

Free Economic Zones

(China, Russian Federation, India, Turkey, United Arab Emirates)

Various types of economic zones became very popular about 30 years ago. Interest in them has diminished to a certain extent until recently though developing countries have started to show their interest again. The issue of establishing a free economic zone has been on Georgia's agenda for the last few years. It will be interesting to see the effect of exposure to the experience of other countries. Economic zones are mostly referred to as Free Economic Zones (FEZ) although some differentiate so called Special Economic Zones (SEZ). An FEZ is considered to be a region of a country (often next to the border) with more a liberal foreign trade regime than on the mainland of the country while SEZs are created mostly for attracting foreign investments and also have liberal state policy. However, many do not distinguish the two and call them FEZs.

In both cases the zones are considered as temporary measures aimed at the acceleration of economic development or support to the development of certain regions of a country. It should also be noted that the meaning of the above mentioned two types of zones might be interchangeable among countries, which is more of a definition issue rather than of essential difference between them. We can state that FEZ functions, which are restricted to the establishment of a free trade regime, are narrower than SEZ functions. While SEZ means a liberal tariff regime, as well as simplified labor and tax legislature, regulations and other measures.

This report briefly reviews the meaning of economic zones, their functions and the impact on the achievement of economic growth in certain countries. In general, such zones are established in regions close to the border and offer the following types of economic freedom:

- liberal labor legislature;
- free foreign trade;
- low taxes (especially corporate taxes) or total tax exemptions;
- a degree of political autonomy (in some cases at the starting stage).

Apart from these, a comparatively low level of development, large domestic market and cheap labor force as well as political stability and relative isolation are factors that need to be in place for the success of SEZs.

It should be noted that there are opponents to SEZs who substantially criticize the establishment of such economic zones based on the following considerations:

1) What are the criteria for selecting this or that region of a country? It is difficult to find a straightforward response to this question.

- 2) Results achieved in SEZs can be achieved in other regions also if the liberal and business supportive legislature and infrastructure will be equally applied to and created in the whole country;
- 3) Why should a certain region enjoy tax preferences? This means indirect switch of fiscal burden to the population of other regions;
- 4) How much does it cost to administer such a zone and how can we ensure that preferences are not misused for money laundering and tax avoidance?
- 5) Who should finance the required costly infrastructure and how much time and effort is required to assure investors in the feasibility of investing in such zones?

FEZs were established in countries that are different from each other, such as China, India, Philipines, Iran, Russia and certain Latin American countries. It should be noted that SEZs might be established with the idea to support the economic development of certain depressed regions though, in general, social issues play a secondary role in making such decisions and governments are interested mainly in the attraction of FDI and trade promotion.

Peoples Republic of China

The experience of several decades has showed that SEZs appeared to be most successful only in the People's Republic of China, which can be explained by several key reasons. Firstly, we should consider the fact that China was the poorest country in the world until 1979 (when the first SEZ was created here) meaning an almost unlimited supply of cheap labor. China used to have and still has a huge advantage due to its ability to mobilize the cheapest labor resources and due to its huge domestic market.

While speaking about high economic growth rate we should take into account the characteristics of political governance of the country. Officially China remains a communist country, whose legislation and infrastructure is quite restrictive for investors and free competition in general. The leadership of a country by one political group for many years means that in circumstances of total political control the government has the ability to mobilize a huge number of people for the implementation of infrastructure or investment projects. It is clear that foreign investors would use the advantages offered by FEZs as the government clearly stated its obligation to conduct a policy supporting economic growth and that the government would not interfere in their activities in FEZs.

The capital of the Chinese Diaspora, namely Hong Kong and Taiwan capital was invested in FEZs, at least at first. The investors used the cheap labor force, a convenient geographic location, huge domestic market and comparative ease of financing and implementation of infrastructure projects. This was rapidly reflected in the fast economic growth of the Chinese economy. The significance of economic zones for this country is shown by the fact that the average economic growth rate in China since 1979 to date was 8.2% while economic growth rate in FEZs was higher than 28%.

