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Economy of an Enclave: Case Studies

Before undertaking a general analysis of enclave economies, I wish to start by examining several individual cases and analyzing their economic development. The cases of Ceuta and Melilla, Gibraltar, Hong Kong, Macao, Buesingen, West Berlin, the Fergana Valley enclaves, East Prussia, and Kaliningrad are described below in detail. Each case is tied to one of the leading questions on the hypothesis, development strategies, and the impact that S–M relations have on enclaves both in negative and positive terms.

CEUTA AND MELILLA

Some 15,000 Moroccans enter Ceuta and Melilla every day (Gold 2000, 123) mainly for the purpose of small trade (see chapter 4 for the map of the enclaves). Deviating figures are given by Carabaza and de Santos, who suggest that in 1987 some 5,000–6,000 Moroccans crossed into Melilla daily to trade. Their goods include clothing and footwear, foodstuffs, perfumes, alcohol, tobacco, cement, and petrol to the value of U.S. $87–100 million per year (Carabaza and de Santos 1992, 294). However the value of their activities within the shadow economy is much greater. Black market trade in the enclaves includes stolen luxury cars, gold, diamonds, and currency. Money laundering exists as well. One network, which was uncovered in Ceuta in July 2000, had laundered drug money to the value of $153 million in eight months.[1] Drug trafficking is also an issue.

Since 1986, Ceuta and Melilla have been part of the EC, but not part of EU customs territory. They are subject to neither the Common Agricultural Policy nor the EU fisheries and trade policies. The enclaves enjoy certain preferential arrangements with the EU as a whole, and additional preferential arrangements with Spain, whereby goods originating in the enclaves qualify for exemption from duty. They also receive heavy allowances both within the EU framework and from Spain. For example, each enclave was awarded 117 million euros for the period 2000–2006 for regional development projects, a large sum if measured against the small population numbers of approximately 76,000 for Ceuta and 70,000 for Melilla.

Both enclaves are excluded from Spanish—and thus EU—customs territory. This allows them to profit from the sale of duty-free goods to citizens of the surrounding state, an occupation that employs thousands of Moroccans who come every day to Ceuta and Melilla for the purpose of small border trade. The enclaves profit from lower taxes and salary premiums in comparison with the mainland. There is also no VAT. Moreover, Spain pumps in money by sustaining a disproportionate number of jobs in the civil service. The six to seven thousand military personnel stationed in each town are naturally financed by the Spanish federal budget, too. Beside duty-free trade, the enclaves earn money from port activities, such as cargo handling; however, this income is less significant for both Ceuta and Melilla. The tourist industry is underdeveloped.

These economic privileges have helped the inhabitants of both enclaves to enjoy relatively high standards of living, though still lower than that on the mainland. In 1985, the GDP per capita stood at 81.5 percent of the national level while GDP at purchasing power stood at 91.1 percent (due to the duty-free policy, prices were generally lower in the enclaves than the average in Spain). These figures had fallen down to 75 percent and 72 percent, respectively, by 1999. Unemployment in the 1980s was at the national average in Ceuta and above it in Melilla. The situation had worsened by the end of the 1990s, with unemployment climbing to 26.4 percent. It means that acquiring more autonomy within the Spanish federal structure did not bring about the much hoped for stability and certainty necessary for larger investments.

As about 80 percent of jobs were already in the service sector, there was no possibility to create more jobs in this field. There is practically no industry in the enclaves, which coincides with the conclusions of the economic part of the general theory of enclaves.

GIBRALTAR

The problem of Gibraltar's dependence was apparent to the British from the earliest days. Most food and other necessities of life for the garrison and the civilian inhabitants had to be brought from the mainland. Agriculture was not possible on the Rock for obvious reasons. For almost 300 years of its history, Gibraltar's manufacturing industry was also negligible, in fact prime activities, both military and civilian, centered around the dockyard. In 1979, 2,858 out of a total workforce of 11,593 were employed in "shipbuilding," yet only 204 in "other manufacturing." At the same time, 579 persons were employed in tourism (hotels and catering). The most striking fact is the preeminence of the public sector. In the same year, 7,196 persons were employed in public services, as apposed to 4,397 in the private sector (Levie 1983, 97). This can be attributed to the military presence on the Rock.

