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Implications from Successful Special Economic Zones (SEZs) in Northeast Asia: Opportunities for developing SEZs in Mongolia

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Introduction

- Mongolia, “The Law of Free Trade Zones”, 2002
- 3 unsuccessful state-supported FTZs: ZamiinUud FEZ, Altanbulag FTZ, Tsagaannuur FTZ.
- SEZ rapid expansion in the developing countries.
- Isolated enclaves and not enough benefits to local economy
- Different tones, China-Shanghai, Malaysia-Penang, India-new policy, Russia-newly defined SEZs
- Where do we fit in these new, changing platform?
- Need to improvise or to take advantage of the niche left by other countries?
- Lessons of successful FTZs from China and Korea

What did they do to attract the FDI and MNCs to the SEZ?

- According to the World Bank, in 2014 in China:
  - 6 SEZs,
  - 14 open coastal cities,
  - 4 pilot free trade areas
  - 5 financial reform pilot areas
  - 31 bonded areas
  - 114 national high-tech development parks
  - 164 national agricultural technology parks
  - 85 national eco-industrial parks
  - 55 national ecological civilization demonstration areas
  - 283 national modern agriculture demonstration areas.

- Among them **Shenzhen SEZ** is regarded most successful by many studies.
- **Success factors are:** *flexibility of SEZ policies and autonomy of local government of SEZs, timely transformation into reform, effective involvement of the Government, FDI attraction, public-private partnership approach, innovation, adaptation, and learning, realistic objectives, good benchmarking and local competition*

Factors to attract the FDI and MNCs to the SEZ

- *Flexibility of SEZ policies and autonomy of local government of SEZs.*
  - Municipalities to make own local rules and policies in response to the need of the investors and MNCs /300 enacted laws and 70% of it related to opening up and market economy/
  - First SEZ to sell investors' products to the Chinese local market
- *Timely transformation into reform*
  - No to more labor-intensive investments
  - Strong competition from other SEZs in China
  - Modern, world class SEZ in high-tech industries with latest and more urban infrastructure
  - New regulations that drove out many former factories (except pollution-free companies) to non-SEZ zones
  - SEZs as an experimental laboratories for developing and putting new policies into effect
  - Avoided the potential disruption in economic, social and political stance

Factors to attract the FDI and MNCs to the SEZ

- *Effective involvement of the Government*
  - Effective in building infrastructure, creating market places, establishing technology innovation platforms and R&D centers
  - To let SEZ authorities to create their own business environment to attract investors without intervention from the government
  - Shenzhen SEZ, favorable business legislations and high quality infrastructure, leading MNCs like IBM, Seagate, Compaq, Olympus, Sanyo and Lucent production facilities
  - Shenzhen the top three hi-tech zone among China's 52 hi-tech zones
- *FDI attraction*
  - Generous financial incentives (some argued it was too generous) to the investors in the SEZs
  - Became important source of capital, skills, technologies, and modern management techniques
  - For Shenzhen, besides the low tax rates there was several additional preferences for investors in the zone. For instance:

Factors to attract the FDI and MNCs to the SEZ

- First 2 year exemption from income tax then 50% reduction for next 8 years
- Export-oriented, newly established entity will be spared from half of the fee for land use. If the business is in high-tech industry there will no fee for land use.
- High-tech enterprises are free of property tax for 5 years. Other projects are exempted from property tax for 3 years.
- High tech companies which is run by foreign investors (including Macao, Taiwan and Hong Kong) can be registered as a domestically-funded if the share of the foreign capital in the total investment are not higher than 25%.

Public-private partnership approach

- Private companies in financing the project and building infrastructure
- For Shenzhen, some part of the basic infrastructure built by private developers and joint ventures from Hong Kong
- In the Puyuan sweater cluster in Zhejiang, the local government formed a shareholding company with 27 private logistics and transport firms to build the cluster's logistics center
- In the technology innovation center in Guangdong, public institutions and private firms joined forces to conduct R&D.

