

**FREE ZONES IN THE COMMONWEALTH  
OF INDEPENDENT STATES:  
A PROPOSED REGULATORY MODEL**

A thesis submitted to The University of Manchester for the degree  
of Doctor of Philosophy in the Faculty of Humanities

2008

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## ABSTRACT

This abstract is for the thesis titled "FREE ZONES IN THE COMMONWEALTH OF INDEPENDENT STATES: A PROPOSED REGULATORY MODEL" submitted by Pavel Repyeuski for the degree of Doctor of Philosophy (PhD) with the University of Manchester in December 2008.

Free Economic Zones, serving as an important tool to attract investments and revive economy, provide for a preferential business regime within a designated territory. They offer the residents a wide range of fiscal and non-fiscal incentives. However, this model of business organization does not successfully operate in the Commonwealth of Independent States and Eastern European transitional countries. This is due to their lack of expertise in legal regulation and insufficient experience in theoretical and practical aspects of such legal regimes.

The thesis, aiming to remedy this situation, introduces a concept of a Regulatory Free Zone Model, a template, which can be applied as a guide in the target jurisdictions that may set up an effective Free Zone.

To achieve those objective theoretical and practical issues surrounding Free Zones as a way of business organization are analyzed. The thesis considers the definition, typologies and historical development of a Free Zone. Drawing upon the elements of the doing business regime suggested by the World Bank successful regulatory examples of such models are examined and analyzed, providing a basis for our Model.

The Model is general enough to be implemented in a number of countries, but also specific enough to fit the conditions of our target recipients. There is analysis of Free Zone types established in CIS in the context of their political, economic and legal situations. Supplementing the data in a case study of a Belarusian Free Zone with the legal SWOT analysis, potential Strengths, Weaknesses, Opportunities and Threats for Free Zones in the target region are discussed.

In conclusion, the need for adaptation of the transposed practices to suit the conditions of a transitional economy is examined emphasising compliance with international provisions restricting Free Zones. The successful regulatory norms are introduced into a structured Model, offering general guidance and practical advice on how a Free Zone in CIS and Eastern European transitional countries can be set up.

Throughout the research a number of related theoretical and practical issues are addressed. These include the cumulative definition and features of a successful Free Zone, the variety of factors affecting the sustainability of preferential business regimes specific to our target jurisdictions, difficulties arising in legal transplanting, downsides of the "race to the bottom" approach in regulatory competition, and finally, an assessment of the feasibility of introducing such a sustainable Free Zone, which can operate at a certain level indefinitely.

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Special gratitude and appreciation goes to family: my parents, Oleg and Galina and my sister Olia for their continuous support and motivation during these five difficult years!

## **THE AUTHOR**

Born in Gomel, Belarus, the author of this thesis graduated from Gomel State University with a Specialist Diploma in Law with honours (5 years of full time education) in 2002. As part of his studies Pavel undertook an exchange year in Ithaca College, NY studying law and was offered a 2 months internship with the United Nations Headquarters in 2000.

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## Preface

*[Free Zones] have multiple facets. Set in a complex environment, they are objects of multidimensional aspects, are at the centre or the periphery of multiple strategies, have multifarious benefits and multifarious costs. [These] can be expressed in ways impossible to render through the lens of a single analytical tool or simple computation. The concern of the analyst should be, on a case by case approach, to come up with a study as complete as possible, revealing through data analysis and interviewing of the actors concerned the multiple dimensions of [a modern Free Zone]. Such approach requires a different model of [the sustainable Free Zone], a model at the cross-roads of the major disciplines of social science, economics, law, political science, sociology, geography. Informed by diversified perspectives, concerned with diverse issues, the policy analyst would present to the policy maker a picture of the Zone that would be less caricatural, without any doubt, but also more complex.*

Claude Baissac<sup>1</sup>

In today's globalized world Free Economic Zones, established virtually in every jurisdiction across the globe, prove to be an important and effective mechanism of economic stability and growth. Facilitating investment inflow, encouraging the development of advanced technologies and know-how, multiplying inland revenue collection, boosting the export manufacture and generally improving the nation-wide business climate, a Free Zone as a way of business organization and environment has been utilized by many developed jurisdictions for centuries.

However, recently Free Zones have become increasingly popular among developing countries and economies in transition, which, in attempt to overcome rapid economic and political crisis, are desperately trying to set up and effectively run various types of Free Zones. In this process, due to the lack of theoretical and practical guidance, as well as insufficient expertise in the field of legal regulation of preferential business regime in such Zones, the governments often have no choice but to engage in risky experiments and improvisations, facing understandable difficulties.

What makes up a successful Free Zone? Which type to choose, how to set it up? How to make it sustainable and profitable, especially in the risky and rapidly changeable conditions of a transitional economy? How to legally regulate the preferential business regime in it? Does one needs to invent such a regulation or is it best to borrow or transplant<sup>2</sup> some of the legal norms from already existing Free Zones? These complicated questions indicate only a small part of the issues a country faces in a process of setting up the Free Zones. And to be successful, the host state should not just find an answer, but has to get it right.

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<sup>1</sup> Claude Baissac, 'A Critique of Cost-Benefit Analysis in the Evaluation of Export Processing Zones' (Presentation at WEPZA Round Table on EPZs in Vienna, 15 April 1996. The Flagstaff Institute 2004) <<http://www.wepza.org>> accessed 28.08.2008

<sup>2</sup> To move a rule or a system of law from one country to another

Despite tremendous international popularity recently acquired by Free Zone as a model of business organization,<sup>3</sup> up to date there exists very little theoretical research and academic conceptual analysis on modelling a sustainable regulatory Free Zone, especially when it comes to offering a legislative model, which can be applied in developing and transitional economies. Very few of the available publications on Free Zones actually go much beyond providing just a list of applicable preferences and mentioning the international regulations with which the Zones have to comply. And even fewer give any kind of guidance for emerging economies on how to set up a Free Zone. For countries in transition it does little good, as these technical and specific details do not cover all the factors one needs to consider when setting up a Free Zone.

Present research is set to remedy this situation. By collecting and analyzing the existing examples of successful legal regulation of some of the Free Zones worldwide, the best sustainable practices will be picked out. Then, after modifying and adapting those to the conditions of a transitional economy, a Regulatory Free Zone Model, which can be used as a guidance by the members of the Commonwealth of Independent States and some Eastern European countries in transition from planned to market economy will be suggested.

As a preface to this thesis below the purpose, targeted recipients, area, methodology and the intended outcome of our research will be explained, as well as outline some of the surrounding legal, theoretical and academic aspects will be provided.

The purpose of this research is obvious from the title: as an outcome a Regulatory Model of a Free Zone will be proposed, which can be implemented or utilized to guide the jurisdictions with transitional economies.

To achieve this rather ambitious objective Free Zone as a model of business environment will first be looked at, focusing at its definition, historical development, typology and classifications. Then various successful Free Zone Models implemented by the world jurisdictions will be considered and the legal norms regulating preferential business regime which make these Zones successful and sustainable will be highlighted. Analyzing and transforming these practices to fit the conditions of the target recipients, as well as bringing into agenda compliance with international standards restricting Free Zones, this thesis will propose a sustainable Regulatory Free Zone Model.

As there exists a vast number of transitional countries worldwide, not to mention the differences in economic, political and locational aspects particular to each of them,

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<sup>3</sup> For more information see World Economic Processing Zones Association <[www.wepza.org](http://www.wepza.org)> accessed 28.08.2008 and World Free Zone Convention <[www.freezones.org](http://www.freezones.org)> accessed 28.08.2008

this study does not aim to propose a Model universally applicable to all. In order to reasonably limit the scope of the research and to ensure viability and practicability of its outcome, the range of target recipients of this thesis is narrowed to some members of the Commonwealth of Independent States<sup>4</sup> for which the Regulatory Free Zone Model will be developed.

The reason behind confining the application of the Model to just the target recipients in the above specified area is relatively simple: firstly, all of these jurisdictions used to be part of the USSR (hence, some similarity in economic and political development); secondly, all of them in economic growth are somewhat behind the developed countries of the Western Europe; thirdly, their economy is, indeed, in transition from planned to market<sup>5</sup>; and, finally, these countries do have a lot of other aspects in common: anything ranging from historical and cultural development to economic and political affairs.

Having dealt with the purpose of this research and its potential users, the need is to further specify what exactly this study targets to achieve and how. In other words, what is a sustainable Regulatory Free Zone Model and applying which methodology and techniques will it be developed?

Definitions of Free Zone are plentiful.<sup>6</sup> The legal definition and various types of implemented models will be thoroughly discussed throughout this research. For now it will be just assumed that Free Economic Zone is a specially designated area within a country which attracts undertakings by offering a regime of fiscal and non-fiscal preferences.

This preferential business regime requires appropriate legal regulation, which would not only make the Zone profitable and allow the host state to enhance inland revenue collection, but also to attract a vast amount of local and foreign investors by reducing regulatory barriers to the minimum and by providing the utmost competitive conditions in relation to other jurisdictions. It is finding the sustainable features of such regime and identifying the best ways to legally regulate it that makes up the central part of this thesis.

Some of the terms, however, like “sustainable” and “regulatory,” do require further clarification. In recent times the word “sustainable” or “sustainability” became increasingly popular, if not trite. It is being used in many contexts, from sustainable development to sustainable environment. The literal meaning of the word is simple:

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<sup>4</sup> Eastern European and European CIS Members: Belarus, Ukraine, and Russia

<sup>5</sup> to a different extent—new members of the European Union are already more economically advanced than the CIS States

<sup>6</sup> Look below in Chapter 1.1

sustainable is “something avoiding depletion of natural resources.”<sup>7</sup> However, most commonly “sustainability” is referred to as “characteristic of a process or state that can be maintained at a certain level indefinitely.”

It is the second, more common meaning of sustainability that is to be applied in relation to this research. Thus, establishing a “sustainable Free Zone Model” mean such a well balanced and wisely construed model of legal regulation of a Free Zone, which can successfully function on a certain level for an indefinite period of time (or at least until it fulfills its objectives and the host state decides to terminate it). Is such sustainable Free Zone possible in theory? Can it be achieved in practice? These are the questions for this research to look at.

Being a piece of legal research, it does not merely aim to describe the composition or organization of an ideal Free Zone. Indeed, a sustainable Free Zone Model from a regulatory point of view will be drafted. To regulate is to “control or supervise something by means of rules and regulations.”<sup>8</sup> Thus, it is the appropriate legal regulation of a Free Zone and its preferential business regime, as well as its application to the target jurisdictions that will be the central part of the proposed Model.

The most difficult issue, however, is choosing the right methodology and the best ways to achieve the above outlined objectives, as there is a number of theoretical, legal and academic aspects surrounding the issue.

As stipulated above, to draft a sustainable Regulatory Model of a Free Zone applicable to CIS, some successfully operating existing Free Zone models across the globe will be looked at and the best practices influencing their sustainability analyzed. Then the practices will be modified to fit the conditions of a transitional economy and actually compiled into a structured Model.

However, how does one determine the best way of doing that? Finding successful examples is relatively simple: for that a representative selection of Free Zones worldwide will be looked at and the best sustainable methods of legal regulation of the preferential business regime they offer will be outlined. But after the legal norms are found, how does one transpose those to target jurisdictions? Does one merely transplant the rule into its new home without any modifications?<sup>9</sup> Or do they need to be adapted to local conditions?<sup>10</sup> Is simple borrowing of just a legal norm enough? Can one

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<sup>7</sup> *Compact Oxford Dictionary* (Oxford University Press, Oxford 2008) 1016

<sup>8</sup> *ibid* 978

<sup>9</sup> On foundations of legal transplants theory see Alan Watson, *Legal Transplants: An Approach to Comparative Law* (Scottish Academic Press, Edinburgh 1974)

<sup>10</sup> D Berkowitz, et al. ‘Economic Development, Legality and the Transplant Effect’ (2003) 47 *European Economic Review* 165, 170



leave aside the institutions, legal concepts, structures or even the “spirit” of a legal system?<sup>11</sup> Will such norm work?

One of the theoretical issues influencing the outcome of this research is the concept of legal transplants, initially developed by Watson<sup>12</sup> in 1970s and to date widely discussed by academics.<sup>13</sup> Legal transplants are traditionally perceived as unilateral changes of legal order by which one jurisdiction imports legal norms from another jurisdiction. In this process the transplanting jurisdiction either adopts the foreign law as it is or develops its own legal norm based on the imported rule.

Transplanting successfully existing legal regulations from the developed Free Zones is an appealing solution which the economies in transitions setting up their own Zones might consider. Indeed, what could seem simpler: just look at how successfully operating Free Zones are regulated and copy the same into domestic legislation. But is such plain transplanting really appropriate? Would the legal norm taken out of the context of a successfully operating Free Zone survive and actually work in a transitional economy?

One should exercise extreme caution with such approach. Even though legal transplanting should (and will) be utilized as one of the methods in developing a Regulatory Free Zone Model for target jurisdictions, plain transplanting does not appear to do enough to achieve this objective.

Here one would agree with Ogus and Garoupa<sup>14</sup> in saying that it is the ability to accordingly adapt transplanted law to local conditions that makes the legal transplanting work. Thus, this research aims not only to outline the examples of successful legal regulation of Free Zones worldwide, but also adapt those to the conditions of a transitional economy, so the target jurisdictions can transpose the Model into their own legal systems.

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<sup>11</sup> A Watson, ‘Legal Transplants and European Private Law’ (2006) vol 4.4 December *Electronic Journal of Comparative Law* <<http://www.ejcl.org/ejcl/44/44-2.html>> accessed 28.08.2008

<sup>12</sup> A Watson, *Legal Transplants: An Approach to Comparative Law* (Scottish Academic Press, Edinburgh 1974) and A Watson, *Legal Transplants: An Approach to Comparative Law* (2<sup>nd</sup> edn the University of Georgia Press, Athens 1993)

<sup>13</sup> Look, for example, at U Mattei, ‘Efficiency in Legal Transplants: An Essay in Comparative Law and Economics’ (1994) 14 *International Review of Law and Economics* 3, 21; P Legrand, ‘European Legal Systems Are Not Converging’ (1996) 45 *International and Comparative Law Quarterly* 52, 53; J Smits, ‘On Successful Legal Transplants in a Future Ius Commune Europaeum’ in A Harding, et al, *Comparative Law in the 21<sup>st</sup> Century* (London, UK 2002) 137, 154; J Fedtke, ‘Legal Transplants’ in J Smits, et al, *Elgar Encyclopaedia of Comparative Law* (Cheltenham, UK 2006) 434, 437

<sup>14</sup> A Ogus, N Garoupa, ‘A Strategic Interpretation of Legal Transplants’ (2006) 35 *Journal of Legal Studies* 340

The concept of legal transplants goes head to head with the theory of global diffusion<sup>15</sup> of law which itself links this research to the ideas of the “race to the bottom” in regulatory competition.

Being labelled as “transplantation, transposition, spread, transfer, import/export, reception, circulation, mixing, and transfrontier mobility of legal norms,”<sup>16</sup> diffusion between legal systems is seen by many academics as an inevitable process of the modern globalized world,<sup>17</sup> which will ultimately lead to a uniform system of legal regulation of, in this case, Free Economic Zones worldwide.

Since this research by no means is trying to create a universally applicable Free Zone Model, the prospective of global legal diffusion may be a positive, but rather incidental factor. However, the effect of such diffusion has to be considered, especially when (or if!) it leads to an emergence of a uniform system of legal regulation of the preferential business regime in Free Zones worldwide, as the latter is linked to another global concept relevant to this topic—“race to the bottom” in regulatory competition.

When setting up Free Zones, to ensure its effectiveness and competitiveness, CIS and Eastern European States in transition cannot avoid “casting a wary eye”<sup>18</sup> at the extent and degree of legal regulation of alike Zones in the competing states. Indeed, the states, like companies, compete for capital and other factors, and if one wants a Free Zone to operate successfully, attracting local and foreign investors, the legal regulation of its preferential regime should be at least more appealing compared to other countries striving to do the same.

Such competition between Free Zones, characterised by constant relaxing of the regulatory regime in the attempts to overtake the neighbours, eventually leads to the “race to the bottom,”<sup>19</sup> when Free Zones reduce their legal regulation of preferential business regime to the minimum. The best known example of regulatory competition is the so-called “Delaware Phenomenon”<sup>20</sup> under which due to introduction of minimum rules, the US State of Delaware became the leading incorporation jurisdiction, attracting thousands and thousands of companies.