In the eighteenth and nineteenth century convict labor was used to supplement the small local labor supply. As convict labor proved to be costly and utterly inefficient, Gibraltar switched to Spanish labor. This remained the case for approximately 90 years, until the dispute over Gibraltar caused Spain to close the border in June 1969. The number of Spanish daily workers reached as many as 13,000 during World War II though it had declined to 5,000 by 1967. These are considerable numbers when contrasted against the local available work force of 10,000–15,000. When the frontier gate was closed in 1969, the local economy received a shock, which they tried to remedy by increasing local labor productivity. The technical training of Gibraltarians was initiated for this purpose. In addition, and probably most significantly, about 3,000 Moroccan citizens were recruited to work on the Rock. This labor body quickly firmly established themselves in Gibraltar and did not vacate their jobs for the Spanish after the border was reopened.

By the end of the nineteenth century, the Gibraltarian economy had picked up following the opening of the Suez Canal in 1869. The Rock became what would now be called an important service center for sea-related activities (coaling station for the new steamships, ship supplies, ship repair, etc.) Though the standard of living was lower than in Britain—the leading industrial nation in the world at that time—it was higher than anywhere else in the Mediterranean area. The M›E›S (that is, the per capita income in the mainland is higher than that in the enclave, while the per capita income in the enclave is higher than that of the surrounding state) proportion had been established and remains as such until today, just as in Ceuta and Melilla.

The economy boomed in Gibraltar after the reopening of the border in 1985, with the number of tourists visiting the Rock reaching 10,000 per day in the first summer afterward. During the first year, there were two million tourists compared with an average of 150,000 per annum in previous years. Daily flights from London had doubled within several months. Tourism continued to boom, providing nearly a quarter of Gibraltar's income in the second half of the 1980s.

Prior to the opening of the border in February 1985, there were 2,000 companies registered in the enclave; by the end of 1986, there were 3,800.

The greatest attraction was, however, that profits were largely tax exempt. Bank deposits increased by 68 percent in 1986 alone. Income tax and taxes on cars and car parts were reduced to make them more competitive with Spain. Goods were free of VAT, so a shopping visit from Spain was financially appealing. Therefore, the prosperity of Gibraltar came at the price of the surrounding state, most notably its southern provinces adjacent to the enclave. There were benefits for Spain as well, but they were spread and therefore not as visible as the drawbacks.

Joe Bossano, who came to power as chief minister in 1988, formulated a strategy for the Rock's economic long-term development. He saw the economic future of Gibraltar as depending "on its potential within the European Community, and this must logically include Spain" (*El Pais* February 1, 1989). Joint use of the airport located on the isthmus by both Gibraltar and Spain, being a hot issue at the time, was viewed by him as a part of a long-term strategy, which focused on economic cooperation with the Campo region. Thus, the economic future of the enclave was seen, first, in its openness to the outside world, especially in the context of the declining British military presence and the attempt to reach economic independency from mainland Great Britain. Second, the economic prosperity within this strategy was to be attained through developing economic contacts with the surrounding state in general and with the bordering region in particular.

In recent years, Gibraltar has seen major structural changes from a public to a private sector economy, but changes in government spending still have a major impact on the level of employment. As of the beginning of the 2000s, Gibraltar has benefited from an extensive shipping trade, offshore banking, and its position as an international conference center. The British military presence has been sharply reduced and now contributes about 7 percent to the local economy, compared with 60 percent in 1984. It was 25 percent in 1991, representing some £40 million per year. Gibraltar has managed to successfully overcome the shock caused by the drastic reduction of military spending by Great Britain. By the end of the 1990s, the financial sector, tourism (almost 5 million visitors in 1998), shipping services fees, and duties on consumer goods generated approximately 80 percent of revenue. The financial sector, the shipping sector, and tourism each contribute 25 percent–30 percent of the GDP. Telecommunications accounts for another 10 percent. Thus, Gibraltar's economy is characterized by concentration, on the one hand, and a balance between the three leading (finance, shipping, and tourism) and two supplementary (telecom and military) sectors, on the other. Overall, this is quite a healthy economic structure combining stability and dynamism. Gibraltar does not depend on just one industry as a source of revenue. The fast deterioration of a single sector is easily possible in the view of the general enclave-specific vulnerability of Gibraltar. It could happen with tourism if tensions should develop with Spain. Anticipated changes in EU legislation are making the financial sector vulnerable as well. The shipping sector is more stable, in fact, as it is based on the comparative advantage of its location and available infrastructure. Should an external shock occur, the balanced economic structure should be able to alleviate the adaptation of the regional economy to the new conditions and mitigate an otherwise deep economic crisis.