While reviewing the positive example of China we should consider that in spite of the success achieved social inequality between the population living in FEZs and in the rest of China significantly increased. So far this has not created problems for the country's development. If China has decided to maintain existing economic growth rates, ignorance of social issues will certainly create problems especially when 800 million of the countries citizens are still considered to be the rural population living in extreme poverty.

Russian Federation

The Chinese experience was replicated with varying success by other countries including Latin America and Russian Federation. SEZs in Kaliningrad District of Russia and in bordering districts of Mexico were established mainly for trade promotion and the attraction of investments.

The Kaliningrad economic zone was the first to be established in accordance with a special law. While China's competitive advantage is cheap labor, which was one of the strongest supportive factors for the development of Chinese economic zones, the FDI contributed to a greater extent to establishing/developing the Kaliningrad zone.

Although FEZs established in Russia were to benefit from the geographic location, they did not receive much benefit as in the Chinese case. FEZs of Russia (including the Kaliningrad FEZ) are situated on the border, mainly on periphery of the country.

Investments in the Chinese economic zones were at large attracted through the Chinese Diaspora. Russia did not have such a big Diaspora. It is true that most of the investments in the Kaliningrad district were Russian investment but frequently it flowed out of Russia. Russia, like China, does not have Diaspora that has appropriate technical experience and knowledge.

Although it should be noted that Russia (especially Kaliningrad) is closer to the European market and European investments than China. This represents a comparative advantage. But as practice showed proximity is not enough to attract investment. The bureaucratic system and political environment created by the country's leadership frequently hampers the capital inflow.

The idea of the establishment of the Kaliningrad FEZ was born in 1991. The Federal law defining the specifics, working regime and certain measures for Kaliningrad was adopted in 1996. The operation of the zone was even further expanded and refined by amendments made in 2006.

The Kaliningrad FEZ offers the following advantages and benefits:

- This is a free customs zone. There is no import duty and subsequently import is becoming cheaper as local production and production costs are becoming significantly lower, which by itself strengthens the export potential of Russian Federation. The geographic location of Kaliningrad is an important factor contributing to the export of Russian products to European markets;

- The regional import quota system under which 35 types of products are sold without any taxation. The volume of products exceeding customs procedures are subject to customs procedures;
- Products produced inside the zone (excluding special exceptions) are customs free on the Russian market.

In the recent years many investors and firms have restrained from investing capital in Kaliningrad because of legislature related problems. It is expected that the situation will change as a new law on GEZ has already been adopted. Those companies that make a minimum of 150 million Russian Rubles (4.25 million Euros) investment will be exempted from the income for 6 years. The new law significantly alters the current economic regime in the economic zone. So, it is disputable how the old and new regimes can exist together. There is discussion about potential positive impact on the attraction of investors and firms in the short term.

Political Environment

The Kaliningrad FEZ was established with active support from the Government of the Russian Federation. President Yeltsin appointed Yuri Mitochkin, a strong supporter of liberal market values as the Governor of the district. Mitochkin was very interested in turning Kaliningrad into a Russian Hong-Kong. The volatile political environment, especially the political-economic changes, which occurred afterwards, hampered implementation of the objective.

Geographic Location

The Kaliningrad district has the following advantages:

- It has a well developed sea port (it should be noted that unlike other Russian ports the Kaliningrad port does not freeze in winter) and has an appropriate infrastructure;
- It borders the EU. Export of Russian products (mainly natural gas) to EU countries goes through Kaliningrad.

But the fact that Kaliningrad is not bordering the Russian Federation and access is through Lithuania hampers the effective operation of the zone.

Labor Force

The Kaliningrad district is very different from China's huge and cheap labor market, which is one of the most important factors for China's economic growth.