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<sup>15</sup> “Diffusion” in ordinary usage means the spread of one liquid throughout a second liquid, thereby transforming the character of both

<sup>16</sup> W Twinning, ‘Diffusion and Globalization Discourse’ (2006) 47 *Harvard International Law Journal*, 510

<sup>17</sup> D Westbrook, ‘Theorizing the diffusion of Law: Conceptual Difficulties, Unstable Imaginations, and the Effort to Think Gracefully Nonetheless’ (2006) 47 *Harvard International Law Journal* 487

<sup>18</sup> M Stewart, ‘Global Trajectories on Tax Reform: The Discourse of Tax Reform in Developing and Transition Countries’ (2003) 44 *Harvard International Law Journal* 139

<sup>19</sup> This term was introduced in W Cary, ‘Federalism and Corporate Law. Reflections upon Delaware’ (1974) 83 *Yale Law Journal* .663, 666

<sup>20</sup> For an overview see J Trachtman, ‘International Regulatory Competition, Externalization, and Jurisdiction’ (1993) 47 *Harvard International Law Journal* 463, 470

The issues relating to "race to the bottom" affect the outcome of this research as when a host state introduces an extremely low regulatory level for its Free Zones, the preferential business regime immediately comes in conflict with various international regulations restricting Free Zones. The proposed Regulatory Free Zone Model should be sustainable and account for both regulatory competition and restrictions imposed by international institutions. But how does one find the right balance? What is the best way to comply and not to lose out in competition? In modelling, these questions should be carefully considered.

One can see, even though this research is of a somewhat unusual nature, as very little academic sources exist on actually modelling a Free Zone (not to mention sustainable legal regulation of its preferential regime), there is a wide range of theoretical issues and concepts, including legal transplants, global convergence of law and regulatory competition, which are relevant here. Even though this research will not be able to consider the above mentioned theories in much detail (as one could easily write a separate thesis on each), the influence of these concepts have to be accordingly considered as the Sustainable Regulatory Model of a Free Zone is drafted.

Below the suggested structure of this thesis showing how the proposed Model is to be developed.

Firstly, the essence and definition of a Free Zone as an internationally accepted model of business organization and environment will be looked at. Since there exists a vast amount of functional types and classifications, they will have to be considered to indicate the best appropriate ones to target jurisdictions. Needless to say, the Model should be general enough not to be confined to any specific type of a Free Zone or any particular jurisdiction. In Chapter 1 a cumulative definition of a Free Economic Zone will also be suggested.

Then various Free Zone Models functioning worldwide will be analyzed. By no means this research will manage to look at each of them; thus, a representative selection of different Models operating in different jurisdictions will be covered: developed, developing, planned and transitional economies. The thesis will, however, consider a wide typological range of Free Zones, from Export Processing Zones and Science Cities to International Offshore Financial Centres. Once again, the good practices and examples in legal regulation of preferential business regime will be singled out and how these could be successfully implemented in the transitional economies will be considered.

As most of the target jurisdictions have already initiated the process of setting up Free Zones, this research cannot avoid looking at some of them to analyze existing

problems and obstacles which prevent sustainable operation. For that a case study on Free Economic Zone “Gomel-Raton” in Belarus will be performed and its legal SWOT analysis, showing Strengths, Weaknesses, Opportunities and Threats of the Zone will be presented.

This research would not be complete without considering international regulations restricting Free Zones, as both non-observance and over-observance of these could tremendously impact sustainability and effective operation of the Zone.

And finally, in the concluding chapter, drawing upon the research and analysis of successes and failures of legal regulation of international Free Zones, as well as considering all the surrounding legal, theoretical and academic aspects, a sustainable Regulatory Free Zone Model for CIS, which can be used as a guide or an example in creating Free Economic Zones will be proposed.

## **Chapter 1. The Free Zone as an Internationally Accepted Model of Business Environment**

### **1.1 Defining a Free Zone**

#### **1.1.1 Essence of a Free Zone**

#### **1.1.2 Cumulative definition of a Free Zone**

### **1.2 Typology and Classifications**

#### **1.2.1 Variety of Existing Classifications**

#### **1.2.2 Comprehensive Classification of Free Zones**

#### **1.2.3 Classification, Based on Specialization and Functions**

### **1.3 Historical Development**

#### **1.3.1 “Ancient” History**

#### **1.3.2 “Modern” History**

This introductory chapter will look at the phenomenon of a Free Zone as a special way of organizing a business environment. Before various Free Zone Models are analyzed it is essential to have a clear idea of what exactly is a Free Zone, how it can be defined, in which variations does it exist, what's its structure, how did it originate and which general changes did it face thorough historical development.

## **1.1. Defining a Free Zone**

Researching any subject, one should primarily start with the definition, as it is the definition which traditionally contains researched subject's essence and main features. Thus, the sections below will look at the essential features of Free Economic Zone as an economic and legal structure and work out a cumulative definition of this unique way of business organization, specific to the target jurisdictions.

### **1.1.1 Essence of a Free Zone**

Throughout history virtually every nation has tried to use various models of economic development, which, although taking different forms and being quite distinct, could be united under a broad category of "Free Zone." Regarded as one of the oldest and at the same time the newest human ideas in economic development,<sup>21</sup> Free Zone, often being used by host countries to ease international trade, attract investments and advance economically depressed territories, represents a complex economic structure of various types, but lacks universally adopted definition or model.

In simplified terms, Free Zone constitutes a separate distinguished part of national economic territory, where the government is enforcing a special favourable regime of business organization, which is not usually applicable nationwide. To better understand the essence of Free Zones, this research will focus on their structure, reasons for creation and key elements of the favourable regime offered. And the best way to do this is to analyze general and specific features of Free Zones.

The first general feature is the status of a Free Zone as a separate, often geographically limited territory. Normally a Free Zone occupies certain part of a country: it can be a city (Free Town of Hamburg in Germany in early times), a port (Free Port of Venice), an airport (Free Economic Zone Shannon in Ireland), or just several enterprises and factories within a town (many small Free Zones, tied up to particular enterprises have been established in Mexico). Occasionally, a Free Zone can occupy the whole economic territory of the country, which is true for the Service Zones (such as International Offshore Financial Centres), which can be hosted by small island jurisdictions (British Virgin Islands). However the situation when a Free Zone occupies the whole territory of the country, rather than a geographically limited part, is more of an exception rather than the rule.

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<sup>21</sup> V Byk, *Free Economic Zone "Gomel-Raton"—Strategy of Sustainable Development* (Gomel, Belarus 2003) 6

Practitioners distinguish three conceptual approaches, which are applied to establishment of Free Zones: territorial, functional and mixed<sup>22</sup>.

A Free Zone, created under a territorial approach constitutes a geographically limited territory enabling all its resident businesses to enjoy special preferential regime (an example of those would be majority of the world Export Processing Zones). Normally the territory of a Free Zone is not very big, something ranging from several hectares to few square miles. However, there are some successful examples when Free Zone occupies a huge territory (like Free Zone "Manaus" in Brazilian Amazonia), but the number of exceptionally large Free Zones is limited.

In a Free Zone, created under the functional approach, a preferential regime of doing business would apply only to certain indicated activities or even particular enterprises (duty free shops in international airports or certain offshore companies). As the functional approach specifically provides for a selective application of the preferential regime, it becomes useful when the host country is creating a Free Zone to advance certain type(s) of business.

A Free Zone, established using the combination of territorial and functional approaches is said to be created under a mixed approach. This allows all businesses of only a certain type, located within the geographically limited territory, to benefit from the special regime. An example of this is illustrated by Science Cities in Japan, where the government is offering preferential regime to certain high tech and innovative enterprises within the geographical areas of the city.

A majority of already existing Free Zones in CIS are set within clearly defined geographical boundaries, which gives grounds to suggest a territorial approach to be the most common for the target jurisdictions. However, one needs to remember that in many Free Zones worldwide the preferential regime can still apply just to a specific industry across the country, such as banking or insurance, or companies with some common behaviour, such as export orientation and high technology content, or sometimes even activities with low moral content such as gambling and prostitution (Las Vegas in the United States).

The second general feature, which has a direct relevance to establishment of a Free Zone, includes aims and objectives of the host countries, which they are targeting to achieve with the help of the Zone. As Robert Haywood, Director of World Economic Processing Zones Association, has rightfully indicated '*the fundamental concept of [Free] Zone is that it is an alternative policy framework, developed by the government*

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<sup>22</sup> T Danko, Z Okrut, *Free Economic Zones in International Business* (Infra-M, Moscow 1998) 77

to promote policy objectives of the government.'<sup>23</sup> Creation of Free Zones by the government for the government does not necessarily imply that the Zones could only be established and managed by the state (even though, in CIS this is mostly the case). It is true that in some jurisdictions a Free Zone can still be initiated by a private institution (like the Silicon Valley, established by Stanford University in the USA), but even in that case it would still remain within strict governmental control, as the degree of preferential business regime offered by the Zone is determined by the state in any case. So one can affirmatively submit that any Free Zone is destined to attain certain governmental objectives.

Depending on the actual situation in the host country, its social and economic development and strategic plans, general aims and goals for establishing Free Zones can be quite distinct and variable. As noted by Baissac<sup>24</sup> '*... [Free] zones are indeed created for economic purposes [but also] they are above all public policy instruments with social and political purposes and not exclusively limited to purely economic considerations.*'

As the objectives can greatly influence the type of the Zone and the extent of the preferential regime it offers, this research cannot disregard those. However, having in mind general complexity of the objectives, it will focus in some detail on the relevant goals and aims for Free Zone establishment in the target jurisdictions, but will do so in Chapter 4 discussing establishment of Free Zones in CIS. In this section the variety of general reasons will be acknowledged.

In well developed industrial countries, Free Zones are often established to promote foreign trade and export of goods (Foreign Trade Zones in the USA), strengthen economic relationship with neighbouring territories (Free Zones in France), boost science and research (Science Cities in Japan) or revive economy of relatively small depressed urban regions (Enterprise Zones in the UK).<sup>25</sup>

Similar reasons could also be established for the developing countries and economies in transition, but in addition to the above, the focus there is more shifted to attraction of foreign investments and capital, hi-tech technologies, modernization of industry and improvement of labour force qualification. These goals would be more common to Free Zones established in the target jurisdictions.

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<sup>23</sup> R Haywood, 'Free Zones in the Modern World' (Flagstaff Institute 2004) <<http://www.wepza.org>> accessed 28.08.2008

<sup>24</sup> C Baissac, 'A Critique of Cost-Benefit Analysis in the Evaluation of Export Processing Zones' (speech at WEPZA Round Table on EPZs in Vienna 15.04.1996. The Flagstaff Institute 2004) <<http://www.wepza.org>> accessed 28.08.2008

<sup>25</sup> V Adrianov, 'Special Economic Zones in World Economics' (1997) 3 *Economics and manufacturing* 133



Apart from the above, some general aims common to most of the host countries setting up the Free Zones can be suggested. These include, but are not limited to:

- stimulating export production and advancing domestic economy;
- providing for capital absorption in terms of local and foreign investments;
- reducing unemployment;
- attracting and approving new technologies (know-how transfer) and experimenting with new policy frameworks when opening the economy to the global world.

When it comes to the former Communist countries of Eastern Europe, often the establishment of Free Zones is a clear indicator of State economy's openness to the investors. However, regardless of the specific aims, one has to bear in mind that creating a Free Zone, the host country is unwilling to fully open its economy for foreign capital and liberalize the business regime on the whole territory—using Free Zone opportunity for partial liberalization and various economic experiments.

The third general feature is the preferential business regime—a combination of concessions and exemptions applied within the Zone, which is more favourable and beneficial than business conditions on the rest of the economic territory of the country.

Preferential regime of doing business offered by the Zone is, undoubtedly, its most important distinctive feature, and its effective legal regulation determines success or failure of the Zone, having a great impact on its sustainability. As legal regulation of preferential business regime in a Free Zone will constitute the key structural part of the suggested Regulatory Free Zone Model, special attention will be given to it when various Free Zones models are discussed throughout our thesis.

Distinctive features of the preferential regime in various types of Free Zones are quite diverse. Understandably, legal regulation of a Service Zone, such as International Offshore Financial Centre, is different from legal environment of a Science City or Tourism and Recreation zone. Without specific relevance to the target group yet, four general groups of preferences, which make the preferential business regime in a Free Zone especially appealing are outlined below:

- Export trade preferences: allow for duty free storage and export of produced goods, ease custom procedures and promote export operations.
- Tax concessions: stimulate specific business activities. These can include anything from lowered tax base (income tax, VAT, custom duties in Export Processing Zones) to total abolition of tax burden (as in some International Offshore Financial Centres).

- Financial preferences<sub>2</sub> include various types of subsidies: lower rate of rent, lease, utilities; discount loans and mortgages, etc.
- Administrative preferences: can be provided directly by the host state (abolition of licenses and special permissions, simplification of entrance and exit of foreign citizens, absence of exchange control) or can be safeguarded by the administration of the Zone (simplification of the registration procedure, waiving of statistics or accounts procedures).

The actual preferences granted by various types of Zones could differ significantly and be applied in various combinations. For instance, Free Economic Zones in Ukraine or Russia grant discounted rate on most taxes and various export trade preferences,<sup>26</sup> when traditional International Offshore Financial Centres, like Isle of Man or Gibraltar, exempt the residents from all taxes (which are substituted by a yearly fixed fee), provide simple registration, and do not request to keep any accounts.<sup>27</sup>

Discussing the essence of the Free Zones, term “Free” which is extensively applied in dealings with the Zones should be clarified, as the preferential regime offered by the Zones is often quite far from being totally regulation-free. The host states do not liberate the residents from existing legal regulation of economic activity, but only ease it by granting certain exemptions and preferences, thus stimulating the business growth. In Free Zones the host state basically limits its intervention in economic process, but never fully withdraws it. The degree of desirable governmental intervention into life of the Free Zone residents will be further discussed in subsequent chapters.

Concluding the outline of the essential features of a Free Zone as a model of business environment, general features determining any Free Zone have been discussed. These include special status of a Zone, its aims and objectives, and preferential doing business regime.

One has to stress that the concept of a Free Zone is not perceived in the same manner by all political and economic players worldwide. Whilst some fear Free Zone is a gateway to criminal world, contributing to smuggling, unfair competition, tax avoidance and money laundering, others emphasise Free Zone as a unique tool to revive economy, attract investments, develop new technologies and further contribute to worldwide prosperity.

In addition to the analysis of the benefits offered by various Free Zone models, the subsequent discussion will focus on potential threats and disadvantages of the

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<sup>26</sup> O Chmir, *Special (Free) Economic Zones and Territories of Prioritized Development (Scientific and Methodical Aspects)* (Shidnii vydavnicхий dim, Ukraine 2001) 18

<sup>27</sup> for more information see N Courtis, *Financial Regulation in Offshore Centres* (Central Banking Publications, London 2001)

Zones, researched in the light of international regulations restricting their operation. However, since the ultimate aim of present research is not speculation about pros and cons of this economic phenomenon, but rather provision of practical advice on a sustainable Regulatory Free Zone Model, this thesis will refrain from advocating for or against the Zones, focusing instead on more details of how to achieve sustainability of their preferential business regime. Before proceeding to that, keeping in mind the essential features of Free Zones discussed above, the next section will look into a definition of that legal structure.

### **1.1.2 Cumulative definition of a Free Zone**

Sharing a similar economic basis, Free Zones can have different designations. Simple analysis indicates that commentators and related organisations seldom show much consistency in the use of terminology regarding Free Zones.<sup>28</sup> Byk, the first director of Belarusian Free Economic Zone “Gomel-Raton,” suggested over 50 of such names.<sup>29</sup> Among the most popular one could mention Free (Open) City, Free Port (Porto Franco), Free Economic Zone, Free Trade Zone, Duty Free Zone, Export Processing Zone, Free Industrial Zone, Tourist Services Zone, Offshore Zone, International Offshore Financial Centre, Free Banking Centre, etc.

Apart from variety of names, inconsistencies can also be found in classifications, as commentators try to classify the same Zones differently, often placing similar Zones within different typologies. A comprehensive classification of Free Zones is suggested in section 1.2.2, but here a specific to CIS definition will be discussed. Considering the number of definitions used worldwide this does not appear to be an easy task.

The best to achieve that objective is to analyze some definitions introduced by various international organizations (such as the United Nations Industrial Development Organisation, United Nations Conference on Trade and Development and the Organisation for Economic Co-Operation and Development), governmental bodies and individual authors and researchers from various jurisdictions. Then the common features of these definitions will be looked at, modified to fit the specifics of the target region, and introduced in a usable definition.