Gibraltar has possessed its own Constitution (the Gibraltar Order) since 1964. The new version, still valid today, was introduced in 1969. According to this legal document, the enclave possesses a large degree of autonomy including large fiscal competences. It is precisely this rule which has allowed Gibraltar to establish itself as an offshore center. Gibraltar passed a series of tax reforms in 2002. These involved:

- the imposition of taxes on offshore companies for the first time through a payroll tax and an annual company registration fee;
- a business property tax;
- the corporate profits tax was to be abolished for domestic companies (thereby helping to alleviate the reform above), bringing them in line with the offshore sector. The exception to this was financial services companies, which would be liable for an 8 percent tax on profits, and utilities, taxed at 35 percent;
- the aggregate tax bill was to be capped at 15 percent of a company's total profits or £500,000, whichever is lower.

Gibraltar is assigned a specific status in the EU. As Britain formally entered the European Community on January 1, 1973, Gibraltar was accorded special status under Article 227(4) of the Treaty of Rome. Gibraltar was not to contribute VAT, nor participate in the Common Agricultural Policy or the Common External Tariff. The enclave was not entitled to any representation in the Community institutions, including the European Parliament. Britain obtained the right of veto over any proposal to change this status. Gibraltar is also excluded from the Schengen agreement as, indeed, is the rest of Great Britain; unlike the mainland, the enclave is also excluded from the Customs Union and from the Common Agricultural Policy.

The issue of Gibraltar's economic development continues to burden Anglo-Spanish bilateral relations. Spain reproaches the Rock and its mainland constantly on the systematic illegal evasion of capital, smuggling, and money-laundering. One recent event was the fishing conflict, which lasted from August 1998 until April 1999, after which the government of Gibraltar adopted a law prohibiting commercial fishing in the territorial waters claimed by Gibraltar. The claim was not recognized by Spain.[2] Although the law came into force in 1991, the first conflicts between Spanish fishermen and the Royal Gibraltar Police didn't occur until 1997. The situation became heated after the police seized the fishing boat *Piraña* and its 15-man crew. In retaliation angry Spanish citizens blocked the border crossing between Gibraltar and Spain on January 29, 1999, for the whole day. Later, border controls were considerably tightened by Spain, which predictably had negative consequences for the Gibraltarian economy as its dependence on tourism had risen sharply by the end of the 1990s, after the reduction in British military forces. The confrontation de-intensified only when representatives of the Spanish fishermen signed an agreement on the regulation of the conflict with the Gibraltar government. However, the Spanish authorities proved reluctant to return to the initial low levels of border control.

From Spain's point of view, Gibraltar's economy is parasitic. Smuggling is not only a historical precedent but was an everyday reality until the very recent past. As early as during the negotiations on Gibraltar in 1704–1705, the Spanish authorities had foreseen that the problem of smuggling would emerge. History proved them right: smuggling began shortly after Gibraltar became British and was present until well into the 1990s (in fact, even after that, although on a much lesser scale). Throughout the centuries, smuggling of merchandise into Spain served Gibraltar as one of its main sources of income. It is directly connected with the status of being a free port. Two methods of smuggling were employed, by land and by sea. Land smuggling reached its peak only when Gibraltar acquired its Spanish labor force at the end of the nineteenth century, when several thousand people entered the enclave every day and left every evening. This type of smuggling disappeared only when the border was closed in June 1969. Smuggling by sea has always been conducted more professionally and on a larger scale. The maritime smugglers formed such a powerful lobby that they once, in the beginning of the 1850s, managed to depose a governor. When Major General Sir Robert W. Gardiner became appalled by the use of Gibraltar as a base for the smuggling industry, he attempted to step up and put an end to such unlawful activities (which was unusual since normally the British Gibraltarian authorities had assumed the fight against smuggling to be Spain's pain in the neck, not theirs). The "merchants" of Gibraltar argued that the enforcement of Spanish customs regulations was no concern of the government of Gibraltar. They lobbied their cause extensively, enlisted certain Members of Parliament and finally succeeded in their undertaking: the governor was recalled. In 1875, with the population of Gibraltar well under 20,000, 4,500 tons of tobacco were unloaded in the port. Of this tonnage, only 684 tons were publicly sold in the market. In other words, 3,800 tons, or about 85 percent, were smuggled into Spain (Levie 1983, 98–99). It is certain that the relative volumes of smuggling were reduced in the twentieth century; however, they remained substantial. The main products of smuggling were alcohol, tobacco, and luxury goods.