We can conclude that the results achieved in Mexico and Russia were not so promising because of the following reasons:

- 1) These countries, especially Russia, remain more developed compared to China, meaning that they did not have the ability to attract investors initially with cheap labor;
- 2) The political will for the establishment of the FEZ was weaker as officially these countries are democratic countries and the implementation of long-term economic programs is related to significant difficulties due to the form of governance;

- 3) Giving preferences to certain regions in these countries is met with serious resistance;
- 4) The level of openness of the economic policy in these countries was higher compared to that of China, which in general, removes the necessity of establishing of economic zone from the agenda.

India

India has also tried to replicate the Chinese model during recent years. The economic characteristics of the two countries are similar at a glance but a more in-depth study reveals significant differences, which make the success of such zones in India questionable. Although India has a cheaper and bigger labor force, its quality is lower and India's labor market is heavily regulated. India lost its competitive advantages required for the establishment of economic zones as presently China is already quite a strong competitive state in regards to foreign trade (60% of China's GDP comes from export while the same indicator for India does not exceed 10%). The economic growth achieved by India can be assessed as unsuccessful in terms of labor generation, which makes this country less attractive from the economic zones point of view. The economic growth of India is driven by small capital and technology intensive sectors (software design, and computers). Labor intensive sectors still make little contribution to the economic growth. The establishment of such zones in certain regions of India met strong resistance from farmers and caused price distortions and problems in the free movement of production factors.

Turkey

According to Turkish legislation (Law on FEZs, #3218; 15.06.1985) An FEZ represents a region where regulation methods of the country are not used at all or they are used partially, or new forms of regulation are developed.

A favorable environment for business development is created by FEZs according to this law. The main goals for the establishment of FEZs are the following:

- Attraction of export-oriented investments and the extension of production in Turkey;
- Acceleration of foreign investment and technology flow into the country;
- Increase of income in the economy and increase of share of foreign capital and foreign trade.

The operation of FEZs in Turkey basically started in 1987. There are now 21 zones in Turkey.

Types of FEZs by Principles of their Establishment and Management

- BUILD OPERATE TRANSFER model zones, which were in the beginning financed through state investments but afterwards the infrastructure was used to be rented to companies with operation licenses. BOT model zones were financed solely by private investments (BOT type zones are as follows: Mersin, Anatolia, Erzurum_East Anatolia, Istanbul Stock Exchange International Securities Market, Tubitak Marmara Research Center, Aegean, Istanbul Ataturk Airport, Trapzon, Samsun, Rize, Adana_Yumurtalik , Kocaeli).
- Zones established with private investments where land parcels and infrastructure are given in ownership to the companies that operate in the zones (Izmir Menemen Leathre, Istanbul Leather and Industry, Istanbul Thrace, Mardin, Gaziantep, Kayseri, Europe, Denizli and Bursa).

Preference Scheme at FEZs

Various amendments were made to the Law #3218 on FEZs and Law #5084 on Support to Investments and Employment, which was followed by the creation of a new classification of capital investment promotion tax preferences:

1. Physical and legal entities who received license before the effective date of the law #5084 (on 06.02. 2004):
 - a) are exempt from income and profit tax payment only during the limited duration of the license;
 - b) are exempt from the employee income tax only until 2009;
 - c) are exempt from all taxes and fees related to their activities in the FEZs until 2009.
2. Physical and legal entities that started their operations in a FEZ in 2004 and later and have an operation license are free from payment of income and profit tax until the end of the year when Turkey will become a full member of EU.

Preferences that existed earlier still apply:

- Repatriation of income generated at a FEZ is allowed to any country including Turkey without a preliminary permit;
- Goods and services originated in Turkey are tax (except VAT) exempt when imported in the zone;
- As FEZs represent part of Turkey-EU, goods under free circulation regime enter EU countries with ATR certificate¹. Import from a third country is tax-free as well. Besides, the goods originated in a third country not in free movement enter EU with an ATR certificate only after the payment of customs duties by the rates set by the Common Custom Tariff;
- Goods can remain at the FEZ without any restrictions;
- There are no regulatory restrictions in FEZ with regards to prices, standards and quality of goods;

¹ ATR certificate gives possibility to export goods from Turkey to EU countries in accordance with the agreement made between EU and Turkey (either in free circulation regime or after payment of common tariffs).