Any definition of a subject should contain its essence and relevant elements. As the concept of a Free Zone was changing through time,<sup>30</sup> so was the definition. It

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<sup>28</sup> Examples with variations of Export Processing Zone are shown in: *Economic and Social Effects of Multinational Enterprises in Export Processing Zones* (United Nations Centre on Transnational Corporations and International Labor Organization, Geneva 1998) 4,6

<sup>29</sup> n 21, 6

<sup>30</sup> On “ancient” and “modern” historical development of Free Zones see Chapter 1.3

comes as no surprise that an age-old concept of Free Zones (characterized by Free Trade Ports of the Roman Empire, Free Cities of the Middle Ages, and Free Ports of the British Empire) has been significantly modified and transformed to whatever makes up Free Zones of the present. These changes should be accounted for in the modern definition.

Many researchers suggest that the classical universal definition of Free Zones was given in Kyoto Convention of 18 May, 1973.<sup>31</sup> Annex F.1. to the Convention defines the term "Free Zone" as *a part of the territory of a State where any goods introduced are generally regarded (insofar as import duties and taxes are concerned) as being outside the Customs territory and are not subject to the usual Customs control.* Legal regulation in such Zones does not free investors and manufacturers from existing tax burdens, but makes those sufficiently reduced. Free Zones are treated as geographical territories within the State with a more favourable doing business regime, guaranteed by reduced governmental interference into regulating economic process.

However, the view that Free Zones *per se* are outside the customs territory of the nation (the principle of extraterritoriality) is being deemed by some researchers to be erroneous. Haywood suggests that all Free Zones are under customs control by the state.<sup>32</sup> This control is simply different than that of the rest of national territory, in terms of granting certain preferences and waiving some duties and taxes, thus providing for the special preferential regime of doing business for residents registered within the Zone.

Researchers from CIS and neighbouring countries—Belarus,<sup>33</sup> Russia,<sup>34</sup> Ukraine,<sup>35</sup> and Poland<sup>36</sup>—have all introduced various definitions of Free Economic Zones, which encompassed and reflected particular features of the Zones to each geographical region.

Russian scholar Adrianov defines Free Zone as *"a part of national territory (possibly outside of customs territory), which offers an increased freedom in doing business, has special regime of governing and provides for preferential conditions in economic activity to national and foreign investors."*<sup>37</sup>

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<sup>31</sup> <<http://www.unece.org/trade/kyoto/ky-f1-e0.htm>> accessed 17.01.2004

<sup>32</sup> R Haywood, 'Free Zones in the Modern World' (Flagstaff Institute 2004) <<http://www.wepza.org>> accessed 28.08.2008

<sup>33</sup> Y Druzik, *Free Economic Zones in the System of World Economy* (RUA Inform, Minsk 2000)

<sup>34</sup> T Danko, Z Okrut, *Free Economic Zones in International Business* (Infra-M, Moscow 1998)

<sup>35</sup> G Emets, O Peredriy, *Free Economic Zones of Ukraine: Issues and Methodologies of Creation, Managing Economic State* (Ukrainian Institute of Academy of Science, Kiev 1993)

<sup>36</sup> M Proskura, *Special Economic Zones in Poland: a Unique Investment Opportunity* (Poland, Warsaw 2000) 33

<sup>37</sup> V Adrianov, 'Special Economic Zones in World Economics' (1997) 3 *Economics and manufacturing* 131

Ukrainian researcher Chmir' describes Free Economic Zone as *"a limited part of country's territory, which has a special regime of economic activity aiming to provide purposeful economic development of the region through attracting foreign investments and activization of international business relations and commerce."*<sup>38</sup>

Belarusian commentator Druzik provides a somewhat different description of a Free Zone, saying that it is *"a part of national territory where for domestic and foreign investors an attractive preferential regime of doing business is created. With help of new technologies, such regime allows to develop preferred fields of economy, which are able to supply high quality products into world market and develop socio-economic life of the region. Business operations in such Zone are governed by market relationships combined with partial state regulation."*<sup>39</sup>

Comparing the above definitions, one can note the difference in approaches to Free Zone between the neighbouring jurisdictions. When the Russian Federation is stressing the importance of offering doing business preferential to both foreign and domestic investors, Ukraine is underlining the need of further regional economic development by specifically attracting just foreign investments and establishing ties with businesses abroad, which seemingly undermines the local companies.

But apart from the various approaches, it is submitted that majority of the researched definitions are far from being complete, as they hardly take into account all major relevant and essential features of the Free Zones. Among the above descriptions, the definition suggested by Belarusian researchers seems to be the most comprehensive; thus, it can be utilized for the development of a cumulative definition applicable to the target region.

It is evident that cumulative definition of Free Economic Zone in CIS should definitely include the major specific features of the Zones relevant to the region. Incorporating the essence of Free Zones, a compilation of elements to be considered when developing a definition.

First of all, a Free Zone in CIS is usually a part of the state's territory with clearly defined boundaries. Even though, in certain rare exceptions, Free Zones can occupy the whole territory of the country, like some Tax Havens in small island jurisdictions, this category is not really applicable to the target region.

Second, a Free Zone would be offering a preferential regime of doing business, appealing to investors. Such preferential regime constitutes a number of administrative, fiscal and financial preferences and concessions, applicable to all or some businesses

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<sup>38</sup> n 26, 267

<sup>39</sup> n 33, 11

within the Zone's territory. Very often, countries in transition are more interested in attracting foreign capital, rather than mobilizing domestic, thus the preferential regime could be made more appealing specifically to that type of investors. Of course, sometimes a jurisdiction offers certain preferences to all foreign investors within the country regardless of their location, within or outside the Zone. But for this research, it is preferential regime offered within the Zone's territory of primary importance.

Third, transitional economies are very interested in attracting modern advanced technologies and innovations, so this target would normally come under specific goals and objectives set up by a host State. Some of the jurisdictions especially welcome high-tech projects, whereas others, like Belarus, are hoping to establish Silicon Valley-like Scientific Parks to foster innovation and high tech development.

Fourth, the transitional economies, especially those, recovering from post-communism dictatorships, usually tend to welcome investments only into certain preferred fields of the economy (i.e. manufacturing, high tech, services), when other fields (like natural resources, oil and gas procession) the governments prefer to keep off limits, especially for foreign investors.

Fifth, manufacturing in CIS would often be export oriented, and the main target for Free Zones in such economies would be to boost export production to secure inflow of "hard currency" rather than to supply goods for the local markets.

Sixth, investors would also have to be actively engaged in fostering the socio-economic life of the host country and bearing some (often considerable) social burden (refrain from cutting off jobs on newly purchased enterprise or develop transport infrastructure in the region). All this, combined with the reduced (but still heavy!) governmental regulation of the preferential regime constitutes additional disadvantages for the investors.

The above discussed elements should, to larger or lesser extent, comprise a cumulative definition of a modern Free Zone, specific to CIS. It is not submitted that the definition will necessarily embrace all those six elements,<sup>40</sup> but they will be considered in developing the definition.

It is also hard to disregard the fact that many of the target jurisdictions, which already started to establish Free Zones, had to provide their own legal definition. For instance, in Belarus, Free Zones (which are officially called "Free Economic Zones") are defined as "*a part of the territory of the Republic of Belarus with exactly determined*

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<sup>40</sup> in fact, quite a few of them could be in accordance of the desire to secure the goals and objectives, set by the host State

*borders and with a special legal treatment establishing more favourable than usual conditions of executing entrepreneurial and other economic activities.*"<sup>41</sup>

This evidences the evolution of Free Zones definition from the classic one, introduced at the Kyoto Convention 1973 (which was anyway only relating to the *Porto Franco* with traditional combination of custom and trade concessions) to a more comprehensive one, mostly used in CIS countries. Indeed, most of the target jurisdictions in addition to foreign investments are trying to mobilize local and do not limit the goals attributed to Free Zones just to foster export trade.

Thus the typical goals would include manufacturing, advancement of new technology and securing the social responsibilities, all which is safeguarded by somewhat reduced but still strong governmental control over the preferences offered by the Zones. Moreover, many researchers see Free Zones as entities providing targeted economic development of certain geographical territories, not necessarily coinciding with the boundaries of one country.<sup>42</sup>

Analyzing and combining the above factors, cumulative definition of genre of a Free Zone, to be applied within our target region is suggested: it is a part (or number of parts) of the territory of one (or several) state(s) with clearly defined boundaries and a special preferential regime of doing business in general (or for particular types of business or services), which with the help of free market economy and stable legislation during the term of Free Zone's functioning guarantees the realization of certain goals and aims set up by the host country(s).

The proposed definition is cumulative and comprehensive, not only including the combination of the general features specific to Free Zones within CIS, but also reflecting upon all necessary elements and conditions for Free Zone's creation and functioning, such as: the territory, preferential regime, leading to open market economy and attainment of certain aims and goals set by the government.

Also, in the definition a new element, which was previously overseen by other researchers is introduced: the term of Free Zone's functioning. Very often a country in transition determines for how long the government guarantees the preferential regime to apply within the Zone, i.e. in what time the special conditions will cease and the preferences will be withdrawn. Sometimes the regime is granted without a fixed expiration date, but this does not mean the preferences would last forever. History reveals many examples, which are looked at in Chapter 4.

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<sup>41</sup> 'On Free Economic Zones' (Law of the Republic of Belarus #213-Z, 7.12.1998, 25 *Publications of National Assembly of Belarus*, 1999) 428

<sup>42</sup> V Ignatov, V Butov, *Free Economic Zones (Methodical and Organizational Approach)*. (Os'-89, Moscow 1997) 53

Thus, for any investor it is important to account for the possibility of expected or unexpected withdrawal of the regime, especially if the legal regulation of a Free Zone is silent about this. A Sustainable Model of a Free Zone should account for possible termination of the preferential regime and it is desirable for the host country to plan accordingly and clearly indicate its term of duration. With that in mind the cumulative definition of a CIS Free Zone should reflect its duration.

Minding the target region, CIS and Eastern European countries in transition, the cumulative definition cannot ignore the perception of a Free Zone by the European Union. The correlation in the approach to Free Zones by the EU and CIS becomes especially relevant considering that some of the target jurisdictions have reasonable chances to join the European Union in near future.

One of the main aims of the European Community is to establish a common market between the Member State by implementing uniform commercial, economic, social and other policies.<sup>43</sup> This also implies creation of an internal market -- an area without frontiers in which free movement of goods, services, people and capital is ensured.<sup>44</sup> Establishment of common and internal markets is hardly possible without having a Customs Union, which would cover all trade in goods and involve the prohibition of custom duties on imports and exports and of all charges having equivalent effect between the Member States, plus an adoption of a common customs tariff in their relations with the third countries<sup>45</sup>.

In such conditions one may hardly expect that the classic concept of Free Zones could be fully implemented and function within the Union, as an idea to offer a preferential regime of doing business within a confined territory in the Member States does not go along the principles of common market and equal treatment.

It is not implied here that no Free Zone could be successfully established and run in the European Union (as there are numerous examples to the contrary, ranging from the Free Zone Shannon in Ireland to what used to be an International Offshore Financial Centre in Cyprus). In fact, the topic of co-existence of Free Zones and European Union regulations could amount to a PhD-type research project alone; thus, it is not analyzed in full. For the purposes of this research it should just be ensured that the Sustainable Regulatory Free Zone Model for CIS does not contradict the principles and regulations adopted by the EU.

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<sup>43</sup> Treaty Establishing the European Community (EC Treaty), Art. 2 and 3, [2000] *Official Journal C* 325. Also see Rudden and Wyatt, *EU Treaties and Legislation*. (8<sup>th</sup> ed OUP, Oxford, 2002)

<sup>44</sup> Article 14(2) EC

<sup>45</sup> Article 23(1) EC



Establishment and regulation of Free Zones within the EU has been initially provided for in numerous Regulations and Directives.<sup>46</sup> However, after 1992 the Regulation 2913/92/EEC<sup>47</sup> established EEC Customs Code; this is now the primary document supplying the current definition and other relevant provisions on Free Zones for all Member States (Section I of Chapter III).

The Code defines Free Zones as '*parts of the customs territory of the Community or premises situated on that territory and separated from the rest of it in which Community goods are considered, for the purpose of import duties and commercial policy import measures, as not being on the Community customs territory.*'<sup>48</sup> The Code clearly puts emphasis on the principle of extraterritoriality, referring, however, not to the territory itself, but to the goods placed within that territory. Even though the boundaries of Free Zones in the EU are to be clearly determined, it is the position of the goods regarding the Community customs territory that is important in the EU definition. And application of the preferential regime could be justified by the principle of extraterritoriality of goods placed within the Zone, which, however, is not deemed to be contrary to the overall principles of the common market.

Comparing and analyzing the definition for Free Zones in the EU with the suggested cumulative definition for CIS, one has to note that Free Zones in CIS are defined more broadly. The suggested cumulative definition in addition to mere custom-free storage of goods, also includes other relevant elements, such as establishment of special preferential regime of doing business (which is not always related to just manufacturing and storage of goods) for the whole territory or certain industries, as well as ensuring the attainment by the Zones of the special goals and aims set up by the host State within the time limit of its duration.

In summary, one has to stress the relative generality of the proposed definition. Certainly, due to many different types of the Zones present in the target region, a specific definition applicable to each particular Zone could differ from the cumulative one, suggested in this section. Indeed, the specific features of International Offshore Financial Centre are quite distinct from a Science City and both of those types of the Zones differ significantly from Export Processing Zone, Tourist Recreational Zone or Insurance Zone. So why would a legal definition be the same?

However, this section did not aim to define every possible type of the Zone present. Rather, it generalized the applicable elements suggested a cumulative

<sup>46</sup> namely, Directives 69/75/EEC and 71/235 and Regulations 2504/88/EEC and 2562/90/EEC

<sup>47</sup> [1992] *Official Journal* L 302, 0001 - 0050

<sup>48</sup> EEC Customs Code, Art.166

definition of a Free Economic Zone which is relevant to most CIS and Eastern European Transitional Countries. The definition is based on a main characteristic common to most of them, and with some minor modifications it could be applied to most if not every single type of the Zones in the target area. This cumulative definition will be a starting point for the proposed Regulatory Model Free Zone for CIS.

## **1.2 Typology and classifications**

This section will look into various classifications of Free Zones adopted worldwide, analyze the existing typologies, and suggest two comprehensive classifications, which are the most applicable to the target region: a general classification on various bases and a specific classification in accordance with the specialization and functions of Free Zones.

### **1.2.1 Variety of Existing Classifications**

Throughout history Free Zone as a phenomenon faced many phases of development and modifications which resulted in introduction of new types and changing the existing types of the Zones. The modern approach to classifying the Zones is bound to reflect such evolution.

Simple research shows a great variety of classifications suggested by experts and commentators for CIS. Some of the classifications are quite basic and only include the main types, others are developed in a bit more details.

Russian commentators Shekhovtsev, Shestakova and Gromov classify all Zones as Free Trade Zones, Industrial Zones, Scientific Zones, Technical Zones (Techno parks) and Service Zones without any further subdivision.<sup>49</sup> Ignatov and Butov add to this list Financial Zones and Mixed (Complex) Zones.<sup>50</sup> Danko and Okrut systemize Free Zones according to four groups: trading (Free Custom Zones, Porto Franco, etc), industrial (Special Economic Zones, Entrepreneurial), scientific and technological (Innovation Centres, Technological Parks), as well as mixed (complex) zones.<sup>51</sup>

Ukrainian academics from the National Academy of Science, Fedorenko and Mudragel, also distinguish three types of Free Zones: export trading (Porto Franco, Export Processing Zones), functional (Techno Parks, Service, Banking Zones), and complex zones. Chmir suggests, in addition to the above, taking into account and using

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<sup>49</sup> A Shekhovtsev, M Shestakova, A Gromov, 'Free Economic Zones: World Experience and Perspectives in Russia' (2000) 10 *Economic Issues*, 104

<sup>50</sup> *ibid.* n. 42, 11-14.