Smuggling of cigarettes is particularly thriving. An average of around 100 million packs is estimated to be smuggled into Spain annually. A pack cost 40 cents on the Rock; the smugglers, having transported cigarettes on their speedboats to the Campo, were able to sell them there at $1.60. Three hundred percent profit serves as a powerful incentive for assuming some risk. If all of the tobacco imports in 1994 were consumed in Gibraltar it would mean that each inhabitant was smoking an average of several pack per day. In addition, cocaine and cannabis are smuggled in large quantities through Gibraltar. In 1989, the Cadiz Customs Office seized 70 kilos of cocaine and 3,900 kilos of cannabis, which was clearly just the tip of the iceberg. Smuggling was virtually unstoppable, with tobacco and cannabis giving way to cocaine and heroine. In 1995, Spain launched an official complaint about smuggling and lost revenue that also concerned Gibraltar's regulations on money-laundering, which forced the Gibraltarian Assembly to introduce new, tougher regulations. On the same day Gibraltar police confiscated over 50 rigid inflatable speedboats that were suspected of being used in drug-trafficking from Morocco to Spain. Violent protests followed. However, the public supported the governmental move, as nearly a quarter of Gibraltar's population marched a week later in favor of the government's actions against money-laundering and smuggling (Gold 2005, 123, 165–166).

While smuggling is the kind of activity the state cannot be officially responsible for (although it is partially the result of lenient public policy), money-laundering is clearly the consequence of lenient legal regulations for offshore banks. Spain accused Gibraltar of being a center for money-laundering on a grand scale. By early 1990, border crossings in each direction totaled over 160,000 pedestrians and 110,000 cars per month. Many of them crossed the border several times per day, carrying each time the maximum currency allowed, i.e. 120,000 pesetas ($860) plus 300,000 pesetas ($2,142) in foreign exchange. With five such trips per day, a shuttle courier could transport around $15,000 worth of currency from Spain to the enclave. Banks in Gibraltar are lenient and do not ask questions as to the origins of the money. One of the most regularly used methods of money circulation was to set up an offshore company in Gibraltar hiding the owner's name from public scrutiny. Then, the assets could be used to invest in buying property in Spain and benefiting from tax concessions as a foreign investor. By early 1992, the amount of investment in Spain originating from Gibraltar exceeded 37,000 million pesetas (over $264 million).[3] Some 30,000 companies were set up on the Rock by the beginning of the 1990s, with deposits conservatively estimated at $3.3 billion (Gold 2005, 123). The number of resident companies had increased by another 25,000 by the beginning of the 2000s. There are twice as many companies registered on the Rock as inhabitants.

Gibraltar evokes high costs not only for the surrounding state, but also for the mainland. Let us mention some of them:

- As the blockade of 1969–1985 began, Britain underwent a commitment of £4 million over three years to help deal with the loss of 5,000 Spanish workers. A further commitment was made in 1974 for capital aid of over £7.6 million for the period 1975–1978, significant numbers considering the small population. Investment was targeted to increase Gibraltar's self-sufficiency.
- Great Britain attempted to attain a wage parity for Gibraltarian workers with those in the UK after Franco closed the border.
- Flights to Gibraltar are treated as internal and therefore cheaper than flights from Britain to nearby Spanish airports such as Malaga. This created a competitive advantage for Gibraltar's airport in servicing tourists coming to Spanish resorts. In 1986, out of 90,000 passengers landing in Gibraltar, 22,000 were heading for Costa del Sol.
- In 1985, the Gibraltar Shiprepair Company received £28 million from the British government in the process of taking over the docks.

  In 1999, a new facet to Gibraltar's financial activities, the betting industry, began to threaten Britain's tax base. The story began as Victor Chandler, a British independent bookmaker, set up a call center on the Rock where he could benefit from a service fee of 3 percent compared with the combined tax and racing levy of 9 percent back on the mainland. Ladbrokes, the largest bookmaker, and Coral, another major competitor, soon followed Chandler. As this betting tax earned Britain up to £480 million a year (although 11 percent of this sum was actually being put back into horse racing, an important component of the British betting culture), Gibraltar's gain was to be sharply increased at Britain's heavy loss. The British government tried to counteract by announcing that it would ban the opportunity for offshore companies to advertise via teletext and other electronic media. It also tried to persuade overseas territories, including Gibraltar, to change their legislation; however, none of the above worked. Finally, it had to abolish Britain's tax on betting in 2001 and a number of jobs were repatriated to Britain. However, the betting industry remains present in Gibraltar, with 11 companies and 537 jobs in 2002 (Gold 2005, 220–21, 358).

If we look at the economic exchanges and economic relations in the triangle Great Britain–Gibraltar–Spain, we find the following. Before becoming virtually financially independent from Britain in the beginning of the 1990s, the enclave depended heavily on the mainland's military spending as well as on the large volume of direct and indirect subsidies and transfers.