Factors to attract the FDI and MNCs to the SEZ

- *Innovation, adaptation, and learning*
  - Importance of innovation and technological know-how for the competitiveness of SEZs.
  - In Shenzhen, very little technological know-how transfer to the Chinese partners
    - To offer preferential access to domestic high-tech companies if they want to enter the zone
    - Universities' research institutions in the zone /the most prestigious universities such as Beijing University, Tsinghua University, Harbin University of Science and Technology and Central China University of Science and Technology/
- *Realistic objectives, good benchmarking and local competition*
  - Clear objectives, plans, expected outcomes for GDP growth, employment, export, FDI even tax revenue
  - Strict annual monitoring of the central government
  - Competing with each other to benefit from the reward system from the central government
  - Recent years, focus of the competition has been shifted to being "green" and contributing to social development

Korean SEZs and its preferential policies

- Masan Free Trade Zone, most successful zone among 8 SEZs of Korea
  - Established in 1970, initially it was prototypical export processing zone
  - To support the development of manufacturing activities that complemented those of the Korean economy
  - Excellent infrastructure (port, airport, roads) and high quality industrial parks with capable management and support service
  - Managed to attract leading foreign MNCs in the electronics industry of Korea. In 1971, these MNCs “imported” only 3 percent of their production components from Korea, but by 1986, 45 percent of these components were sourced from Korea
  - Achieved its main goal to serve as a catalyst for production diversification for domestic industry by creating reliable cluster for high-tech manufacturing sector

Korean SEZs and its preferential policies

❖ Preferential policies of the Republic of Korea SEZs

Sector	Benefits
Tax breaks	• Corporate tax exemptions for the first 3 years and a 50 per cent reduction the following 2 years (for investments of more than US$ 50 million, a 100 per cent exemption for the first 7 years and a 50 per cent reduction the following 3 years) • A flat 17 per cent income tax for foreign CEOs and executives at foreign companies • Capital goods import tariff exemption for 3 years • Acquisition, registration, property, and aggregate land tax exemptions for the first 3 years and a 50 per cent reduction for the following 2 years.
Financial support	• Companies that locate in FEZs will either be exempt from or subject to reduced land fees • Financial assistance for the construction of such facilities as hospitals and schools to make life more convenient for foreigners.
Deregulation	• Minimal land-use regulations governing factory construction and enlargement. (currently applicable to Seoul metropolitan area) • Lift restrictions on entering businesses reserved for SMEs (small and medium enterprises) • Direct foreign currency payments for ordinary transactions of less than US$ 10,000 allowed.
Employment and labor-management	• Unpaid weekly holidays allowed (currently paid) • Exemption from obligatory employment of veterans, the disabled, the elderly.
Educational improvements	• Schools can be established by foreign investors. • Domestic residents can attend foreign schools.
Foreign hospitals and pharmacies	• Foreign-financed hospitals and pharmacies for foreigners allowed.
Foreign broadcasting	• The ratio of cable network foreign broadcasting retransmission channels expanded from the current 10 to 20 per cent.
Administrative support	• English allowed for processing of public documents. • Foreign Investment Ombudsman’s office will be established.

Negative impacts and sides of SEZs

- *Negative impact on economic indicators*
  - Used as bridge for durable goods to enter local market threatening domestic industry, decreasing foreign exchange and caused increase in inflation
  - Banned imports of 17 durable goods to SEZ
  - There were some demands to close the SEZs.
- *Investment disparity*
  - 1981, 91% of total foreign investments from Hong Kong
  - 1995, 96 per cent of Shenzhen's textile industry and 95 percent of its garments industry were owned by Hong Kong investors
  - Caused by lack of accurate regulations concerning wages, employment and hiring/firing policy
  - Too much red tape
  - Hong Kong investments (71%) only on real estate /excessively high price of land in Hong Kong which was causing migration to Shenzhen SEZ/
  - Foreign companies started withdraw their investments and closed their branches in China
  - 5 new regulations related to reduce the red tape, especially in entry and exit procedures and wage requirements

Negative impacts and sides of SEZs

- *Speculation and loss of land*
  - The “Zone fever” /1992-1993, granted rights of 127,000 hectares of land to real estate developers but only 46.5% of it was actually developed into zones/
  - On very low compensation rate to farmers
  - Local governments and municipalities, their own special zones promising incentives and land to real estate developers.
  - Impossible to estimate actual number of special zones /According to 1993 estimation there were 6000 to 8700 zones. In 1994 the government cancelled over 1000 zones/
  - 1986-1995, 5 million hectares of arable land were transferred to infrastructure and real estate development
  - Government restricted the permission to build hotels, restaurants and commercial buildings as it was affecting negatively to export output
  - Hainan SEZ - biggest bubble in real estate at that time having almost empty office buildings, hotels and villas
  - According to Cartier (2001), the concept of SEZ developed without any causal analysis on arable land and natural resource base