<sup>51</sup> T Danko, Z Okrut, *Free Economic Zones in International Business* (Infra-M, Moscow 1998) 10-16

as a classifying basis the geographical situation of Free Zones and its relations with national economy.<sup>52</sup>

Other European experts also use various bases for classifying Free Zones. Trampus from Italy distinguishes Free Trade Zones, Free Towns, Free Ports, Harbour Free Zones, Free Warehouses, Industrial Free Zones and Export Processing Zones.<sup>53</sup> Professor Kibritcioglu from Ankara University in Turkey classifies Free Zones by the exception degree and types of activities the latter perform. According to the exception degree Free Zones are divided into Open Free Zones, where all customs laws of the country are invalid and Closed Free Zones, where concessions are possible only under specific conditions. According to types of activities, Kibritcioglu outlines Free Trade Zones, Free Processing (export) Zones, and Free Zones for Financial Activities (off-shore, banking, and insurance), Free Medical and Free Gambling Zones.<sup>54</sup>

Belarusian researchers offer more complex approach to the classification. Abramchuk proposes that one should use the following classifying criteria: geographical location, aim of creation, level of integration into local or world economy and type of ownership<sup>55</sup>. One should agree with Druzik that classification of Free Zones is not just simple labelling and sorting by different bases.<sup>56</sup> Classification should include development, evolution and functioning of the Zones, as the latter are constantly modifying economic structures. This is the point to bear in mind discussing the functional classification, as such classification should account for the specialization and functions of Free Zones, which will accordingly depend on general aims and objectives, set by the host state for Zones to achieve.

As shown in this section, there exists a great variety of Free Zone classifications and neither practitioners nor academics agree on a uniform classification applicable worldwide. In the subsequent two sections by looking at different types of Free Zones likely to be established within the target region, the way of organization and functioning and by considering various types of classifications offered by other commentators, the author will suggest a general comprehensive classification of Free Zones and the specific classification, based on specialization and function.

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<sup>52</sup> n. 26, 16-17

<sup>53</sup> See F Trampus, *Free Ports of the World* (E.U.T., Italy 1999) 16-18

<sup>54</sup> A Kibritcioglu, 'Free Zones in Turkey and Their Macroeconomic Effects' (Seminar on "The Concepts and Instruments of the Economic Development in Turkey: A Model for Palestine?" October 26-30, 1995, Antalya, Turkey) <<http://ideas.repec.org/p/wpa/wuwpit/0301001.html>> accessed 28.08.2008

<sup>55</sup> See S Abramchuk, *State Regulation of Free Economic Zones in the Republic of Belarus*. (Publishing of S. Lavrov, Brest 2001)

<sup>56</sup> n 33, p. 34

### 1.2.2 Comprehensive Classification of Free Zones

All above mentioned types of classification, although not being totally complete, obviously do have their own logic. Analyzing various approaches a comprehensive classification of Free Zones is synthesised below. This classification does not only coherently combine, unite and modify different approaches suggested by the above commentators, but introduces a new basis for classification previously overseen by other researchers: time limit for which the special preferential doing business regime is guaranteed. No doubt, the attractiveness of the Zone for investors and its sustainability will depend on the term of Free Zone duration and this time factor should not be disregarded.

According to the suggested scheme, Free Zones could be classified, using the following basis: geographical location (in relation to the border of the host and other states), principle of organization, relations with national economy, ownership, importance in attainment of the host country's objectives, term of duration and, finally, specialization and functions with proper subdivisions. Each of the criteria is outlined below.

In terms of Free Zone's geographical location Zones located within the borders of the host State should be distinguished from those adjusted to the neighbouring states. In relation to borders of the country, one can name the Inner Free Zones, situated on the inner territory of the country, not in the proximity to its borders and Border Free Zones, located nearby the border, co-operating with neighbouring countries. As the Inner Zones are situated inside the country, they are usually quite independent not only from other Free Zones within the same jurisdiction, but also from the neighbouring states and their Free Zones.<sup>57</sup> Border Free Zones, attached to the borders, often integrate with neighbouring countries, establishing close ties with similar Zones on another side. Free Zone Terespol in Poland and Free Zone "Brest" in Belarus are examples of this. Both being located just across the border, they co-operate and have close economic ties.

For geographical location in relation to the border of other States, we can identify National or Regional Free Zones, situated on the territory of the host country, International Free Zones, uniting several neighbouring States and Transnational Free Zones, embracing different countries throughout the world. A good example of International Free Zone is Tumen River Area Development Program in Russia. This recently established Free Zone, initiated by the UNDP, unites border territories of Russian Federation, People's Republic of China and Democratic People's Republic of Korea, serving as a symbol of border co-operation of neighbouring countries for

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<sup>57</sup> For instance, Free Zone "Shannon" in Ireland

# COMPREHENSIVE CLASSIFICATION OF FREE ZONES

<b>Basis of classification:</b>	
<b>Regarding the national border of the host state</b>	Inner
	Border
<b>Regarding the border of other states:</b>	National or regional
	International
	Transnational
<b>Principle of organization:</b>	Territorial
	Extra-territorial
<b>Relations with national economy:</b>	Integrated
	Isolated
<b>Ownership:</b>	State
	Private
	Mixed
<b>Importance for the host country:</b>	National
	Local
<b>Term of creation:</b>	Unlimited
	Limited
<b>Specialization and Functions:</b>	Export
	Manufacture and Trade
	High Technology and Innovation
	Tourism and Recreation
	Service (Offshore)
	Mixed (Complex)

regional sustainable development. Trans-frontier co-operation is also well developed in Europe, where over 150 Trans-frontier European Zones were created recently after adoption of "European Framework Convention on Trans-frontier Cooperation."<sup>58</sup>

With Transnational Free Zones the case is more complicated, as some renowned Free Zone experts, such as Robert Haywood, do not recognize Transnational Zones. He argues, that common markets, like the EU, custom unions like MERCOSUR and Free Trade areas like NAFTA, as well as the proposed FTAA cannot be Free Zones by nature, as Free Zones are generally established within a single country (with few exceptions of cross border Zones), while it is Free Trade Areas, which are established between the different countries.<sup>59</sup> Thus the above mentioned examples of business environment would fall under the category of FTAs and not Free Zones.

Acknowledging Haywood's view, it is submitted that the concept of a Free Zone *per se* and the cumulative definition of a Free Zone offered above do not preclude a Free Zone to occupy a part (or whole) territory of several (not even necessarily neighboring) countries. The European Union or NAFTA could potentially be covered by the definition of a Free Zone, thus being classified as Transnational Free Zones. For the target jurisdictions, however, due to the nature of their economic development, creation of Transnational Zones is not very viable.

On the basis of the principle of organization, one can outline Territorial (local) and Extra-territorial Free Zones. Territorial Free Zones usually occupy quite a limited area within one region or territory, on which the preferential business regime covers selected or all enterprises (Enterprise Zone Salford/Trafford in Manchester, the UK). In Extraterritorial Zones the regime applies only to the specified and named entities regardless of their location (several companies in different regions of the country could be under same regime). An example of such zone could be Insurance Free Zone in New York, which covers only insurance businesses within a geographically limited territory.

According to the relations with national economy, one could distinguish Integrated and Isolated Free Zones. Integrated Zones are usually fully integrated into national economy by closely cooperating with national enterprises or consumers outside the Free Zone territory (Science Cities in Japan). Isolated Zones do not have significant integration into local economy, thus mostly encouraging export oriented activities. Such Zones, like International Offshore Financial Centres or Special Economic Zones in China, are primarily created for attracting foreign investors who are not permitted to interfere with national economy.

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<sup>58</sup> Adopted by the Council of Europe in Madrid, on May 21, 1980

<sup>59</sup> R Haywood *Free Zones in the Modern World* (Flagstaff Institute 2004) <<http://www.wepza.org>> accessed 28.08.2008

Classification by the ownership includes State Zones, which are owned by the government of the host State, Private Zones, owned by non-governmental institutions and private bodies, or Mixed Zones. In CIS the majority of Free Zones are governmental and are managed by the government or local administrations. The type of the property ownership in such Zones, however, is mixed: part of the property belongs to the State, but significant part can be owned by private investors (one of the usual conditions of an investments contract). Discussing the Birth of a Free Zone as a starting element for the Model in Chapter 6, special attention will be paid to issue of the Zone's ownership and whether another alternative could be offered.

Under the category of Mixed Multi-National Zones one should also include Free Zones established in a host country by other nationals. Rare examples of that could be Free Zones started up by Koreans in Russia, Singaporean Free Zone in China, or Japanese Free Zones in the Philippines. Such Zones emerge due to simple reasons, when, say, Koreans are trying to learn and understand how to do business in Russia. Mixed Multi-National Zone could be either Private or Mixed, but it is still always thoroughly controlled by the host State. Haywood notes an enormous growth in the Dual-National Free Zones around the world.<sup>60</sup>

Every jurisdiction by setting up a Free Zone is trying to achieve different and usually quite specific aims and goals. Using that criteria, the importance of a Free Zone for the host country's objectives, Free Zones involved nationally (achieving various national aims, from attracting foreign investments and boosting the economy to import of high-tech industries), and Free Zones, involved locally (regional) (aiming to reduce unemployment, revive depressed urban regions or help a particular field of economy) can be distinguished. Target goals and aims, given for the Zone to achieve, are being determined by the government. Sometimes, a complex combination of national and local goals is being set. The importance of this criterion for CIS has already been stipulated above.

The term of duration of the preferential doing business regime in a Free Zone matters a lot, as this is one of its defining points.<sup>61</sup> Depending on the legal regulation and specific plans of the host State, special preferential doing business regime within the Zone can be granted on a limited or unlimited basis.

Most of the European Free Zones publicize the planned term of duration. This could be something ranging from 10 years for Enterprise Zones in UK, 20 years for Tourism and Recreational Zones in Ukraine to 50 years for Free Economic Zones

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<sup>60</sup> R Haywood, *Overview of Globalization and the Impact of Free Zones* ( The Flagstaff Institute 2004)  
<<http://www.wepza.org>> accessed 28.08.2008

<sup>61</sup> See discussion in Chapter 1.1.2

“Minsk” and “Gomel-Raton” in Belarus.<sup>62</sup> Certain types of the Zones, like most of the International Offshore Financial Centres, do not state such a term, deeming to be “eternal.” But one has to remember that nothing is eternal and preferential regime could easily change with the change of political or economic situation within the country. The term of duration of a Free Zones is a very important basis to be considered in drafting the Sustainable Regulatory Free Zone Model.

Comprehensive classification discussed above is important for the target jurisdictions, as it provides a systematical structure of Free Zone typologies and each jurisdiction setting up a Zone would have a better idea where it fits in. With that in mind, the last classifying basis, specialization and functions of the Free Zones appears to be the most significant, as it systematises Free Zone under their main criterion. Importance of this classification has prompted its inclusion under a separate section.

### **1.2.3 Classification, Based on Specialization and Functions**

A general classification based on geographic location, ownership, principle of organization and the term of duration has been suggested above. None of this, however, reflects the functional types and specializations of Free Zones, which are outlined in a separate sub-classification below. This classification is of key relevance as it distinguishes the major functional (i.e. more practical rather than theoretical) features of each class of the Free Zones, which would be of use to CIS countries setting up the Zones. On that classifying basis, one can outline six functional types of the Zones: Export, Manufacture and Trade, High Technology and Innovation, Tourism and Recreation, Service, and Mixed Zones.

Export Zones—historically created at the sea ports (nowadays also airports). These are the territories usually dealing with entrance, storage, sorting, packing and transit of goods without any significant residential manufacturing activities. The distinguishing feature of such Zones is that in order to set them up, a host country does not require inputting big investments and is able to gain profits fairly soon. Incorporating in such Zones is also profitable for foreign importers due to low or zero customs duties and easy possibility to re-export the goods.

Free Zones under this category (which include various types, like Free Trade Zone, Custom/Duty Free Zone, Porto Franco, and Border Trade Zone) are mostly dealing with import/export and trade, but not manufacturing. This type of Zone is deemed to be the oldest, evolving from Phoenician city of Tyre and Greek Island of

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<sup>62</sup> ‘About Establishing FEZ Minsk and Gomel-Raton,’ Presidential Decree from 2.03.98 (*Decrees of the President of the Republic of Belarus and Decisions of Cabinet of Ministers of Belarus*, Legal Texts, Minsk 1998) 155



Delos in 300 BC. However, classical Export Zones, which are physically part of national territory, are considered to be beyond the country's border financially; thus integration of Export Zones into national economy is very low and 'pure Export Zones,' dealing only with exporting goods, did not gain extended popularity, often being transformed into Manufacture and Trade or Complex Zones.

Manufacture and Trade Zones are the most widely spread nowadays—over 700 around the globe.<sup>63</sup> These multifunctional export-oriented Zones combine the best features of Export Free Zones—beneficial regime of low or zero custom duties--and specialize on manufacturing low-cost products for export.

Creation of such Zones is profitable for the host countries. First of all, they provide additional inflow of money from exporting produced goods; second, they help to deal with economic and other problems by creating work places, establishing new and modernizing existing technologies. Manufacturers, registered in such Zones are mostly engaged in electronics and textile production, processing of light industries or assembly industries.<sup>64</sup> Examples of Manufacture and Trade Zones include, but not limited to Export Production Free Zone, Import Substitute Manufacturing, Economic and Technical Development Zones.

High Technology and Innovation Free Zones were emerging naturally and by transformation of Manufacturing Zones when high technology became a vital part of human life. These can be considered the newest types of Free Zones, widely spread around the world in 1970-80s. High Technology and Innovation Zones are usually located in economically developed countries with sufficient scientific and intellectual potential. Establishment of these Zones allows host countries to organize innovative high-tech manufacturing: computers, internet technologies, electronics, medicine, etc.

First Technological Park, the famous Silicon Valley, was established by Stanford University in the United States in 1950s and by the end of the century there were over 170 Scientific and Technological parks across the United States.<sup>65</sup> In Japan a vast amount of these Zones, also called "Science Cities," was created by the state in leading scientific and educational institutions. These Free Zone Models will be analyzed in the next chapter.

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<sup>63</sup> S Shuleiko, *Institutional Factors in the System of Foreign Investments of National Economy (Conceptual Analysis)*. (Gomel, Belarus 2001) 51, 52

<sup>64</sup> *ibid*, p.24

<sup>65</sup> *ibid*, 28

## CLASSIFICATION, BASED ON SPECIALIZATION AND FUNCTIONS

<b>Types of FZ:</b>	
<b>Export:</b>	Custom Free Zone
	Duty (Tax) Free Zone
	Porto Franco
	Transport
	Free Trade Zone
	Border Trade Zone
<b>Manufacture and Trade Zones:</b>	Export Oriented Production
	Import Substitute Manufacturing
	Zone of Economic and Technical Development
	Industrial
<b>High Technology and Innovation:</b>	Innovation Centers
	Business Incubators
	Techno Parks and High Tech Zone
	Scientific Parks
	Industry and Technology Research
<b>Tourism and Recreation:</b>	Medical Recreation
	Tourism and Vacations
	Complex and Mixed
<b>Service (offshore):</b>	Banking
	Insurance
	Transport
	Trusts
	Investments and Property Management
	Tax Havens
<b>Mixed (Complex)</b>	Special economic zones (Russia, China)
	Free Regime Territories (Brazil, Argentina)
	Free Economic Zones
	Free Entrepreneurship

In the countries of the European Union High Technology and Innovation Zones, started to appear in 1970s, even though at a smaller stage, than those at the USA or Japan. Article 157 EC Treaty states that the Community and the Member States shall *"encourage an environment favourable to initiative and to development of undertakings throughout the Community [as well as] fostering better exploitation of industrial potential of policies of innovation, research, and technological development."* European Union regards Technological Parks as an important tool equalizing the level of economic development of the new Member States with the existing ones by encouraging innovative technological development.

Among High Technology and Innovation Free Zones one could also place Business Incubators and Innovation Centres, Science Cities, Technological Parks and High Tech Zones, Industrial and Technological Research Zones. For instance, a Science Park (or a Science City in Japan) is usually established in or near well-known universities and research centres. Innovative and applicable research is generally the main role of such parks, as production (except occasional high technology products) is not normally organized there. Innovation Centres are working with entrepreneurs, helping them with high-risk new technologies, as Business Incubators are aimed at creation and development of new enterprises and small businesses.

Some researchers suggest uniting Innovation Centres, Tourism and Recreation Zones and Tax Havens under the category of Service Zones.<sup>66</sup> However, due to a rather distinct nature of the above Free Zones, it would be more appropriate to separate them into the different sub-groups. Tourism and Recreation Free Zones—is a specific type of the Zones, which can be mostly utilized in countries with favourable climate conditions and well-known historic heritage centres, thus attracting many tourists (Dubai). To that category one can add Free Medical Zones (Switzerland), Tourism and Recreation Zones, and even Free Gambling Centres (Nevada the US). Tourism and Recreation Free Zones can often in fact be Complex or Mixed.

