Jiangling SEZ in 2009.

Figure 3: Map of Algeria[91]



Question #4: What are the sources of funding for the Arzew SEZ?

Creating a Special Economic Zone does entail some up-front costs. These costs are unlikely to be funded by a foreign state. Bruce Riedel's assessment that "the United States is not a major player in Algerian affairs; Europe potentially could be but is probably too broke" applies to funding the SEZ.[92] Algerian foreign currency reserves are one possible source of funding, but the government seems resistant to the idea. Instead, the SEZ should be funded by private companies investing in the SEZ. Not only does this decrease the costs for Algeria, but it also increases the likelihood for success as privately-funded SEZs tend to be more successful and achieve higher growth than publicly-funded SEZs.[93] This approach also decreases the extent of Algerian bureaucratic involvement. Algeria's prime location between Europe and Africa enables it to act as a gateway for investors seeking entry into Middle Eastern, European, or francophone West African markets.

Potential Objections

There are several potential objections to this policy proposal.

- *Given the failure of past SEZs, Algeria will not be able to implement a successful zone.*

  Response: Two key differences separate this plan from the failures of earlier Algerian SEZs. In the past, as with the Jiangling SEZ, the Algerian government could adopt legislation contrary to signed investment contracts with limited consequences. With the BIT credibility mechanism, the Algerian government will only be able to break the investment contract under penalty of economic retaliation from the concerned state.

  Previous attempts to create a SEZ in Algeria foundered in part because of an inefficient bureaucracy. This plan recommends the creation of a single government office to oversee every aspect of the SEZ. Though the problem of an inefficient bureaucracy cannot be avoided, the negative impacts can be mitigated to some extent through the creation of a single government office.

- *A SEZ will bring employment opportunities, but they will be geographically concentrated, which doesn't actually solve the problem for those unable to move to Arzew*.

  Response: The employment opportunities will be geographically concentrated and will provide jobs mostly in the Oran-Arzew-Mostaganem. There may, however, be some indirect job growth in other regions as well. Nevertheless, a single SEZ is not an all-encompassing solution for Algeria's unemployment problems. Rather, it is a first step. Over time, Algeria should create more SEZs in other regions of the country and thereby increase employment opportunities in other regions. Additionally, Algeria must find other avenues for job creation in the private sector.

- *Corrupt Algerian bureaucrats will award investment contracts on a personal basis rather than through fair competition*.

  Response: Corruption remains a significant problem in Algeria. The ongoing corruption scandal in Sonatech, the national oil company, highlights the difficulty of doing business in Algeria without dealing with corrupt officials.[94] The Algerian press frequently covers corruption in the public sphere and has directed anger against the regime for its corrupt practices.[95] This press coverage provides one avenue to combat corruption.

  Algeria has some experience in bidding rounds for natural gas and oil exploration. It could use a similar system to garner bids while allowing for international monitoring and access to non-sensitive information throughout the bidding and decision-making process. The BITs also provide an avenue through which to implement anti-corruption guidelines.

Finally, it is easier to target anti-corruption measures in the SEZ than attempt to implement them nationwide. The SEZ is geographically enclosed and will be handled by a separate government bureaucracy. The regime has much to gain from a successful SEZ and therefore will be more likely to maintain anti-corruption measures. Combined, these factors can limit corruption and provide transparency throughout the bidding process.

Conclusion

Algeria's high youth unemployment rate, reliance on hydrocarbons, and inability to attract foreign investment have the potential to destabilize North Africa, increase migration to southern Europe, and heighten radicalization for terrorist recruitment in Algeria. Creating a Hybrid Export Processing Zone between Oran and Mostaganem, which will aid Algeria by attracting foreign investment, creating jobs, and diversifying the economy away from hydrocarbon exports. This incremental approach to economic liberalization will allow the regime to control the pace of liberalization in order to avoid costly political unrest and civil war in response to drastic liberalization.

Appendix A: Special Economic Zone Typology: An Overview[96]

Type	Development Objective	Size	Typical Location	Eligible Activities	Markets
Traditional EPZ	Export Manufacturing	< 100 Hectares	None	Manufacturing, processing	Mostly Export
Hybrid EPZ	Export Manufacturing	< 100 Hectares[a]	None	Manufacturing, Other Processing	Export and Domestic
Free Trade Zone (Commercial Free Zone)	Support Trade	< 50 Hectares	Ports of Entry	Entrepôt, Trade-related	Domestic, Re-export
Freeport	Integrated Development	> 100 Km^2	None	Multi-use	Domestic, Internal and Export
Enterprise Zone Empowerment, Urban Free Zones	Urban Revitalization	< 50 Hectares	Distressed Urban or Rural Areas	Multi-use	Domestic
Single Factory EPZ	Export Manufacturing	Individually Designated Enterprises	Countrywide	Manufacturing, Processing	Export and Domestic

[a] Only part of the 100 Hectares is considered an EPZ

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