Negative impacts and sides of SEZs

- *Labor dispute*
  - Labor abuse within the zone. 7 million /12 million workers/ contract (migrant) workers with no legal or social protection
  - 3 issues: 1) The use of child laborers 2) Poor living conditions 3) Excessive compulsory overtime
  - Owed wage arrears to their workers
  - One-third of the workers received less than minimum wage /minimum wage in Shenzhen increased to Y1500 (US$240) in 2012/
  - Very poor migrant women from rural area. No complaints, small hands.
  - Occupational health and safety requirements are not up to the standards /factory fires, explosions, lost limbs and even suicides by workers/
  - Crime rate is also high the zones, for instance, now Shenzhen's crime rate is nine times higher than in Shanghai and is well-known for its human trafficking and sex trade in China
  - Smuggling large amount of goods through the zones /Shantou and Xiamen SEZs/
- Due to its dark side which is rarely acknowledged as the dazzle of FDI and technological miracle blinding the public awareness.
- Investors will no longer be able to enjoy the duty free import and low tax rates in the zones

What is the future trend of SEZ?

- Era of low labor cost, scale economy, preferential access to markets, duty-free inputs, quality infrastructure and generous fiscal incentives is ending
- 2008-2009 global financial crisis
- USA and European economies ceased to be a global engine of demand
- Consolidation of supply chains both in terms of suppliers and production location
- Expiration of Multi-Fiber Agreement (MFA) in 2004 almost wiped away textile and apparel manufacturing SEZs in Latin America, Africa and Eastern Europe in favor of low cost Asian producers
- Need to offer something more valuable advantages to the MNCs
- Traditional assembly activities of global production network are no longer attractive /huge cost advantage like Bangladesh and Vietnam or big market like China/

What is the future trend of SEZ?

- Shift away from the traditional EPZ model towards the SEZ model
  - Forward and backward links between the zones and local economies
  - Shift away from fiscal incentives to value added services
  - Presence of attractive investment environment
  - Multiuse developments including industrial, commercial, residential, and even tourism activities
- SEZs specialized in high-end services like information and communication technology (ICT) and biotech.
- Privately owned (in some cases privately operated) SEZs are growing in numbers
- Lessons from Chinese SEZs in Africa:
  - Clear distinction between political support and political objectives. No commercial base
  - Strong connection with the competitiveness of national economy and national investment environment
  - Lack of access to global market and poor infrastructure
  - *De jure* and *de facto* implementation. The lack of a clear and transparent legal and regulatory framework and an authority with the capacity to enforce it

What is the future trend of SEZ?

- Expansion of regional trade agreements is creating opportunities and threats
  - Multilateral trade efforts failed, bilateral and regional trade agreements growing
  - Usually domestic market is prohibited in most SEZs
  - Regional agreement erases barrier between domestic and foreign markets SEZs policy has to adapt to this new circumstances in terms of rules of origin, treatment of exports and fiscal incentives
  - Creating opportunities for smaller countries giving them the market access to bigger markets
  - Market access is often the number one investment location determinant
- Regional agreements can lead to increased investment opportunities that can improve the competitiveness of the SEZ

SEZ Projects in Mongolia

- Post-Mining economic driving force
- “Concepts for establishment of Free Economic Zones”, 1995. “The Law of Free Trade Zones”, 2002. The Laws on Legal status of several FTZs in 2003 and 2004.
- Free trade policy, openness to foreign investment and businesses.
- To improve export capacity, foreign investment, latest technology – 3 SEZs in different locations:
  - Biggest port between China and Mongolia
  - Main port to Russia
  - Crossroad for 4 countries

SEZ Projects in Mongolia

- Expected benefits from SEZs
  - Positive impact to export growth (composition) and import-substitution sector. Mongolia's main export products are all mining-related products (89.2% in 2012) and we import almost all consumer products (close to 90% in 2013).
  - Improvement in manufacturing sector. The GDP share of this sector was only 8% in 2012. It is anticipated that the most important benefit will be an increase in manufacturing through foreign and domestic investments, especially in case of Zamiin Uud.
  - Development opportunities for regional and rural areas. Employment, local businesses, and the national economy are expected to be greatly benefitting from successful SEZ creations.
  - High technology, management skills, and know-how are most sought-after benefits from SEZs.