Another important section for this research would be the Service Zones, in particular International Offshore Financial Centres.<sup>67</sup> It applies to Free Zones, which create preferential business and financial regime, together with certain fiscal conditions and banking secrecy, for non-resident companies, engaged in provision of different, mainly financial, services, and not engaging in local business or manufacturing. Among Service Zones in addition to classical Offshore Zones and Tax Havens one should include Free Banking Zones and Insurance Zones (both widely represented in the USA),

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<sup>66</sup> n 21, p.50

<sup>67</sup> Analyzed in more details in Chapter 3

Investments and Property Management Zones, Trust Zones. Service Zones are usually created by small (often island) countries with low level of natural resources and manufacturing possibilities, aiming to improve economic situation by offering a preferential financial regime for non-resident businesses. Such regimes have certain advantages and even though, in most of the countries of Eastern Europe very few Service Zones have been created, one could definitely (but carefully) borrow a lot from legal regulation of such regimes.

Last, but not least, comes Mixed and Complex Free Zones. Such Zones are created by introducing a preferential doing business regime on the whole or part of the territory of the region with combination of different features from two or more types of Free Zones. These Zones usually do not have narrow specialization, attracting businesses engaged in various activities, thus having a complicated structure and often a big size. Examples could include Special Economic Zones in China, Open Regions in People's Democratic Republic of Korea, or Free Zone "Manaus" in Brazil.

In this section the suggested classification, based on specialization and functions of Free Zones, has a schematic nature and non-fixed character, being flexible and subject to change. Certainly, it does not and cannot include all possible variations of names and types of the Zones as they are constantly changing.

Developing a sustainable Regulatory Free Zone Model this research is not trying to fit in any specific types, but to make the Model of general application. Comprehensive classification of the Zones, discussed above becomes very useful, as it categorizes all the major species of Free Zones within the target region, uniting them under the certain typologies in accordance with their most distinguishable features and helping the target jurisdictions to make an appropriate decision on the class and type of a Free Zone they want to set up.

### **1.3 Historical Development**

Continuing conceptual analysis of Free Zone as internationally accepted model of business organization this research focuses on the emergence and historical development of this phenomenon. The first forms of Free Zones have been established ages ago and some of the old types of Zones still survived to the present day; historical evolution of Free Zones is an important modelling factor to analyze, as this would outline some of the sustainable Zones' features, which could be incorporated or accounted for in the Model. Historical development of Free Zones discussed in this section is divided into two periods, 'ancient' and 'modern' history.

### 1.3.1 “Ancient” History

Free Zones have long lasting history. There is no unity among researchers regarding the first established Free Economic or Trade Zone. According to Byk,<sup>68</sup> the first ever mentioned Free Zone was on Delos Island in the Greek Sea. In 166 B.C. local administration freed the trade from taxes and customs formalities. This island, situated on East-West trading route, became one of the largest and richest trade centres at that time. Other researchers, such as Y. Druzik, argue for the leadership of Free Ports in the historic scale, naming Tunisian Port Karfagen of 814 B.C (which was fully destroyed by the Romans later on). Due to vagueness and extensiveness of Free Zone’s definition and lack of historic evidence, it will not be possible to positively name the first Free Zone ever established. But what is beyond doubt, is that Free Zones are as old as duties and customs within the fiscal system of a State, or even as international trade itself.

During the Middle Ages many European countries created Free Zones and Porto Franco. For example, Hamburg in Germany since 1189 was one of the main trading centres in Europe, as well as Italian Free Zones of Genoa and Venice, created in 1876. Some of the “old” Zones, like Copenhagen Free Zone, created in 1891, are still operational.<sup>69</sup>

Analyzing the historical development of Free Zones, various phases in that process are to be acknowledged. Once again, there is no unanimity among the researchers about the number and sequence of the phases. Some suggest starting the coverage of historical development of Free Zones with Ancient Times (B.C.),<sup>70</sup> others rather think of Industrialization Era (15<sup>th</sup> -19<sup>th</sup> centuries) as a starting point.<sup>71</sup>

To make things simple, this Thesis suggests dividing the general historical development of Free Zones into two periods: the “ancient” period, which would range from the time first Free Zones was established (whenever this was in B.C.) all the way to the mid of the 19<sup>th</sup> century, and “modern” period, from the mid of the 19<sup>th</sup> century to the present.

Apart from acknowledging the problems with determination, little time will be spend on describing the “ancient” period of Free Zones development, as for the purpose of modelling a sustainable Regulatory Free Zone, a more recent historical development in that field is of interest.

Just as a general note, the “Ancient” historical period is characterised by emergence of simple types of Free Zones, such as Free Towns, Porto Franco, Duty Free

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<sup>68</sup> n 21, p.10

<sup>69</sup> *ibid*, 9

<sup>70</sup> V Dergachev, *Geopolitics* (VIRA, Kiev 2000) 53

<sup>71</sup> n 33, p13

Zones, etc. The role of the Zones at those times was merely to promote trade between the countries and attract merchants by granting them various preferences and exemptions.

By the middle of 19<sup>th</sup> century many of the European Free Zones faced decline due to increasing state interference in economic regulation, imposing restrictions on the Zones. The surviving Zone types had to modify and adapt to fit the changing world and new Zone categories (like International Offshore Financial Centres, Technological and Industrial Parks, IT Zones, etc) appeared. Subsequent section will look at the phases of 'modern' period of Free Zones' historical development.

### **1.3.2 "Modern" History**

As noted above, the "modern" period of historical development of the Free Zones is of more interest for this research, as apart from revealing the actual changes Free Zones had to undertake in the past few centuries, it indicates the trends and tendencies for future modifications, which will be accounted for in establishing a Sustainable Regulatory Free Zone Model.

It is proposed to divide the "modern" history of Free Zone development into a number of sub-phases. The First Phase covers the age of the industrial revolution—from the second half of the 19<sup>th</sup> century to the beginning of the XX century. Prior to that, the most common type of Free Zones was Custom Free Zones, first established in the 17<sup>th</sup> and 18<sup>th</sup> centuries in the forms of Transit and Free Warehouses and Free Trade Zones. These simple structures were created by the host countries to promote trade and attract merchants, as well as to prepare goods for export.

During the first phase the simple Trade Zones began to undergo some changes. This was due to the industrial revolution, when technology started to grow and the implications appeared for the Economic Zones to shift from performing mere trade activities to combining free trade, storage, manufacturing and production. This is when some of the oldest currently operating European Free Economic Zones were established.<sup>72</sup> However, the process of transition, which eventually resulted in extensive emergence of vast types of Free Zones has only really started in the second phase and could not have been fully completed till the end of the third phase.

The Second Phase of development, timed between 1940s-1980s, is characterized by rapid continuation of the modification process of simple Free Zones, previously focused on trade, where goods were just stored and distributed duty-free into more complex Zones which dealt with export-oriented manufacturing, processing and

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<sup>72</sup> above mentioned Genoa, Venice and Copenhagen

entrepreneurship. In this stage the transformation of single-oriented Zones into the mixed and complex structures could not yet be completed, but the process was certainly under way.<sup>73</sup> Countries, setting up various Free Zones at that time, started to realize that single-oriented Zones, targeting just free trade or duty-free storage, would not be strong enough to compete in the changing world, so further modifications would have to be made.

A classic example of single-oriented Duty Free Zone, which was later modified into a complex Zone with special preferential regime for export production, is Industrial Free Zone in Shannon, Ireland, created in 1958. As spotted by some researchers, modern species of Free Zones have used the Irish "Shannon" as a prototype, following the successful example of Shannon International Airport Zone, which after the long-haul flights stopped using the Airport for re-fuelling and was transformed into a Free Trade Zone, inviting the foreign firms to set up manufacturing facilities in the area.<sup>74</sup> During the Second Phase the Special Zones, including the very first Tax Havens, also started to develop outside traditional Europe, namely the small island countries and the USA.

The Third Phase in 1980's is marked by a world-wide transition of single-oriented Free Zones into Complex Zones, combining various functions: trading, production, customs concessions and scientific research. This is the phase during which already existing Free Zones were transformed and modified into the complex structure to encompass various aspects of preferential regimes of doing business, from Free Trade in free ports to special Recreational and Service zones.<sup>75</sup> Most of the Free Zones established during this phase were already constrained to be the complex ones.

The third phase could also be characterized by a significant increase of the number of Free Zones worldwide, as economically developed and developing countries realized the role of complex Free Zones in attracting investments and reviving the economy. For instance, only in the USA alone, where in 1985 just 150 Free Zones were established, by 1995 there were registered more than 500 Zones and this number is still growing.<sup>76</sup>

Another specific feature of the 1980's is the intense development and growth of International Financial Centres—special types of Free Zones, concentrated on financial services and provision of tax incentives (namely Offshore Financial Centres and Tax

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<sup>73</sup> V Adrianov, 'Special Economic Zones in World Economics' (1997) 3 *Economics and manufacturing* 135.

<sup>74</sup> 'Economic and Social Effects of Multinational Enterprises in Export Processing Zones' (United Nations Centre on Transnational Corporations and International Labor Organization, Geneva 1998) 1 n 33, p.113

<sup>76</sup> R Zimenkov, 'Free Economic Zones: American Experience' (1998) 3 *Russian Economic Review* 78, 86

Havens). During this phase not only many new Centres were being established worldwide, but already existing traditional Tax Havens, previously offering just tax escapes, were then being transformed into International Offshore Finance Centres, providing the whole range of financial offshore activities, ranging from business consultancy and banking, to insurance and investment fund management.<sup>77</sup>

Some of the researchers<sup>78</sup> suggest outlining into a separate phase the emergence of narrowly specialized (IT Zones) and Scientific-Technical Zones, like Technological Parks or Science Cities. However, it is suggested that one should leave the latter remaining within the third phase, as 1980's was exactly the time when such Zones started to widely appear. Indeed, the creation of High Technology and Innovations Zones like Technological Parks, Business Incubators, and Science Cities was one of the distinguishing features of the third phase of Free Zone's development. Silicon Valley, although being established in 1950's, with the growth of computer and internet technologies by 1980's became the leading High-Tech Zone of the times. Science cities Tsukuba and Kansai in Japan were also developed within the above time scale.

The Fourth and still ongoing phase is the creation of International and Transnational Complex Zones. This stage differs from the first three, as during it in addition to the traditional territorial Free Economic Zones, which occupy just a small part of a country's territory, it prompted the emergence of global Zones, establishing a preferential business regime in a whole region and uniting the neighbouring countries.

The emergence of International Complex Free Zones is already very rapid in well-developed economies and is just starting to take place in the developing ones. Among economically developed regions, one could mention the European Union and North Atlantic Free Trade Zone in the USA. A good example for CIS is Common Free Trade Area of Belarus, Russia, Ukraine and Kazakhstan. A distinguishing feature of International Complex Zones is that using the principles of free economy, they unite neighbouring countries, offering the preferences to all residents.

The creation of International Zone within the territory does not necessarily mean the liquidation of traditional territorial Free Zones. Common Free Trade Area of Belarus, Russia, Ukraine and Kazakhstan do not require of participating countries to get rid of the territorial Free Zones. The same applies to the European Union, where no such restriction exists. However, concerning offshore jurisdictions within the International Zones, the situation is different. As discussed in Chapters 3 and 4, both the

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<sup>77</sup> R Johns, *Tax Havens and Offshore Finance: a Study of Transnational Economic Development* (Frances Pinter, London 1984) 20,21

<sup>78</sup> S Abramchuk, *State Regulation of Free Economic Zones in the Republic of Belarus* (Publishing of S. Lavrov, Brest2001) 31



EU and Eastern European States in transition are basically eliminating offshore-type Zones on their territories. This is explained (and to some extent justified) by the main difference between territorial Free Zones and Offshore Zones, as the latter offer mainly financial services and tax avoidance.

In future the development of International Complex Free Zones, uniting the neighbouring nations, could lead to elimination of classical territorial Free Economic Zones, because when the whole country is offering an attractive preferential doing business regime, there is no need to establish a territorial Zone within one country for the same purpose. However, this will only happen if participating countries manage to introduce the same attractive nationwide regime as provided for in Free Zones, which is not very likely, as it deprives the nations of traditional budgetary income, arising from taxes, duties and customs. This would be a brave experiment which many jurisdictions are not ready for: it is always easier to "sacrifice" a limited part of the territory by designating it to a Free Zone experiment.

Analysing the modern phase of historical development of Free Zones, one could distinguish several patterns. First, throughout the past few centuries, there was an obvious transition from single-oriented territorial Free Zones, concentrating mainly on free trade, merchant operations or export manufacturing, to complex Free Zones, offering preferential regime of doing business, which includes not only low taxation, custom free manufacturing, but also scientific and hi-tech activities, recreation and tourism. During that evolution, new types of Free Zones, like International Financial Centres, located in small jurisdictions, have emerged.

The second important pattern of development is the establishment of International Complex Free Zones, which unite the neighbouring nations. These global establishments aim to promote free trade, cut down customs and taxes, and introduce free movement of goods, capital, workers and services between the participating countries. In future this pattern could lead to establishment of global preferential doing business regime in a region of several countries, which could eliminate traditional territorial Free Zones. However, for this to happen, all spheres of economy should be equally liberalized in all participating countries, which is extremely difficult to achieve.

The phases of historical development, showing the transformation and modifications of Free Zones, come especially useful when one tries to analyse and predict the future of these unique economic structures. Certainly, the shift from single-oriented to complex Zones and a potential for emergence of new types of the Zones should be accounted in the Regulatory Free Zone Model, which, emphasising the future of the Zones, cannot disregard the past.

In summary, this chapter looked at a Free Zone as internationally accepted model of business organization, specifically focusing on essence, cumulative definition, classifications, typology and historical development of the Zones. Findings of the above research will provide a clear foundational basis for the subsequent discussion, as it allows understanding what exactly is a Free Zone, which functional types of it exist, why and how it is being introduced, and how has it been modified through time. All this knowledge helps in discussing the existing worldwide Free Zone Models and will further be utilized in developing a Sustainable Regulatory Free Zone Model for CIS.

To conclude this chapter, the author refers to Robert Haywood' Free Zone concept:

*"The Zone concept is so powerful, that more and more countries are recognizing a new paradigm of Free Zones. While the old Free Zones were often described as a static, labour-intensive, incentive driven, exploitive enclaves, the new Zone paradigm is a dynamic, investment-intensive management-driven, enabling, and integrated economic development tool."*<sup>79</sup>

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<sup>79</sup> R Haywood, *Free Zones in the Modern World* (Flagstaff Institute 2004) <<http://www.wepza.org>> accessed 28.08.2008

## **Chapter 2. Free Zone Models in the World Economies**

### **2.1 Developed Economies**

#### **2.1.1 Free Enterprise Zones in the United Kingdom**

#### **2.1.2 Science Cities in Japan**

### **2.2 Developing Economies: Export Processing Zone in Mauritius**

### **2.3 Planned Economies: Special Economic Zones in People's Republic of China**

### **2.4 Modelling a Sustainable Doing Business Regime**

According to different sources, currently there are over 5000 Free Zones worldwide, with about 1200 export oriented Free Zones and 500 Service (offshore) Zones.<sup>80</sup> Analysis of comprehensive data provided by different researchers shows that Free Zones were created in at least 120 countries,<sup>81</sup> but different types of Zones are customary for different types of economies.

Traditionally, industrially developed countries (such as the members of the European Union or the USA) tend to establish export-oriented Industrial Zones with diverse specialization; countries with rapidly developing economies (such as China, Korea, or United Arab Emirates) are more likely to set up Free Trading and Processing Zones; and developing countries of Africa and small island economies tend to introduce Export Processing Zones and Service Zones.<sup>82</sup>

After researching Free Zone as internationally accepted model of business environment and analyzing its essence, definition, classification, typologies, origin and historical development, this thesis will now consider different Free Zone Models, successfully operating worldwide.

This research does not aim to describe every possible species of existing Free Zones, but will analyze the specific typical Zone examples in developed, developing and planned economies. This will allow to identify major positive and negative elements in legal regulation of preferential business regime offered and see how this influences Free Zone's sustainability. The findings of this chapter will be modified and

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<sup>80</sup> see table 1 in V Byk, *Free Economic Zone "Gomel-Raton"—Strategy of Sustainable Development* (Gomel, Belarus 2003) 19,24

<sup>81</sup> R Haywood, 'Free Zones in the Modern World' (Speech on CFATF Meeting, Aruba, 18.10.2000. The Flagstaff Institute 2004) <<http://www.wepza.org>> 28.08.2008

<sup>82</sup> for more details see T Danko, Z Okrut, *Free Economic Zones in International Business* (Infra-M, Moscow 1998)

adapted to fit the conditions of a transitional economy, to be utilized in drafting the Regulatory Free Zone Model for CIS.

