



საქართველოს სტრატეგიისა და საერთაშორისო ურთიერთობათა კვლევის ფონდი  
GEORGIAN FOUNDATION FOR STRATEGIC AND INTERNATIONAL STUDIES

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თავისუფალი ეკონომიკური ზონის  
შექმნა — “უკვდავი” იდეა

ვლადიმერ პაპავა



THE “IMMORTAL” IDEA OF A FREE  
ECONOMIC ZONE

VLADIMER PAPAUA

ექსპერტის აზრი

EXPERT OPINION

აპრილი 2007 APRIL

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საერთაშორისო ურთიერთობათა კვლევის ფონდს  
წერილობითი ნებართვის გარეშე წიგნის არცერთი ნაწილი არ შეიძლება  
გადაიბეჭდოს ნებისმიერი, მათ შორის ელექტრონული ან მექანიკური ფორმით

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## **The “Immortal” Idea of a Free Economic Zone**

Those of us who have grown up in the Soviet era still remember a strange saying which made us smile even then: “Lenin is dead but his deeds and ideas will always be alive.” I would never believe that this phrase—even in a modified version—would ever be relevant again in an independent Georgia.

Specifically, I am referring to the idea of creating a free economic zone based on the concept of Aslan Abashidze, former leader of Ajara—despite having been evicted from Georgia and with his words, fortunately, having no importance in our country any more—whose ideas, it appears, are still alive. As early as in 2004, the Government of Georgia announced its intention to create a free economic zone in Zugdidi. Later, this question was touched upon several times in connection with different regions of Georgia as, most recently, in late 2006 with the wish to create a free economic zone in Poti being expressed at the top government level.

I think the reader will be interested to consider once again what a free economic zone actually means. Besides, it would be useful and interesting to recall the developments that took place in Georgia from the time that this idea was first raised in the history of an independent Georgia.

### **What is a Free Economic Zone?**

A free economic zone is a distinct area (territory or segment) of a national economy wherein the government has established a

special system of privileges and advantages which are not applicable to other areas of the country or other segments of the national economy.

Conceptually, there are two different varieties of the free economic zone: one is based upon a territorial approach and implies that a free economic zone is to be established in any delineated area of the country's territory and that all residents in that area will enjoy all of the privileges and advantages of the free economic zone. The other variety is of a functional nature and represents a favourable treatment regime applicable to certain economic activities regardless of the places of residence of the economic agents engaged in such economic activities. By their specialisations, the free economic zones may be divided into the following categories: customs, trade, industrial, scientific and technological and service-based zones.

A free customs zone represents one of the simplest forms of the free economic zone. Such a zone may consist of some free transit, consignment and other warehouses to store those goods which will be treated in a different way from those which are subject to the country's regular legislation. The existing customs law of Georgia already stipulates such free customs zones.

Free trade zones are the most widespread varieties of the free economic zone. Most often they are limited to some minor places (with not more than a few dozens of square meters of area) wherein some trade transactions, as well as packaging, sorting and stamping of goods, is carried out. The organisation and structuring of such zones may vary from so-called "duty free"

stores to international agreements establishing some trade privileges and advantages.

Remarkably, some kinds of free economic zones have been operating in Georgia for a long while. Duty free stores, for example, have been established in Georgian airports, seaports and other similar transit places. In addition, Georgia is a signatory of the CIS Free Economic Zone Agreement which was concluded by the country members of the CIS in 1994 and which provides for duty free trade and minimum administrative procedures (quoting, licensing, contract registration, etc.) for the CIS countries in relationship with each other. Further, Georgia has concluded bilateral free trade treaties with a number of other nations.

The purpose of industrial zones is to encourage the manufacturing of export and import-containing goods. In such zones, all registered economic agents may enjoy some significant tax and other privileges. Additionally, there may be established therein some simplified administrative rules for company registration, investing, repatriation of profits and the movement of foreign individuals within the zone.

A scientific-technological zone is another variety of the free economic zone. Technopark, as a technology transfer undertaking, is the most widespread form of such zones. The most active period when such zones were created around the world was in the 1970s and 1980s. Technoparks require particular governmental support. The scientific-technological zones are usually created in major scientific centres and their purpose is to encourage research, design and various scientific

activities. The majority of the scientific-technological zones operate in highly developed countries as their creation and successful functioning requires some serious government subsidies.