- Currencies used at the FEZ are convertible and this process is managed by the Central Bank of Turkey;
- Unlike many FEZs of the world sales on domestic market are allowed in Turkey. Domestic barter is allowed as well;
- Bureaucracy is minimized.

Concessions are applied to all firms in Turkish zones notwithstanding their origin.

Management and Control of FEZs

FEZs are headed by the **General Directorate of Free Zones** of the Under Secretariat of Foreign Trade. The Directorate is responsible for setting main principles and policy for the establishment and management of the zone, implementation of research activities, coordination, control as well as issue and revocation of the licenses required for commercial activities in the zone.

Every free zone has its **Directorate** at the local level, which reports to the General Directorate. It is authorized to conduct the necessary supervision and inspection of the zone, coordinate activities of such state institutions as police and customs, and municipal governance.

Directions for the development of zones are not defined directly by the zone administrators. Companies themselves select the type of license (trade or production) and specializations of the zones are conditioned only by advantages of the companies.

Licensing Procedure

1. An operation license form is filled in and then it is submitted to the Directorate General of a free zone by the Director or Manager of the zone;
2. An application fee is credited to the Central Bank;
3. The company submits the application and receipt for payment of the fee to General Directorate of the zone;
4. the General Directorate reviews the application;
5. In case of refusal to issue a license the application fee is reimbursed;
6. In case of positive response applicants apply to General Directorate with the renting and selling agreements to be made with founder/management company;

The production license validity period is a maximum of 10 years for hiring firms and 20 years for those firms that are willing to construct their own facilities in the construction zone. When the license is issued for production the validity periods are 15 and 30 years respectively for local firms and investors.

United Arab Emirates

Dubai is one of the best trade centers in the Middle East not only due to its strategic and geographic location but also on account of the free economic zones operating there.

After oil deposits were discovered in United Arab Emirates in the 1960s, the economic condition in this country dramatically changed.

By 1985 when the revenues from the oil had considerably increased and consequently the GDP per capita, the government of the United Arab Emirates started to implement significant projects. Specifically, they started to invest the accumulated capital in the infrastructure development as a result of which all the seven states in the country were developed. Among the states Dubai ranked the second place as the most quickly developed state both in terms of economics as well as demography.

The oil and petrol businesses dominated the country. Although the leaders of the country took into consideration the circumstance that the supply of oil was limited and was sufficient only for several decades. Hence, they started to implement large scale and aggressive economic projects.

The main emphasis was made on establishing the free economic zones. These zones have the best conditions for investors, foreign labor, and international companies. The development condition of the infrastructure here is one of the best in the world. Namely, the ports, roads, airports, telephone and internet connections are the best in the whole region. The Dubai International Airports serves up to 60 air companies hosting more than 150 flights per day and ranks second place in terms of the number of passengers after the Tokyo Airport and lags behind only Seattle as both sea and air ports together. Dubai Sea Port is among the top 15 ports in the world in terms of cargo shipment.

At present several large free economic zones are successfully functioning in Dubai. They are as follows:

- Jebel Ali Free Zone
- Dubai Airport Free Zone
- Dubai Internet City Free Zone
- Dubai International Financial Centre
- Dubai Media City Free Zone
- Dubai Techno Park Free Zone
- Dubai Cars and Automotive Free Zone

Jebel Ali Free Zone is a free economic zone created in Dubai at the end of 70s. This is one of the biggest and fastest growing free economic zones. Jebel Ali is built around the sea port (being directly connected both at the sea port and the airport). Its harbor is located on 100 square meters at 40 kilometers from the center of the city of Dubai. The government of the United Arab Emirates invested 2.5 billion USD in total for the development of this free zone. Initially the warehouse facilities were created and developed in the zone and the distribution of products made by foreign and local companies has started. Afterwards manufacturing production and services were added.