As a logical completion of this analysis in section 2.4 with the help of economy ranking provided by the World Bank in Doing Business Report on measuring business regulations,<sup>83</sup> the general elements affecting modelling a sustainable doing business regime will be discussed. These finding will later on become a basis for the Regulatory Free Zone Model.

While looking at the developed, developing and planned economies in this section and analyzing some of the relevant Free Zone Models, discussion of International Offshore Financial Centres as Free Zone Models is avoided, since this is analyzed in Chapter 3. It is appropriate to single out these into a separate chapter due to a very special degree of liberalization of regulatory doing business regime offered by the Tax Havens. Also in this Chapter development of Free Zones in CIS will not yet be discussed: this is to be analyzed under a separate heading, in Chapter 4.

## **2.1 Developed economies**

Focusing on developed economies, this research was to concentrate on the most economically advanced and prosperous world jurisdictions, such as the countries of the European Union, United States of America or Japan. Having long history of economic success, these countries have established a wide range of Free Zones. Even though, one could identify virtually any Zone type and model in the above jurisdictions, the most widespread and common there are Free Trade Zones, ranging from Custom and Duty Free Zones in the Continental Europe to Foreign Trade Zones in the United States.

Majority of the researchers agree that international establishment of Free Trade Zones started with the development of Free Zone “Shannon” in Ireland. Shannon, initially specialized in fuelling the long-haul flights aircrafts, which travelled from Europe to North America, faced a sharp decline when new types of planes, not needing midway re-fuelling, appeared. To save the Zone, the Irish Government in 1959 declared “Shannon” a Zone of Free Entrepreneurship and Export Manufacturing. The Zone, by offering considerable preferences and flexible fiscal escapes for the resident companies, attracted many local and foreign businesses, especially targeting the entrepreneurs engaged in developing and introducing innovative technologies. Now Shannon is one of the wealthiest and best regulated Free Trade Zones within the EU and following its success the Irish government established over 50 of other similar local Free Zones.

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<sup>83</sup> <http://www.doingbusiness.org/economyrankings> accessed 10.09.2008

As there already exists a vast amount of research on Free Zone “Shannon,” with some logical and comprehensive explanations of its success by various commentators,<sup>84</sup> this research, although noting the elements contributing to Shannon’s sustainability, will not be further describing the Zone here. Instead it will focus on other types of Free Zones, common to the developed economies, making a representative selection between the types and jurisdictions, namely focusing at Free Enterprise Zone (as in the United Kingdom) and a Science City (as in Japan).

Before proceeding any further, this thesis have to address one obvious question, which could be posed by some critical commentators: why looking at the developed economies, Free Zone Models established in the United States of America, one of the most prominent developed countries, are purposely avoided. Why does this research focus on the United Kingdom and Japan instead?

The explanation for this is rather practical. Indeed, choosing the appropriate jurisdictions and Free Zone Models to focus on was difficult. And no matter how much one wants to cover the widest possible scope of countries, the nature of this PhD research implies certain constraints.

United States is famously responsible for establishing many successful types of Free Zones, ranging from ‘the best State for Incorporation’—Delaware to Californian “Silicon Valley,” and its experience cannot be underestimated. But considering the amount of already existing academic writings and research on the American economic phenomenon, plus accounting for the huge scope and extent of this topic, itself amounting to a separate thesis, the decision has been made to limit this research by relating it as much as possible to European boundaries. Besides, most if not all, Free Zone Models established within the United States, are also present in Europe or nearby countries. By excluding the US experience current research is not ignoring those types of Free Zones, but merely analyzing their successful and unsuccessful elements, using the examples which can be the most relevant to CIS.

### **2.1.1 Free Enterprise Zones in the United Kingdom**

This section will look at Free Enterprise Zones as one of the successful examples of local and relatively small types of Free Zones, set up by the government to advance economically depressed regions throughout the country. Such Zones were established under the Urban Development Programme in the United Kingdom in 1980s.

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<sup>84</sup> see R Haywood, *Overview of Globalization and the Impact of Free Zones* (the Flagstaff Institute 2004). <<http://www.wepza.org>> accessed 28.08.2008

Urban Development Program in the UK started up in the second half of the 20<sup>th</sup> century with the creation of government-run corporations under the Local Government, Planning and Land Act 1980. The corporations were established to attract investments and further develop the infrastructure in certain small-scale territories within the country.

Among possible examples is a region of Docklands near Thames, successfully run by the London Docklands Development Corporation, management by which eventually resulted in construction of Docklands Light Railway. Another example is Liverpool Merseyside Development Corporation which was established to prepare the International Garden Festival in Liverpool. Private capital, mostly local, was successfully attracted to these territories in return for the promise by the government to sell after the Festival a part of the area for the companies (the rest of the territory was used for the city park).

A particular feature of the Urban Development Program was its short term of duration, as by the end of 1990's the Programme was practically complete and the Zones were de-designated. Considering logical sensitivity of investors to the duration of the Zone and its preferential regime, one has to underscore that sustainability of the Zone could directly depend on this. However, the UK experience shows that even relatively short term Free Zones could as well be attractive for investors, provided they offer comparative benefits and preferences for doing business. This also illustrates how establishment of a small short-term Special Free Zone within a city area can advance local communities and foster the development, since the results of this experiment are still at the service for local communities.

More interesting to this research is an experiment of Free Enterprise Zones, carried out by the UK Government from 1980 to 1995. In 1980s the Government created 26 Enterprise Zones within the UK. The purpose of the Zones was to test how far industrial and commercial activity could be encouraged by the removal of certain fiscal burdens and statutory or administrative controls. The government was especially interested to determine the extent to which the Zones would maintain and generate additional economic activity and increase employment in relatively small areas, also contributing to its physical regeneration.<sup>85</sup>

The sites for the Zones, carefully chosen throughout the country, constituted the areas with serious problems of economic and physical decay. Mostly well-populated centres were chosen: Salford/Trafford in Manchester, Dudley, Swansea, etc., where so-

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<sup>85</sup> PA Cambridge Economic Consultants 'An Evaluation of the Enterprise Zone Experiment' (Her Majesty's Stationery Office, London 1990) 4

called Inner Cities or Urban Zones were established. Few of the Zones, as an experiment, were set up outside the traditional urban centres, with some of those being easily accessible (Accessible Zones) and some being remote—Remote Zones, located away from major populated areas.

This Programme was also relatively short termed, designed for just 10 years, after which the Zones were de-designated. For evaluation of the experiment the government employed PA Cambridge Economic Consultants, who prepared 3 comprehensive reports—in 1987, 1990 and 1995. These reports outlined some of the successful elements in Zone management and regulation of the preferential regime, which could be relevant for the Regulatory Free Zone Model.

The first and main issue for us to look at is the actual extent of the preferential regime, offered by the government. The key features are summarised below:

1. Total exemption from local authority rates (except charges for water).
2. Capital allowances, which amounted to 100% for the year of expenditure against the income and corporation tax, and capital expenditure on industrial or commercial buildings.
3. Simplified planning regime. Some types of development deemed planning permission to be granted (i.e. there was no need to apply for such a permission at all), but this only applied to planning which was in line with the conditions of the initial scheme. For the rest of the activities, however, the planning permission procedure was also speeded up, which constituted a significant incentive for those businessmen, who wanted to build their own premises.
4. Speedier Administration. Zone authorities attempted to deal with planning and other decisions with minimum delay, often in 14 days. This was a very important preference, reducing overall bureaucracy. The same rules also applied to suppliers of gas, electricity and water within the Zone's territory.
5. Reduction in statistical requirements. Businesses within the Zone were excluded from most of the compulsory Governmental statistical requirements (except census of employment)
6. Customs facilities, making the criteria for private customs warehouses more relaxed. This preference, however, appeared to be not of the greatest importance to most of the residents, as Free Enterprise Zones by nature are not traditional Custom Free Zones, so activities through customs there were marginal.
7. Other preferences of minor importance: exemption from Development Land Tax (the tax was abolished in 1985) and Exemption from Industrial Training Board Levies

Analysing the above features of the preferential regime offered by Free Enterprise Zones and comparing it with the regimes guaranteed by some other researched types of Free Zones (such as International Finance Centres or Free Trade Zones), one may first have an impression that the preferences offered by the UK government were not tremendously important for the investors, being of rather narrow and moderate scope. However, considering that the United Kingdom is a low tax jurisdiction *per se* and has already a fairly attractive doing business regime, even small tax breaks and statutory preferences could make a difference in terms of attracting an investment.

An important distinguishing feature of Free Enterprise Zones is that they were mainly targeting national investors rather than the foreign ones and out of 2800 firms in all 23 Zones covered by the evaluation by 1986, only 14% of companies came from overseas.<sup>86</sup> This proves the idea that, when carefully modelled, even insignificant reduction in state regulation and some exemptions from rates could be a good incentive for domestic investors.

To assess the success of the experiment, Cambridge Economic Consultants conducted an extensive evaluation, questioning up to half of the enterprises registered in the Zones, trying to find out the strengths and the weaknesses of the offered preferential regime. The results of the research were summarized in the Final Evaluation of Enterprise Zones, published in 1995.<sup>87</sup> Some of the findings and outcomes of that evaluation are of particular interest.

First, reflecting on the general strengths of a governmental policy package as a whole,<sup>88</sup> a majority of companies noted the exemption from rates to be the most beneficial, as this was the one preference received by all firms. Certainly, a sustainable Free Zone should ensure uniformity of the regime's application to all residents within the same category.

The value of capital allowance, in contrast, served more as an incentive for property developers and investors in property, rather than mere tenants. For the latter it was, to some extent, illusory, as the exception from rates and capital allowances were effectively "compensated" by an increased rent in the successful Zones. This indicates a potential for abuse of the preferential regime by some property owners who tried to receive dual revenue by benefiting from the exemptions of the regime and overcharging the tenants, who are trying to get established within the Zone without purchasing the

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<sup>86</sup> PA Cambridge Economic Consultants, 'Second Interim Evaluation of Enterprise Zones' (Her Majesty's Stationery Office, London 1990)

<sup>87</sup> PA Cambridge Economic Consultants, 'Final Evaluation of Enterprise Zones' (Her Majesty's Stationery Office, London 1995)

<sup>88</sup> *n* 85, p.6



property. In that situation a better governmental regulation of property market within the Zone (such as increasing the incentives for tenants in contrast with property owners) might be desirable.

Second, the success of the experiment can also be judged by the number of companies registered in the Zones during the duration of the Programme. Throughout the ten years, more than 5000 companies have altogether been established (but only approximately 1500 of them being new businesses). Forty percent of companies questioned stated that provided the Zones were never designated, they would not have invested in that particular region (however, only 1% would consider locating the investments abroad).<sup>89</sup> Thus, it certainly looks like the Zones achieved their primary goal of mobilizing domestic investors within the designated small or local territories.

The report has also revealed that the major factors influencing the decision-making regarding the investment for new and existing companies varied significantly. The newly established businesses among the most important factors named location of the Free Enterprise Zone, availability (and the cost) of premises, an extent of the relief from business rates and actual availability of labour. Existing companies placed more emphasis on opportunities for future expansion, tax allowances and constraints at their previous locations.<sup>90</sup> These are the factors to consider while shaping the preferential business regime in a Free Zone: for the Zone to be sustainable, the state has to ensure that preferences are the most applicable and appealing for target businesses.

After analysing the specific benefits of the Free Enterprise Zones experiment in the UK and looking at the strong sides of the Zones, a number of relevant factors influencing a successful establishment and operation of a Free Zone can be synthesised. These factors have strong impact on the Zone's sustainability and should be accounted for in the development of the Regulatory Free Zone Model for CIS:

- Site selection (locational preferences): considering the outlined above problems with property management and price increases for tenants, this thesis suggests that public ownership of the land and premises located on it is desirable. First of all, this eliminates possible land reclamations and, secondly, the government can responsibly control the rent issues, and not deter more vulnerable small investors, who can not afford to buy the premises. Easy transport access, developed infrastructure and availability of highly skilled labour should also be regarded while selecting a site for a Free Zone.

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<sup>89</sup> *n* 86, 111-119

<sup>90</sup> *ibid*, pp.37-39

- The size of the Zone: usually a selected one large site is better than several fragmented sites—to maintain a clear identity of the Zone, fragmentation should be avoided. This would make life easier for the host state in terms of providing sufficient control and (or) management of the Zone and would clarify for the potential residents the boundaries of the regime's application. Availability of land is also important for possible future expansions.
- Specialization and sectoral focus of the Zone: the host state should have a clear idea of the Zone's specialization and types of welcomed investment projects, ensuring the best attainment of local goals and objectives.
- Management of the Zone: one coherent Free Zone managing body (most likely established/appointed by the government) is preferable to ensure maximum benefits to attract inward investments and to gain marketing advantages.
- The preferential regime: in the above example of Free Enterprise Zones, even though the rates relief was found to be the most important benefit in attracting investors, one cannot disregard the significance of the availability of enhanced capital allowances and the relaxed planning regime. Certainly, the specifics and extent of the preferential regime adopted could differ significantly according to types of the Zones and economic situation within the host state. However, it should still remain competitive, stable and investor-friendly, being coherent with overall economic development strategy for the area.
- Public relations and promotion: last, but probably not least, a Free Zone should be actively promoted and advertised nationally and internationally by the management.

One cannot avoid here mentioning the term of duration, which for the UK Free Enterprise Zones was relatively short—just 10 years. Sometimes investors may see limited term as a threat of instability and high potential for change, and often when the preferences are withdrawn, many companies would want to locate elsewhere.

However, termination of the Zones revealed that the majority of businesses had taken root and did not intend to leave after the Programme had ended. This is a strong argument in favour of short or limited-term Free Zones, which could be used by a host state as a trap (in the positive way), allowing attraction of businesses by offering appealing, but relatively short-term, preferences and hoping that after the regime is gone, the companies would not go. Such a tactic sustains as long as the potential investors are clearly informed before hand about the duration of the regime. But when the preferences are given for an unidentified period, and the government “suddenly” changes its mind (as it recently happened in Russia with most Offshore Centres), then

the problem of political and economic uncertainty and instability arise, having a negative impact on the sustainability of the Zone.

Summarising the UK experience under Free Enterprise Zones Programme, it is submitted here that the Zones have generally fulfilled their goals in attracting additional employment and boosting the economic activity, plus securing supply of new developed premises and locations. Investors were found to be among the main beneficiaries—and all companies registered in the Zones performed generally better.

Obviously, some of the features of the regime, implemented in these Zones were quite specific and not suitable for wider application within the target region. But it appears the UK has managed to find a balance between offering relatively modest preferences and still increasing the business activity within a limited geographical area. It should be remembered that Enterprise Zones were mostly targeting domestic investors, rather than foreign, so one has to be careful blindly applying this specific model in CIS. But some of its successful elements, outlined above, should definitely be taken into account.

On a final note one has to mention that Free Enterprise Zones, like the UK, have been created in other depressed urban regions in Europe and beyond. For instance, in the United States such Zones were set up in areas, where 70% of the population were receiving lower than average income per family, plus rocketing unemployment rates.

### **2.1.2 Science Cities in Japan**

For a better picture of the variety in typologies of the Free Zones found in the countries with developed economies this research will look at High Technology and Innovation Zones, the type of Free Zones rather distinct from Free Enterprise Zones analyzed above, especially in terms of objectives, structure and offered preferential regime.

High Technology and Innovation Free Zones, widely ranging in specialization from Innovation Centres and Business Incubators to Scientific or Technological Parks and IT Zones, are usually established as a result of mutual co-operation between business enterprises and leading research universities.<sup>91</sup> One of the first, best known and, probably, so far the most developed High Technology and Innovation Zone is Silicon Valley in California, which specializes in developing IT technology products and software.

However, this section will focus on High Technology and Innovation Zones of Japan, which recently became one of the world leading jurisdictions in developing and

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<sup>91</sup> Samuel Coleman, *Japanese Science: From the Inside* (Routledge, London 1999) 13

implementing IT Zones.<sup>92</sup> The Zones, called Techno polis or Science Cities, were established in Japan in accordance with the Techno Polis Program, developed by the government, which provided for the establishment of 20 Science and Technology Zones in depressed regions of the country.<sup>93</sup>

The idea of “Techno polis” (which encompassed the city and territory adjacent to it—hence the Zones are called “Science Cities”) provided for the close and complex collaboration between high-tech industries, scientific institutions and universities, ensuring involvement of local labour within the residential areas and providing for the development of modern industrial and social infrastructure.