Service zones, as it is clear from the term itself, represent a kind of zone which specialise in providing the most friendly environments and favourable treatment for different services such as, for example, banking, insurance, tourism, transport, etc. The so-called "offshore" zones are the most popular varieties of service zones and, as a rule, they are established on islands or coastal areas. It is important to note that some offshore zones have turned into havens for the laundering of "dirty money" and various fraudulent businesses.

In addition to the above-described varieties, some complex zones have been created in different parts of the world. They represent combinations of two or more models of free economic zones.

### **What Privileges May be Established?**

The following privileges and simplified mechanisms may be established in almost all types of free economic zones:

- Foreign trade-related privileges which may stipulate the liberalisation of customs tariff policies (reduced or zero customs duties, advantageous VAT and excise duty systems on exports and imports, etc.) and the lifting of non-tariff-related restrictions (prohibition of exports and imports, quoting, licensing, registration).

- Fiscal benefits consisting of different types of subsidies, preferential lending systems, reduced lease rents for land and facilities, etc.
- Lifting of restrictions on foreign currency transactions.
- Administrative privileges aimed at simplifying the registration rules, accounting systems and visa regulations, etc., of economic agents.

Remarkably, all of the above-mentioned privileges are applicable within the territories of free economic zones. As a result, any goods transported from a free economic zone to any other territory of the same country will be subject to those procedures and regulations as are generally applicable to imports. For this reason, the movement of the country's citizens into the zone is restricted and may be subject to special licensing.

### **What is the Goal of a Free Economic Zone?**

In addition to the organisational and functional classifications, the free economic zones may significantly differ from each other by the reasons of why they were created and the roles they may play within the national economy. Bigger and more developed countries, for example, usually create free economic zones in order to pursue their regional policy goals. The best examples of this are the free economic zones created by the United Kingdom, which are located far away from Great Britain (the British Virgin Islands, for instance), and those created in the peripheral areas of the Russian Federation in which the central Russian government



has been having a difficult time in carrying out their regulatory and co-ordinating functions.

As for the developing and post-Communist countries, free economic zones are only testing grounds for implanting free economy principles. Such countries are either reluctant or unable to widely open their economies to foreign investments or to pursue special trade or investment policies throughout their territories or within all sectors of the national economy. For this reason, they prefer to "open" their economies only in some localities and, to this end, they use free economic zones. China is a good example of such practices. The process of establishing free economic zones started in this country in 1970s and it was used as an experiment for the implementing of free market relations.

As far as the significance of free economic zones is concerned, one cannot avoid a discussion of such issues as the influence of the free economic zones on the development of the national economy. Remarkably, the degree of influence of free economic zones over the national economy is rather modest in developing countries and not even discussed in developed countries.

The period after the end of World War II was the most extensive time for creating free economic zones across the world (although the first simple examples of free economic zones were known in the 17th and 18th centuries). It was conditioned by the economic underdevelopment of many nations, the political weakness of their governments and the scarcity of financial resources.

## **What Are the Lessons from International Experience?**

The efficiency of free economic zones is closely associated with the country's economic strength. This has been confirmed by research carried out in 26 nations of the world. Specifically, it has been established that the average costs that the government needs to incur if its goal is to attract foreign investments in a free economic zone amount to USD\$4 per USD\$1 of foreign investment. If in China's four free economic zones the aggregate amount of foreign investments amounted to USD\$4 billion, for example, its domestic investments and expenses exceeded USD\$22 billion.

Presently, some tax and administrative privileges no longer represent the only factor which may make a free economic zone attractive for serious foreign investors and their investments. It is more important for them to have some developed infrastructure (transport, manufacturing and warehousing facilities, water supply, electricity, etc.) in the free economic zone and the availability of huge markets surrounding it. Doing business in the territory of a foreign nation is always associated with some additional expenses. Despite the availability of some good privileges and a cheap workforce, the manufacturing of goods even in a free economic zone—especially at the initial stage of its formation—requires rather large costs for which reason there should be a certain combination of different and interrelated favourable factors in place if the goal is to attract foreign investors. As paradoxical as it may seem, however, this goal can be achieved rather easily in the whole territory of a country, more so than in any particular locality therein, provided that the right

economic policy and priorities have been set forth and consistently pursued and carried out.