SEZ Projects in Mongolia

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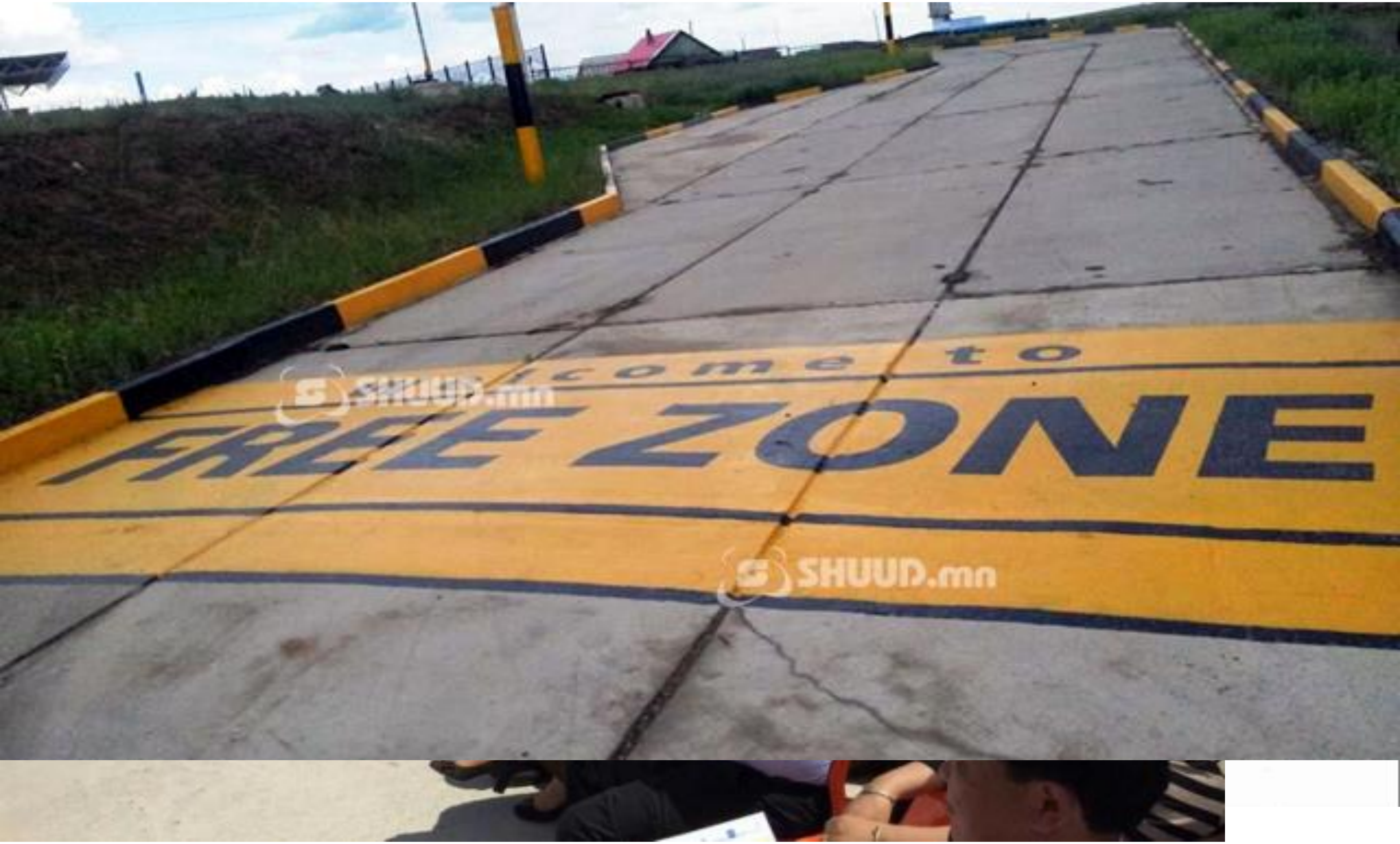
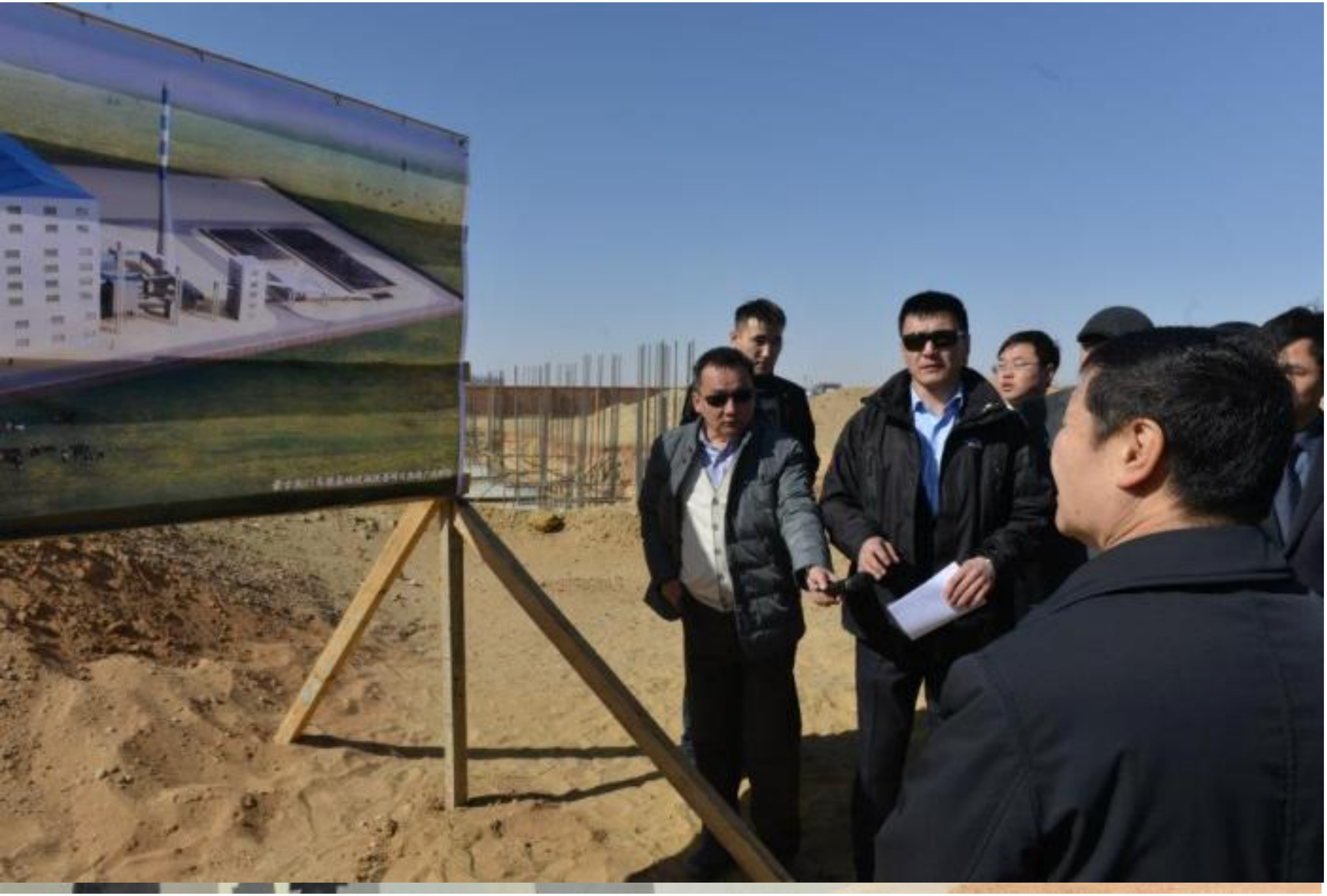
Zone	Type of Zone	Location	Objectives	Targeted Sectors
Altanbulag	FTZ (Trade Facilitation & Logistics)	• Mongolia-Russian border • 25 km from Sukhbaatar City • 335 km from Ulaanbaatar	• Important transport corridor connecting China, Mongolia and Russia • Free access to third country markets • Developing into a major trade, industry, commerce, and service center in Northern Mongolia	• International trade between Russia, China, and Mongolia • Becoming a link between Asia and Europe • Hotels, resorts, and auto service centers • Promotion of rent free spaces for businesses that operate in auto parts or construction material sectors
Zamiin Uud	Free Economic Zone (Trade Facilitation & Logistics)	• Mongolia-China border • South of Zamiin-Uud city	• Creation of a major commercial, industrial and tourism center • Increase of economic welfare, jobs and business opportunities for residents of Dornogobi and Umnugobi province • Benefitting from the transport corridor linking Russia and China	• Foreign trade, manufacturing, tourism, resorts, casinos, and warehousing
Tsagaannuur	FTZ (Trade Facilitation & Logistics)	• 68 km away from the provincial capital Bayan-Olgiy • About 1,720 km away from Ulaanbaatar	• Accelerate development of Western Mongolia through foreign and local investments • Create more jobs and business opportunities for local residents.	• International trade between China, Kazakhstan. Mongolia and Russia. • Heavy and light industries, hotels, resorts, service industries