At present this free zone covers a vast range of production (trade, services, storing, and distribution) and is distinguished with the best tax concessions. Specifically, the

companies and their employees do not pay the income and corporate (profit) tax for 15 years. It is also possible to extend this period by an additional 15-year period.

The companies operating in the free zone can employ a citizen of any country all over the world, there are no export or import duties and 100% repatriation of the profit of a foreign company is allowed.

In the Jebel Ali Free Zone more than 2 300 companies from 97 countries operate among them those from Japan (Nissan, Mitsubishi, Honda, and Sony) and large European companies (ABB, Shell, BASF, etc) that play a key role in the development of the free economic zone.

Dubai Airport Free Zone was created in 1996 and is located next to the Dubai International Airport. More than 460 companies operate here and enjoy several concessions, among them:

- Complete exemption from the income, profit, import and export taxes;
- 100 percent foreign ownership;
- 100 percent repatriation of capital and profit;
- Direct access to approximately half a billion customers;
- Easily accessible and cheap labor force;
- High quality infrastructure;
- Quick and effective cargo services;
- Easily accessible electronic communications;
- 24-hour working regime.

Dubai Internet City Free Zone is the park of information technologies in the southern part of the city and is considered to be the most expensive and exclusive. It was built in 2000 and developed at the support of the Government. Similar to the other free zones, foreign companies can enjoy different types of ownership, tax and customs concessions, and these are guaranteed by law for the period of 50 years.

Dubai Internet City Free Zone allows large companies to concentrate their resources. In this zone operate such companies as Microsoft, IBM, Oracle Corporation, Sun Microsystems, Cisco, HP, Siemens, i-mate, e-dinar, Acette, etc. In total up to 850 companies are registered and 10 000 persons are employed. Though the activities are progressing, the center does not have enough space to allow all the companies to operate.

As of 2005 the zone has become the victim of its own success as notwithstanding the regular constructions it turned out that there is no enough space to accommodate offices. They have started to issue temporary special permits to companies so that they can work outside the zone till relevant space is available for them. However, the number of the permits is restricted and many companies have to wait for receiving the permit. From the beginning of 2007 intense construction is underway and there is no clear indication when the construction will be completed and then the companies at the top on the waiting list will be able to receive their offices.

Dubai International Financial Centre is regarded to be the free financial zone of the city. The main priority of the zone is concentrated on the following sectors: **banking services** (investment banks, corporate banks, and private banks); **capital markets** (shares, debt management instruments, commodity and secondary trade), **asset management** and **funds registration** (registration, administration, and management of funds), insurance, reinsurance and various financial transactions.

Sector financial institutions issue licenses. Similar to other free zones this zone also offers such concessions as the zero rate taxation, 100% foreign ownership, no restriction on currency transactions or capital and profit repatriation.

Regarding the employment issue, the Center has created up to 10 000 places. Though the majority of the employees are foreigners the local community members are also hired according to their skills and experience at relevant positions.

Dubai Media City Free Zone is a tax-free zone. It was built by the Government of Dubai and the main goal of its establishment is to support the development of the media in the United Arab Emirates. Currently the media city proves to be the foundation for different media organizations, namely: information agencies, electronic media, press, production and other means of broadcasting. In Dubai Media City operate some of the most important and famous broadcasting companies: Reuters, CNN, BBC, Canon, Voice of America, the Middle East Broadcast Center).

Dubai Techno Park Free Zone – the main goal of the Park is to encourage the production of high technologies that will facilitate the long term economic development of the country.

Dubai Cars and Automotive Free Zone has been established at a special initiative with the goal to make the Middle East the most affordable region in the automotive business. Specifically, it supports customers, suppliers, traders, retail and wholesale traders. This zone systematically takes care of attracting foreign direct investments and tries to create a business model that will expand the operations of strategic importance in many regions of the world, specifically in Asia, Africa, Middle East, East Europe and Latin America.

All the economic zones existing in Dubai are a good examples as to how the resources and local capabilities can be consolidated, that will support both the current as well as future investors to carry out their business activities without obstacles, to earn profits and thus support to a great extent the development of the long term development of the country.