### **The Essence and History of Ajara's Initiative.**

Since the very first years following Georgia's regaining independence, the idea of creating a free economic zone within the country became very topical and appeared as no surprise as this was a time when some serious barriers had been set up in the foreign trade practices. Taxes were imposed not only on imports, for example, but also on exports with certain categories of goods being subject to various non-tariff restrictions (such as prohibitions, quoting, licensing and mandatory registration). Naturally, under such circumstances, an idea of creating free economic zones as oases for doing business came onto the agenda and Aslan Abashidze, the then leader of Ajara, became the initiator of this idea. This initiative, however, did not remain unnoticed by some of Georgia's other regions and was soon picked up by the local leaderships of Poti, Tbilisi (with an idea to establish such a zone in the neighbourhood of the city's airport), Kazbegi, Lagodekhi and Akhalkalaki.

It was for this reason that in the early and mid-1990s the Government of Georgia was working extensively on the development of the legislative framework for the establishment of free economic zones. Remarkably, the Government embarked upon significant economic reforms in parallel which included the programme of the liberalisation of foreign trade. As a result, non-tariff restrictions were lifted completely and exports were entirely exempted from taxes as were the imports of raw materials to be used for the production of exportable goods. As of 1996, all

restrictions on the repatriation of return on foreign investments were cancelled. In 1997, the same was also done with respect to foreign currency transactions. In light of the Government's apparent progress in its transition to a free economy, the idea of creating free economic zones lost its initial expediency as the range of privileges to be granted to a free economic zone became rather narrowed.

In the meantime, the Ajarian leadership, motivated by an idea to artificially increase tensions with Tbilisi, continued insisting on the development of a legal framework for a free economic zone within its territory and stubbornly disregarded the reality that the privileges characteristic of a free economic zone had by that time already been enjoyed by the whole country. Some time later, to add some greater significance to this demand, the Abashidze government hired some Chinese experts to draft legislation for a special economic zone. Interestingly, in this context the word "special" was given the same meaning as is usually borne by the word "free." The only economic privilege that the Chinese experts stipulated in the proposed bill was a 50% reduction of the profit tax. No other privilege could be granted for the simple reason that, as was mentioned above, the whole country had already been operating in a privileged foreign economic regime at that time. The major weakness of the "Chinese" bill, however, was precisely in the 50% reduction of the profit tax: if the authors of the bill believed that the 50% reduction of the profit tax was enough to encourage economic activities in the free economic zone, then it would be rather wise to extend this profit tax regime to the whole country rather than any specific locality within.

## **What has Changed after the Rose Revolution?**

If before the Rose Revolution the idea of a free economic zone resembled "trying to open a door that was already open," the logical question which may now inevitably come to a reader's mind is this: what has changed after the Rose Revolution that gave new life to this old idea?

For economists, the revitalisation of the idea of a free economic zone may seem to have been caused by the deterioration of foreign economic relations and regimes. In fact, nothing of this kind has taken place. Moreover, the taxation regime of imports became even more liberal. With the exception of agricultural produce and some construction materials, customs duties were reduced to zero for all other items.

After the Rose Revolution, the bureaucratic procedures for opening businesses became significantly simpler throughout the country which means that a potential zone cannot be granted this kind of privilege.

As to the regime of a no-visa entry into the country, if before the Rose Revolution this privilege was enjoyed only by the citizens of some CIS countries, after the Rose Revolution the Government decided to grant it to nationals of the US, the EU countries, Switzerland, Japan, Israel and some other nations. Not even this privilege, then, could be granted to a free economic zone.

In conclusion, the legislative changes which were adopted after the Rose Revolution made the idea of creating a free economic zone in Georgia even more senseless than it used to be. If it is

still possible to invent any new privileges, let us say, it would be much better to make such a zone applicable to the whole country rather than to any particular zone.

### **Thoughts in the Past... and in the Future.**

If the Government stubbornly decides to establish a free economic zone, then it will need to drive the country back to the condition it was some ten-to-twelve years ago and to turn down all reformatory achievements and to close the economy—all of which will automatically lead to the deterioration of relationships with the international financial institutions and the closing of the Paris Club's door for Georgia not to mention a likelihood that Georgia may be expelled from the World Trade Organisation—in order to have an economic justification of such a measure. It must be hoped that the Government will think twice and understand that the idea of the free economic zone is not worth all of the foregoing.