Instead of engaging in detailed description of various Science Cities, this section will outline some successful elements of that type of a Free Zone and its preferential business regime, which could be utilized in constructing the Regulatory Free Zone Model for CIS. This will be done by looking at the experience of one of the oldest Japanese Science Cities, Tsukuba.

Tsukuba Science City, located 60 km northeast of Tokyo, was established in 1963 to promote science and technology and to become a centre of advanced research and higher education, as well as to resolve the excessive concentration of population and industry in Tokyo. Main requirements for the Zone’s establishment were: availability of the university in the town (with high innovative research potential), easy transport connections and well developed infrastructure.<sup>94</sup>

The government had to invest significantly to prepare the Zone for operation, but when in 1980 the construction of most of experimental and research facilities were finished, Tsukuba Science City started to rapidly develop. Currently the city unites over 300 national and private research institutions and businesses.<sup>95</sup>

What exactly is the formula of Japanese Science Cities’ success? A combination of elements can be identified:<sup>96</sup>

- Availability of suitable locations: being tremendously labour consuming, a Science City should be located within or very close to a major city of the country, so developed infrastructure and scientific bases, highly skilled labour

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<sup>92</sup> Akira Goto, et al *Innovation in Japan* (Oxford, Oxford University Press 1998) 19-21

<sup>93</sup> see James W. Dearing, *Growing a Science City* ( London, Routledge 1995)

<sup>94</sup> Odagiri, Hiroyuki and Goto, *Technology and Industrial Development in Japan: Building Capabilities by Learning, Innovation, and Public Policy*. (Oxford, Clarendon Press 1996) 43-50

<sup>95</sup> for more information at Tsukuba Science City see <<http://www.info-tsukuba.org/english/index.shtml>> accessed 28.08.2008

<sup>96</sup> see B Lambert, ‘Building Innovative Communities: Lessons from Japan’s Science City Projects’ (working Paper 107, European Institute of Japanese Studies 2002) <<http://web.hhs.se/eijswp/107.pdf>> accessed 28.08.2008

market and social networks can be readily at hand, and the government would not have to spend additional resources and time trying to develop all that.

- And still, one would expect the government to significantly invest in the initial stages of the project;
- Joint interest for collaboration by the government (local authorities), universities and private capital.<sup>97</sup> A combination of these is important, as success of the Science City would depend on effective research and innovative production, which is always very costly.
- Additional specific preferences to businesses and research institutions have to be provided for by the government. These can include lowered tax basis, simplified amortisation for high-tech companies, reimbursement of the construction costs by the State and sufficient governmental funding for the research.<sup>98</sup>

The mere evaluation of Technological and Scientific Parks as a type of Free Zone indicates that, unlike for the well developed and rich World economies, for CIS establishment of Science Cities might be difficult. This is mainly due to the limited resources available: it will not be always possible for a developing economy to create projects of a similar scale or nature as a Science City.<sup>99</sup>

However, it is not suggested that something like a Science City is never to come to life in CIS,<sup>100</sup> as the obvious advantages and potential of this Zone Model should not be underestimated. Many post-Soviet countries still have a significant amount of highly qualified programmers, scientists and other hi-tech specialists, who could definitely be useful in establishing IT Zones. But to make it successful, one has to account for the above discussed elements of High Technology and Innovation Zones, plus to accordingly account for the specific features of the target region.

Concluding, the above discussed Free Zone models established in the developed economies represent only a small portion of the actual range of Zones successfully operating in these countries.<sup>101</sup> Not having an opportunity to discuss them all, the most polar and distinct model has been chosen, revealing the diversity in Free Zone typology and showing how much various types of Free Zones can have in common.<sup>102</sup>

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<sup>97</sup> N Yashiro, 'Japan's New Special Zones for Regulatory Reform' (2005) *International Tax and Public Finance* Vol 12, #4, 561-574

<sup>98</sup> see H Shiga, 'Industrial Cluster Projects and Expeditions of Kansai Science City' (2007) *Japanese Society for Artificial Intelligence* Vol 22, #3, 411-414

<sup>99</sup> see Kunio Goto, at al, *The Science City in a Global Context* (Austin, TX: IC2 Institute, 1998)

<sup>100</sup> Interfax 'Silicon Valley' in Belarus could be established by investors' *Interfax*, (Minsk, 11.11.2004) <<http://www.charter97.org/bel/news/2004/11/11/dolina>> accessed 28.08.2008

<sup>101</sup> see S M Pekkanen, *Japan's Aggressive Legalism: Law and Foreign Trade Politics Beyond the WTO* (Stanford, California, Stanford University Press, 2008)

<sup>102</sup> Martin Fransman, *Visions of Innovations: The Firm and Japan* (Oxford, Oxford University Press 1999)

## 2.2 Developing economies: EPZ in Mauritius

In this section Export Processing Zone, one of the most typical species of Free Zones, widespread in the countries with developing economies and economies in transition will be analyzed. Mauritius was chosen as an EPZ to focus at as it has become a classic example of Free Zones of that species.

Free Zones started to emerge in the developing economies since 1960's. Initially, due to lack of resources, under-developed infrastructure and political instability, the number was relatively small, but by the end of the 20<sup>th</sup> century there was a growth of the Free Zones establishment in Asia, Africa and Latin America, which lead to the creation of a large number of Export Processing Zones.

According to the Director Emeritus of World Export Processing Zones Association Richard Bolin, Export Processing Zone has become a proven policy tool which government can and should use in all countries to ease the pain of delay, red tape, bureaucracy and lack of welcome and assistance inflicted on manufacturers trying to be involved in unfamiliar environment to produce for the global market.<sup>103</sup> Indeed, it was the EPZ, which brought many jurisdictions since 1950 (including Singapore, Korea, Taiwan, Hong Kong, Ireland, and Dubai (UAE)) out of poverty.

Some observers, however, note that, with the exception of Mauritius, Tunisia and Egypt, other EPZs established in Africa have achieved a very marginal impact, low FDI, failing to establish linkages with the domestic economy and having a very limited foreign exchange contribution.<sup>104</sup> Mauritius is one of the few successful examples of EPZ development in Africa, which justifies looking at the reasons of its success.

This discussion acknowledges and draws upon the work of Claude Baissac, an expert adviser in emerging markets for Africa, the Caribbean and the Middle East, who has conducted an extensive research on Africa's EPZs. Using the successful example of Mauritius, Baissac suggested some implications for Free Zone development in the whole of Africa, which is essential to note. Without deeply engaging into analysis of specific African regulations, this section looks at some of the criteria, contributing to successful operation of the abovementioned Export Processing Zone, which with proper modification could be used in establishing a Regulatory Free Zone Model for CIS.

Baissac suggested dividing EPZ formation in the developing economies into an "Asian" model and the "rest of the developing world" model, with the assertion that the

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<sup>103</sup> R L Bolin, *Why Export Processing Zones are Necessary* (the Flagstaff Institute 2004)  
<<http://www.wepza.org>> accessed 28.08.2008

<sup>104</sup> C Baissac, 'Look again at EPZ impact' (2004) 20 October *FDI Magazine*  
<[http://www.fdimagazine.com/news/fullstory.php/aid/854/Look\\_again\\_at\\_EPZ\\_impact.html](http://www.fdimagazine.com/news/fullstory.php/aid/854/Look_again_at_EPZ_impact.html)>  
accessed 28.08.2008

Asian Model, due to its specific regulation, has been more successful in promoting and development.<sup>105</sup> Understandably, EPZ Mauritius appears under the “Asian” model.

The Island of Mauritius, gaining independence in 1968, at the time of Export Processing Zone establishment in 1971, economically was entirely dependent on sugar export market. Legal regulation and operation regime of the Zone were so successful, that by 1985 the EPZ managed to overtake export of sugar as a prime source of export earnings and basically changed the productive sector of Mauritius economy.

There are still extensive debates among the researchers trying to explain the reasons for Mauritius’ success. Some suggested that this was solely due to Mauritius government’s adoption and effective implementation of IMF-backed stabilisation plans and World Bank-supported structural adjustment programs (which included the devaluation of Mauritian currency, wage restraints and liberalisation of the exchange rate).<sup>106</sup> Baissac, however, even though recognizing a huge role played in this process by the State, suggests a complex combination of elements, which made the Mauritius EPZ a success.<sup>107</sup> These are briefly summarised below.

First, it was the government, which initially created the Export Processing Zone by adopting export-orientation strategy as a keystone of national development policy. State officials, after analyzing the export-oriented policies in successful Free Zones of Hong Kong, Puerto Rico and Singapore, decided to embark on an entirely new form of manufacturing activity—the processing of raw materials into finished goods, dedicated mostly and specifically for export. Such policy instantly enhanced EPZ Mauritius export activities and allowed attraction and advancement of local labour in terms of new manufacturing technologies.

Second, the state officials managed to convince those initially opposing the project (sugar barons and the Communist Party) as to the usefulness of that risky idea thus providing for the necessary political and economic support.

Third, the government has also adopted the required legislative provisions, which, even though provided for the state ownership of EPZ, laid down the framework for EPZ development and adaptation over the years. This has resulted in introduction of the political institutions designed to coordinate and promote the Zone, such as the enhanced Ministry of Commerce and Industrial Coordination Unit which were both in charge of investment process within the Zone.

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<sup>105</sup> C Baissac, ‘Maximizing the Developmental Impact of EPZs: A Comparative Perspective in the African Context of Needed Accelerated Growth’ (2004) June vol. XXVIII, #1 *Journal of the Flagstaff Institute* 53-76

<sup>106</sup> H Grubel, ‘Free Trade Zones and Their Relation to GATT’ in R H Snape (eds) *Issues in World Trade Policy* (Macmillan Press, USA 1984) 143

<sup>107</sup> n 105, pp.66-72

Fourth, the government has granted a certain preferential business regime to EPZ residents, especially targeting local investors. Domestic firms received the right to invest into EPZ which limited the escape of capital abroad and enabled the private sector to enter the export market and effectively use it for domestic manufacturing of internationally competitive (and export-oriented) goods. Partnerships with foreign companies have also upgraded the competitive position of domestic firms by giving the latter required experience.

One has to agree with Baissac:<sup>108</sup> in addition to theoretical and practical help from international institutions, such as World Bank, OECD or IMF, a very important role in success of a Free Zone is played by the government. Political determination, readiness to push the barriers beyond traditional views and ability to involve all layers of the society are all contributing to the success.

But what exactly can be borrowed for the Regulatory Free Zone Model for CIS? Drawing on the successful experience of Export Processing Zones and a specific example of Mauritius, some relevant points can be further developed and analyzed:

1. First, instead of generating static benefits, such as employment and foreign exchange, a Free Zone policy should seek maximisation of dynamic benefits, including domestic investment and partnerships with foreign companies. As showed by the EPZ Mauritius example, attracting foreign investments and creating close ties with neighbouring countries helps not only to advance the economy, but also bring into the country innovative modes of business organization and modern technology. Besides, in long term future the dynamic benefits are likely to improve the static ones (for instance, capital inflow and new technologies will in due time create more workplaces, etc).
2. Second, the development of a Free Zone should be pragmatic and progressive, with limited use of state funds where possible. There is no doubt that to establish a successful Zone, the government might have to invest into its infrastructure. However, as mentioned above, rather than acquiring large scale property or territory, which requires further development (constructing new buildings, roads, etc.) one should limit the geographic territory of a Free Zone or choose an already developed area. This point was also stipulated by the Science Cities example: rather than setting an unreasonable regional development objective for a Free Zone, it should preferably be located in a developed urban sector—to attract best qualified labour and to use the existing infrastructure.

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<sup>108</sup> *ibid.*, 72



3. Third, alongside the government, the private sector should be involved in Free Zone development and, when possible, even management. To ensure this, the national legislation regulating business relationship and establishment in the Free Zone should be feasible in terms of the ownership, taxation, accounts and business development, not to mention a stable preferential regime. And the importance of close co-operation of all involved sectors ranging from the state officials to labour representatives cannot be emphasised enough.
4. Last, a necessary criterion for any Free Zone type is promotion of the Zone at home and abroad. To achieve that, once again, it is desirable to use not only the governmental promotion centres and the Free Zone officials, but also to utilize the private agencies.

Next section considers an example of a Free Zone Model from a planned economy.

## 2.3 Planned Economies: Special Economic Zones in People's Republic of China

Due to the specifics of this research considering a model of a Free Zone typical to a planned (Communist) economy cannot be avoided. China was chosen among the few remaining such economies as it is the only country where non-democratic or socialist governmental regime effectively co-exists with successful economic development. As CIS and many other Eastern European countries in transition used to be planned economies just years ago, they still share many common features with the Chinese regime. Thus, the elements of successful Free Zone organization in such a country as China should be accounted for in establishing the Regulatory Free Zone Model for CIS. This section considers the experience of Chinese Special Economic Zones.

Special Economic Zones (SEZ) in China are remarkably compared by Just Faaland, in 1985 the President of OECD Development Centre, to *[laboratories in which different doses of market economy planning was experimented upon and adapted in the socialist economy of the country]*.<sup>109</sup> They have been functioning for over 30 years, when first Free Zones were established in the end of 1970s as a result of Open Door Policy.

Now China has five SEZ, namely Shenzhen, Zhuhai, Shantou, Xiamen, and Province Hainan, which attract most of the foreign investments into the country. In addition to those there are 14 coastal cities, where various types of Free Zones are

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<sup>109</sup> M Osborne, *China's Special Economic Zones* (OECD Development Centre 1986) 9

introduced, ranging from classical Free Ports to Custom Free Zones and Free Trade Zones. Joining the list is a recently created special economic region of Pudun, next to Shanghai, where foreign investors (unlike in other Chinese Free Zones) are even allowed to establish financial organizations, supermarkets, organize stock markets and issue stocks. After 1991 the government also opened up some more border towns and administrative centres of intercontinental colonies for international business.

Researchers agree that the Chinese concept of 'Special Economic Zone' has undergone many changes. Started as a replica of Export Processing Zones in Taiwan and other developing countries, throughout the years, Free Zones in China had evolved from simple Export Oriented Zones to more sophisticated Special Economic Zones, encompassing a complex of activities and emphasising the Zones' socialist nature and comprehensive development.<sup>110</sup>

Most commentators note that the success of Chinese Special Economic Zones would not be possible without effective legal regulation distinct from other parts of the country. From the very start of SEZ experiment, Guangdong and Shenzhen Zones were the leaders in legislative innovation; however, by today the preferential regime is accordingly established in all SEZ and coastal cities.

This section does not analyse each of the SEZ individually. Instead, Shenzhen Special Economic Zone is taken as an example (being the fastest economically grown SEZ in China),<sup>111</sup> to identify the main features of legal regulation of SEZ's preferential regime, which contribute (or in some cases, prevent) to the success of this species of Free Zones in a planned economy.

When China started the SEZ experiment, the main problem in attracting foreign investors was legal regulation of that process. To gain investors' trust, the regulation of SEZ activities had to be more open and straightforward than any domestic law: it should deal successfully with issues like private property, individual rights, corporation rights, contract and patent law<sup>112</sup>—some fundamental fields, the rights in which have been tremendously restricted in China because of its Communist nature.

The liberalization of the regime for the Free Zones did not happen quickly, forced to undergo a long and painful process of re-determination and clearance. For instance, initially foreign investors did not have the freedom of contract in law, as contracts could only be altered or dissolved with the consent of the approval body, the

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<sup>110</sup> D K Y Chu, 'The Special Economic Zones and the Problem of Territorial Containment' in Y C Jao, C K Leung (eds), *China's Special Economic Zones* (Oxford University Press, Oxford 1986) 23

<sup>111</sup> C L P Kung, 'Foreign Direct Investment and the Development of Special Economic Zones in China: A Comparative Study of Shenzhen and Zhuhai, 1980-2000' (Thesis, University of Hong Kong 2004) <<http://library.hku.hk/record=b2979367>> accessed 28.08.2008, p.35

<sup>112</sup> n 109 p. 64

Municipal People's Government Agency of the Zone. The Agency had extensive competency in supervising contracts' performance, mediating disputes and imposing fines in appropriate circumstances. The particular problem was that these considerable powers were vaguely defined, as it was not clear whether and how the contract control organ could decide on breach of contract or on payment of fines, which gave rise to instability and abuse. Other imperfect provisions of national law, negatively regarded by investors, included obligation by a parent company to provide full guarantee for its subsidiary for contractual obligations of the latter, difficulties with accepting foreign law as a law of contract, inability to freely hire and dismiss employees.