SEZ Projects in Mongolia



SEZ Projects in Mongolia: Zamiin Uud FEZ



Assessment of SEZ projects of Mongolia

- In 2004, USAID, “Assessment of Mongolia’s Free Trade Zone Program and Site Evaluation” For Zamiin Uud
- Two major recommendations:
  - No economic cost-benefit analysis for the establishment of the FEZ
  - No full commercial feasibility study for the FEZ had been conducted including market assessment, market planning, infrastructure requirements, implementation planning, as well as business and financial modelling
- Altanbulag /opened in 2014/, more complete infrastructure, proper feasibility studies, a detailed master plan finalized. Costs for infrastructure are fully funded by government (however, in 2013 its budget took a cut).
- Altanbulag FTZ started providing benefits to the local economy.
  - As dams, sewerage, roads, and lights were constructed
  - 120-250 new jobs were created
  - Market for local herders, farmers, and small shops is growing.
- However, the future development of the zone is lagging.

Outlook and areas of improvement

- As every other SEZs are looking for, we are expecting following possible outcomes from successfully established SEZs:
  - Projected tax revenues
    Revenues from granting a concession, license, right, or production-sharing agreements
  - Job creation
  - Introduction of new technologies and management know-how
  - Backward and forward linkages with other local firms, leading to potential formation of clusters
- Also there are potential costs:
  - Losses of tax revenue due to tax breaks
  - Expenditures on infrastructure paid by the government
  - Negative environmental impact or other negative externalities

Outlook and areas of improvement

- Here are some of the much needed improvements to be made in areas of legal and administrative aspects of FTZs.
  - Laws on FTZs is not up to the standard. They are incomplete and unclear, for example, these laws are not detailed in the level of supplemental services and activities within the zones and this creates uncertainty in how to establish living standards and working environments for the workers inside the FTZ.
  - Inconsistency of GoM policy toward developing FTZs in the long term. After every election, sudden changes of whole FTZ master plan and unrecognizable new vision for the FTZs are not surprise. For example, Altanbulag FTZ has “officially” opened 4th time overall and it’s counting.
  - Inability to run FTZs effectively from administrative offices. Even though the administrative offices have big budget and enough staff, they mostly outsource from outside to organize main activities and events which are vital for developing FTZs successfully.
  - Some of feasibility studies and detailed master plans for the FTZs are not thorough. They lacks reliable research and sophisticated insights.
  - Funds for infrastructure development of FTZS are scarce. Unreliable government policy, restrictions on FDI and poor economic situations are making it worse to be able to attract investment from abroad.

Conclusion

- SEZs - one of the most effective catalyst for economic development
- Not many countries successful countries.
- China:
  - Flexible policy, autonomous municipalities, timely reform, effective government, significant flow of FDI, public-private partnership, innovation-adaptation, clear goals and local competition,
  - Chinese SEZs, especially Shenzhen SEZ has fulfilled the goal by serving as a catalyst for economic transformation.
- However, the zones of China didn’t have an easy path to reach this level. There was the initial negative impact on economy, huge disparity in investment diversity, speculation of land and labor abuse in the zones.
- Traditional EPZ model is no longer effective
- Investors are looking for more than mere assembly activities
- Newly defined SEZs are offering multiuse developments including industrial, commercial, residential, and even tourism activities (and there are other SEZs specialized in high-end services like information and communication technology (ICT) and biotech). One interesting trend is the growth of privately owned and operated SEZs.

Conclusion...continued

- In case of Mongolia, it has 3 SEZs on paper, one of them is recently opened others are still in the construction stage. The Laws are not completed. SEZs are doing poor jobs. Works to be done looks as below:
  - Developing SEZs based on mining industries using M&A, joint ventures, or licensing. Mongolia's competitive advantage is in mining sector so we need to exploit it under SEZ development.
  - To look into the possibility of joint SEZs with China or other countries. In the East, there could be collaboration with Erlian border coof China. In the West, Mongolia could cooperate with Khorgos of Kazakhstan.
  - During his visit, Chinese president Xi Jinping agreed to establish Joint SEZs between China and Mongolia. He approved that Mongolia will have favorable conditions regarding transportation cost and routes through Chinese territories. It will make a huge difference for trade and manufacturing in SEZs of Mongolia.
  - The building of meat processing and other food facilities in Altanbulag FTZ should be based on demand estimations of Siberia and Ural's areas of Russia (because Mongolia has a quota on food products only in this area).
  - Need of "one at a time approach" to all these separate "Industrial Parks", "Logistics Centres", "Cluster cities", and so forth. There is a wise Mongolian saying that if you chase two rabbits at one time then you will be left empty-handed.

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Thank You !