These were substituted by Gibraltar's special economic status as an offshore center. Gibraltar owes a large part of its economic success to this status, including virtually all of its financial sector, its telecom sector, and a large part of its shipping activities. The last large component of the enclave's contemporary well-being, tourism, is in fact heavily dependent on this special economic status both directly and indirectly, too. There are industries that clearly operate to the detriment of the mainland, the most vivid example being the story of betting companies relocating to Gibraltar in 1999. The enclave's exchanges with Spain undoubtedly bring some economic benefits to the surrounding state. However, in many respects Gibraltar gained its current well-being and its economic independence from Britain at the detriment of Spain.

Normally we discuss the impact of the surrounding state on an enclave. Caused by the small size of an enclave in relation to the surrounding state, it seems to be natural to focus on this question. However, it can't be ignored that an enclave has some impact if not on the whole of the surrounding state, then at least on the bordering regions. This is certainly the case with Gibraltar and the Spanish regions that border it. Complaints center mostly on the smaller local demand for highly taxed goods such as alcohol, cigarettes, gasoline, but also luxury goods such as consumer electronics and brand clothing, that can be brought over the border in Gibraltar.

The Spanish town of La Linea de la Concepcion borders directly on Gibraltar. The town suffers under an economic depression that was triggered by the closing of the Gibraltarian borders in 1969, when around 5,000 people became unable to continue working on the Rock and important flows of people, services, and information were curtailed. As the border to Gibraltar was closed, it was not only the enclave that experienced a severe economic shock but also La Linea. However, though Gibraltar managed to overcome the shock with the help of its mainland, this was not the case with the bordering Spanish town. La Linea de la Concepcion initially had about 100,000 inhabitants; however, its population had shrunk to approximately 60,000 by the year 2000. Nowadays, there is a strong interdependence between Gibraltar and the neighboring Spanish region, most notably La Linea itself. When the Spanish government "tightened the screws" on the border policy with Gibraltar, La Linea suffered no less than the enclave. It led to demonstrations in the Spanish town calling for "fewer restriction, more solutions" (Gold 2005, 212).

Political considerations can outweigh economic reasoning due to the sensitivity of an enclave in the bilateral relations between the mainland and the surrounding state. In Gibraltar, the second half of the 1980s and the 1990s were marked by heightened debate on the joint use of the airport located on the isthmus. As this airport served not only the enclave but also the bordering regions of Spain, including the resorts of the Costa del Sol, the idea was to arrange its joint use. The model already existed: the Swiss-French airport Mulhouse-Basel functions successfully. There are two exits from the airfield there, one on the Swiss side and another on the French side so that passengers heading for either destination can avoid crossing the border. The same was envisaged for Gibraltar's airport. The number of passengers could have more than tripled from 300,000 to a million annually, with an extra 400 jobs created in Gibraltar, not an insignificant number for the enclave. However, the idea was totally misapprehended in the enclave. Its people, highly sensitive to the question of governance, feared that this would result in the infringement of sovereignty. Political considerations and perceived political risks outweighed the economic benefits.

HONG KONG: A "MODEL" COASTAL ENCLAVE?

GDP growth averaged a strong 5 percent in 1989–1997. The gross domestic product per capita of Hong Kong rose from about 50 percent of the British GDP per capita in 1980 to more than 85 percent in 1990. It even exceeded that of Great Britain in 1992 and remained higher ever after. Hong Kong's life expectancy was also higher than that of Britain. However, after 1997, Hong Kong experienced two recessions. The general opinion of economists does not, however, link the recessions to the newly established ties with the People's Republic of China, claiming rather that these were the consequences of the Asian financial crisis in 1998 and the global downturn of 2001–2002. Here are some facts from the years preceding the sovereignty transfer illustrating Hong Kong's success story. Per capita income exceeded $25,000 in 1995, placing Hong Kong among the top ten countries in the world, on the level of the leading West European countries. It became the world's sixth highest in terms of household spending power. Life expectancy reached 81 years for women and 75 years for men; infant mortality was as low as five per 1,000 live births. In 1995, Hong Kong, with its six million inhabitants, was:

- the world's busiest container port, handling more containers than the whole of Britain;
- the world's eighth-largest trading entity in terms of value. Total imports and exports exceeded $250 billion, twice as large as its GDP;
- the world's eleventh-largest exporter of services;
- the world's sixth-largest stock market;
- the world's most expensive business location, topping $150 per square foot per year—a fact that reflects its commercial attractiveness;
- Asia's most popular travel destination.