It must also be noted that if the decision about the creation of a free economic zone is still made, however senseless it may be, it cannot be limited to the Poti area. The law is going to be general one and, furthermore, numerous lobbyists, including foreign ones—not to mention the MPs elected by a majority vote—will try to drag the idea of creating similar zones in some other regions of Georgia too. If this happens, it must be taken into account that, as already mentioned above, the foreigners will move in and out of the zone freely whereas our citizens will have to fight for special passes and permits. Furthermore, and predictably so, people from our neighbouring countries will freely move in and out of the potential zones established in the bordering regions

dwelt with the peoples of the same ethnic origin (as they do presently) whereas Georgians not working in those zones will have difficulties entering into such territories. It seems that no one has thought about problems such as these. It must be doubted, however, that those who are in charge of such issues have ever thought seriously about anything...

პროფესორი ვლადიმერ პაპავა არის სტრატეგიისა და საერთაშორისო ურთიერთობათა საქართველოს ფონდის მთავარი მეცნიერ-თანამშრომელი, ცენტრალური აზიისა და კავკასიის ინსტიტუტისა (ჯონს ჰოპკინსის უნივერსიტეტის ნიციშეს სკოლის, აშშ) და აბრეშუმის გზის კვლევის პროგრამის (უფსალას უნივერსიტეტი, შვედეთი) მიერ დაფუძნებული ერთობლივი ცენტრის ასოცირებული მთავარი მეცნიერ-თანამშრომელი, და საქართველოს პარლამენტის წევრი. 1994-2000 წლებში ვლადიმერ პაპავა იყო საქართველოს ეკონომიკის მინისტრი, და როგორც საქართველოს მთავრობის წევრი საერთაშორისო სავალუტო ფონდთან და მსოფლიო ბანკთან მოლაპარაკებებში აქტიურ მონაწილეობას იღებდა. მან ეკონომიკის მეცნიერებათა კანდიდატის სამეცნიერო ხასისხი დაიცვა საბჭოთა კავშირის მეცნიერებათა აკადემიის ცენტრალურ ეკონომიკურ - მათემატიკურ ინსტიტუტში, ხოლო ეკონომიკის მეცნიერებათა დოქტორის სამეცნიერო ხასისხი კი თბილისის ივანე ჯავახიშვილის სახელობის სახელმწიფო უნივერსიტეტსა და ლენინგრადის სახელმწიფო უნივერსიტეტში.



ვლადიმერ პაპავა საქართველოს მეცნიერებათა ეროვნული აკადემიის წევრ-კორესპონდენტია. 2005-2006 წლებში ის იყო ფულბრაიტის მკვლევარი ჯონს ჰოპკინსის უნივერსიტეტის ნიციშეს სკოლის ცენტრალური აზიისა და კავკასიის ინსტიტუტში (ვაშინგტონი, აშშ).

Dr Vladimer Papava, is a Senior Fellow at the Georgian Foundation for Strategic and International Studies (GFSIS), a Senior Associate Fellow of the Joint Center formed by the Central Asia-Caucasus Institute (Johns Hopkins University-SAIS) and the Silk Road Studies Programme (Uppsala University) and a Member of the Parliament of Georgia. Dr Papava served as Georgia's Minister of Economy from 1994-2000 during which time he was actively involved in fiscal and institutional reform and was one of the leading participants in the negotiations between the Government of Georgia and the IMF and the World Bank. He is the author of nearly 200 publications including works on theoretical and applied studies of post-Communist economies and the economic development of Central Caucasus countries. He holds the degree of Candidate of Economic Sciences from the Central Economic-Mathematical Institute of the Academy of Sciences of the USSR (Moscow) and a Doctor of Economic Sciences from Leningrad State University (Saint-Petersburg) and Tbilisi State University (Tbilisi). Dr Papava is a corresponding member of the National Academy of Sciences of Georgia. In 2005-06, he was a Fulbright Fellow at the Central Asia-Caucasus Institute and the Nitze School-SAIS, Johns Hopkins University (Washington, DC).

3a Chitadze Street  
0108 Tbilisi, Georgia

Tel: 995 32 473555  
Fax: 995 32 985265