It is no secret, that to achieve success with SEZ experiment, the Chinese Government had to work hard to bring legal regulation of investments and the preferential regime in Zones closer to internationally accepted standards (with certain limits imposed by planned economy). From 1994 to date, the regulations did improve tremendously with many foreign investor-related laws and procedures being simplified, which thus re-gained investors' trust, increased attractiveness of Special Economic Zones. Foreign capital started to flow in.<sup>113</sup>

So, once again, what exactly has contributed to the success of Chinese Special Economic Zones? Throughout this research a number of positive and negative features specific to this particular type of Free Zones is grouped together. The positive elements are well connected with the successful state regulation of preferential business regime and other investment-related activities. Some negative elements could be explained by the restrictions imposed by a planned economy. The positive elements are analyzed first. These include the following.

1. Clear political governmental will. To establish SEZ the Government had not only to gain investors' trust, but also to overcome the Communist ideology, widespread in the country. This included the necessity to introduce a special preferential regime of doing business (discussed below) and liberal national legislation. Chinese SEZ were exempt from the governmental plan of resource distribution, enjoying priority access to raw materials, development works and foreign exchange. Plus, the state managed to reduce the regulatory barriers, making the legislation in SEZ much milder than nationwide.

2. Careful planning and administration: Chinese government showed a thorough approach towards SEZ establishment. From the very beginning the Zones were planned to be separate administrative and political territories. A special office was created in the Central Government, which dealt with arising problems locally and effectively lobbying

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<sup>113</sup> *ibid*, p.40

for the required legislation centrally. For each Zone, SEZ Development Company was created, which was a planning and development enterprise, as well a negotiations bureau for the foreign and Chinese investors coming to the SEZ. The Development Company was given extensive competence, from real estate development to provision of Chinese partners for foreign joint ventures.<sup>114</sup> Appropriate planning plays a huge role in SEZ success: the Zones should not appear spontaneously, but in accordance with the specially developed, viable and transparent scheme.

3. Complex orientation of the Zones. SEZ in China departed from being merely export-oriented and shifted to multi-purpose Zones, to include agricultural activities and services (such as tourism) as well as some non-industrial activities.

4. Selectivity of investment projects. The government would not welcome all investment projects offered for the Zones, but carefully choose the ones most relevant to local goals and objectives. The projects where technology transfer or manufacturing of new export products was involved are given preference. This secured not only modernization of the technology and know-how transfer, but also manufacturing of export substituting products. The scale of the investments was also decisive in the selection process, as aiming to attract sufficient funds, the government was only approving large scale projects—in the range from 5 to 50 million USD

5. Location of SEZ. Most of Chinese SEZs initially were located in demarcated areas outside existing urban centres. This permitted the concentrated development of new joint-venture-type industrial and research projects and allowed easy expansion of initially small scale Zones. However, the government had to invest a lot into infrastructure, which can be seen as both a positive and a negative element.

6. Governmental investments into infrastructure. Over 80% of investments into housing, offices, roads and other infrastructure prior to SEZ start up were covered by the government, so everything was ready when investors came.

7. Preferential regime in SEZ. The Zones were offering a preferential doing business regime, significantly different from the national one in China. Even though the regime might not be considered the most liberal, in addition to other comparative advantages and objective factors, it was still appealing for the investors. The range of preferences included tax free import on all required materials and machinery, exemption from export duties, tax holiday 3 to 5 years, fixed tax on profits after that—only 15%, simplified entry-exit procedures, concessions in land use fee, low cost labour.<sup>115</sup>

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<sup>114</sup> *n* 109, pp. 98-100

<sup>115</sup> information available <<http://www.szinvest.gov.cn/info/faq.htm>> accessed 19.09.2008

8. Other objective advantages. Attractiveness of Chinese SEZ was also supported by favourable geographic location (sea access, border location), natural resources and climate, as well as the potential possibility to go inside the huge local market of China after the liberalization of the economy.

The above discussed positive elements of Chinese SEZ are of rather general nature and thus can be considered by CIS establishing Free Zones. However, the analysis would not be complete without acknowledging the generally negative elements of SEZ regulation in China, which include the following.

1. Communist ideology, which is still reflected in every sphere of SEZ regulation, from contracts and property rights to technology transfer and workers' layoff. Even though many updates have changed SEZ regulation in a positive way, bringing it closer to market economy, the country in general is still a long way from it. Communist ideology and the planned economy were really the main reasons of general lack of openness of the country's economy to foreign capital, resulting in many unnecessary administrative barriers and draw-backs in SEZ regulation. All this has a negative impact on investor protection and spoil the image of the Zones.

2. Additional burdens on the investors. These included requirement to hire Chinese managers and other labour, equal pay for foreign contractors and Chinese lower-skilled workers, provisions on transfer of technology and know-how.<sup>116</sup> All these extra requirements in addition to inability to freely manage the established companies resulted in serious limitations for the investors. Some of the rules were too strict. For instance, Shenzhen provisional Technology Regulations indicated a long list of documents, data and equipment, which must have been provided by foreign investors in securing know-how transfer. Plus, the supplier was fully responsible for training the Chinese staff ensuring the recipients mastered the entire technology. The technology transferred had to be effective and capable of producing competitive products for international market, making the foreign supplier liable for all losses. In recent years, however, some of the restricting provisions were relaxed.

3. Extensive powers and competences of SEZ Administration. This can be compared with the "state within the state" concept, when SEZ Administration is authorised to carry out most of the governmental functions on the territory, such as formulating SEZ development plans and implementing it; examining and approving investment projects; handling industrial and commercial registration and land allotment; coordinating working relations among banking, insurance, taxation, customs, frontier inspections and other SEZ organizations; providing staff and workers needed by SEZ

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<sup>116</sup> n 109, p.66

enterprises (thus, enterprises did not have authority over their own labour force); establishing educational, cultural, and health facilities, plus public welfare and maintaining public order.<sup>117</sup> The rest of the national legislation to a certain extent still applied on the SEZ territory, however the Administration was granted the powers to implement the special provisions needed.

4. Governmental investments into infrastructure. As mentioned above, since most of Special Economic Zones were established in rural areas, the state had to invest significant funds in the infrastructure, which resulted in gross state expenditures and the ultimate need to recover this from investors.

Comparing and analysing positive and negative elements in SEZ regulation in China, one has to note that even considering the serious downsides of the communist ideology in a planned economy (which in addition to over-regulation of the preferential business regime by the State laid down additional burden on foreign and domestic investors) the positive elements of Chinese model of SEZ are explicit. These can be verified by constant growth of SEZ and inflow of foreign investments into the country.

Some of the recent Chinese commentators argue that Foreign Direct Investments is not the main determinant of economic success of Chinese SEZ, but governmental support and domestic investments are.<sup>118</sup> Noting this view one has to specify that FDI, indeed, was initially influenced by governmental support. However, such a support alone would not be sufficient and in addition to the preferential business regime, the investors should be granted other economic and personal freedoms.

As a final outcome of this section, a schematic illustration, the Formula of Success for Chinese Special Economic Zone is offered below.

**SUCCESS OF CHINESE SEZ is:**

**(Effective planning, Political will and Governmental support**

**+ (plus)**

**Complex orientation and Scale of the projects**

**+ (plus)**

**Location and other Objective factors)**

**x (multiplied by)**

**Decentralization and carefully selected Preferential Business Regime**

**- (minus)**

**Over-regulation and unnecessary Restrictions**

**= (equals)**

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**Inflow of Foreign Investments and Success of Free Zone Project**

<sup>117</sup> K Herbst, 'The Regulatory Framework for Foreign Investment in the Special Economic Zones' in Y C Jao, C K Leung (eds), *China's Special Economic Zones* (Oxford University Press, Oxford 1986) 125

<sup>118</sup> n 111, p.36

## 2.4 Modelling a sustainable doing business regime

Above in this Chapter successful examples of existing Free Zone models, taken from the developed, developing and planned economies have been discussed. Further and more detailed analysis of International Offshore Financial Centre as a Free Zone Model follows in Chapter 3. And Chapter 4 focuses on the development of Free Zones in CIS, as this is the actual target area for the application of the Regulatory Free Zone Model, proposed in Chapter 6.

However, up to now this research, while looking at various elements influencing the success of Free Zone models, avoided any conceptual analysis of the preferential business regime, even though it is the legal regulation of the business conditions within the Zone that serves as a decisive factor for the investors.<sup>119</sup> Remediating this the next section focuses on modelling a sustainable doing business regime and analyzing its key elements.

Detailed statistics on business regulations in global jurisdictions are provided by the World Bank Group in the Doing Business Database.<sup>120</sup> Every year World Bank experts collect a wide range of information about particular features of doing business in 181 countries. The data is then schematically arranged and the indicators are comparable across the economies.

These statistics provide valuable information on regulatory regime and its reforms in various jurisdictions, allowing comparison across economies in terms of attractiveness of the doing business regime and highlighting the good practices among the states. Information in the Database provides for the general costs and complications in doing business and can be used to analyze specific regulations that enhance or constrain investment, productivity, and growth of the economies.<sup>121</sup>

In modelling a sustainable doing business regime special attention should be paid to the effect of regulatory competition between the States<sup>122</sup> and it is the above statistics which allow investors to appreciate competitiveness of the chosen regimes and to make a responsible choice where to invest. In making such a decision, a potential

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<sup>119</sup> S Abramchuk, *State Regulation of Free Economic Zones in the Republic of Belarus* (Publishing of S. Lavrov, Brest 2001) 18

<sup>120</sup> For objective measures of business regulations and their enforcement across 181 economies see <[www.doingbusiness.org](http://www.doingbusiness.org)> accessed 28.08.2008

<sup>121</sup> full text at <[http://www.doingbusiness.org/documents/Doing\\_Business\\_2007\\_Country\\_pages.pdf](http://www.doingbusiness.org/documents/Doing_Business_2007_Country_pages.pdf)> accessed 28.08.2008

<sup>122</sup> J Trachtman, 'International Regulatory Competition, Externalization, and Jurisdiction' (1993) 47 *Harvard International Law Journal* 464

investor should consider the following factors describing ease of doing business and structuring a preferential business regime:<sup>123</sup>

- how difficult and expensive is it to start up a company within the Zone;
- how strict is the State and administrative regulation of business activities (i.e. dealing with licences and property registration);
- what is the level of taxes;
- how efficient is an overall business regime (being assessed by looking at how easy it is to enforce a contract under domestic law);
- how easy, fast and efficient is it to wind up (terminate) a business, in case investors want to relocate.
- and finally, what is the level of overall investor protection (from change or termination of the preferential regime, State reclamations or other potential detriments).

On next page a chart with the most recent data from the Report describing the above indicators is introduced. For the best comparison and analysis the following groups of countries relevant to present research are included:

- Some CIS and Eastern European Countries with economies in transition (Belarus, Russia, Ukraine and as a comparasment for the region, Poland),
- United Kingdom and Ireland as representatives of Western Europe,
- USA and Japan as some of the most developed countries,
- China (planned economy) to be compared with the special regime in Singapore,
- and, finally, Switzerland, as an example of an attractive European low tax jurisdiction.

Research of this topic took several years, and the statistics supplied by the World Bank have been amended annually. Even though, for comparative analysis it was interesting to see how the ranking changed among the above jurisdictions throughout the years, this is not discussed in this section due to space limitation. The compiled chart below provides only the latest ranking information for the current year. This is highlighted in bold under the respectful Rank 2009 lines. Note, that this data is a simple ranking, placing the assessed countries between numbers 1 and 181. Such rank is indicative, but it does not necessarily illustrates the point well.

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<sup>123</sup> O Chmir, *Special (Free) Economic Zones and Territories of Prioritized Development (Scientific and Methodical Aspects)* (Shidnii vydavnychiy dim, Ukraine 2001) 112, 114



# EASE OF DOING BUSINESS 2009 IN EASTERN AND WESTERN EUROPE<sup>1</sup>

		Belarus	Russia	Ukraine	Poland	UK	Ireland	Switzerland	USA	Japan	Singapore	China
Doing business	Rank 2009	85	120	145	76	6	7	21	3	12	1	4
	Rank 2009	97	65	128	145	8	5	52	6	64	10	15
	Number of procedures	16	7	10	10	6	4	6	5	8	6	13
	Number of days	69	28	33	31	18	19	20	5	23	6	35
Starting a business	Number of procedures	18	22	18	25	19	10	15	18	11	8	29
	Number of days	354	531	242	322	115	181	152	69	96	129	367
	Rank 2009	14	49	140	84	22	82	13	12	51	16	74
	Number of procedures	7	6	10	6	2	5	4	4	6	3	3
Licensing	Number of days	231	52	93	197	21	38	14	12	14	9	32
	Rank 2009	181	134	180	142	16	6	19	46	112	5	3
	Payments per year	125	23	98	43	7	8	13	10	15	16	44
	Rank 2009	14	18	49	68	24	39	32	6	21	14	1
Enforcing contracts	Number of procedures	28	31	28	41	19	18	22	6	20	29	31
	Number of days	225	178	183	980	229	217	215	300	242	120	292
	Rank 2009	71	89	143	82	6	9	36	15		2	1
	Time in years	5.8	3.8	2.9	3.0	1.0	0.4	3.0	1.5	0.6	0.8	2.4
Closing a business	Rank 2009	104	88	142	38	9	5	164	5	12	2	3
Protecting investors	Rank 2009											

<sup>1</sup> Rank for 2009 (the most up to date version, in bold) taken from <http://www.doingbusiness.org/economyrankings/> [accessed 23.09.2008]. The rest of the statistics (current on 09.2006. No separate statistics under this categories available after that) taken from [http://www.doingbusiness.org/documents/Doing\\_Business\\_2007\\_Country\\_pages.pdf](http://www.doingbusiness.org/documents/Doing_Business_2007_Country_pages.pdf) 15.11.2006

That is why it is decided to include some other, slightly outdated, but still very informative statistics, such as the number of procedures or days it generally takes to start up a business, obtain a licence or enforce a contract, or the number of tax payments per year or the amount of years it takes to close a business. This information (which is not in bold print on the graph) is correct as of the year 2006, since after that the

World Bank has not provided the relevant data. So, using the preceding graph and comparing the statistics for these countries (having in mind the current political and economic situation as well as the regulatory barriers for business operation) this section will discuss the key compositional features of a preferential regime which play a key role in sustainability of the proposed Free Zone Model.

## **1. Overall Doing Business Rank for 2009**

The ease of doing business index ranks economies from 1 to 181. For each economy the index was calculated as the ranking on each of the topics covered in “Doing Business 2009” report of the World Bank. Thus, this rank is a comprehensive indication to the investors of the ease of starting up and conducting a business within any particular economy. The higher the ranking is, the better are the conditions for business.

It is submitted that the ease of doing business index is not to be utilized as direct investment advice as it is of rather limited scope. The drafters of the report noted<sup>124</sup> that the index does not account for an economy’s proximity to large markets, the quality of its infrastructure services, macroeconomic conditions or the strength of underlying institutions. However, the Doing Business indicators provide the necessary imperial data, which may improve the investors’ understanding of these issues and overall influence their choice of an investment jurisdiction.

From the chart one can note that the well developed world jurisdictions, which have already introduced an appealing doing business regime (Singapore, US, UK, Ireland, etc.) are ranked sufficiently higher than CIS and Eastern European States in transition. This indicates to the target jurisdictions that to be competitive in investment attraction they need to improve performance in all of the categories discussed below.

## **2. Starting a business**

Legal regulation of starting up a business is a key initial factor, affecting the choice of a jurisdiction by an investor.<sup>125</sup> To remain attractive, a jurisdiction should ensure that this process is run as fast and smooth as possible. Statistical data on this

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<sup>124</sup> <<http://www.doingbusiness.org/documents/DB09Easeofdoingbusinessrankmethod.pdf>> accessed 23.09.2008

<sup>125</sup> S Shuleiko, *Institutional Factors in the System of Foreign Investments of National Economy (Conceptual Analysis)* (Gomel, Belarus 2001) 43

indicator relates to procedures, time, cost and paid-in minimum capital required to open a new business in a selected jurisdiction, plus the number of procedures and days it takes to complete.

Noting the ranking, the general tendency is still preserved here: more advanced economies are ranked higher than the developing ones. The only two surprises are Switzerland and Japan, both ranked relatively low, perhaps, due to high regulatory barriers and thorough checks of the investors.

More interesting is to look at the number of procedures and days it takes to complete. There is no direct subordinate relationship between these two variables. Thus, 4 procedures for business start up in Ireland could take 19 working days to complete, but 5 procedures in the United States would only take 5. This observation indicates that when it comes to starting up a business, a large number of moves, required by an investor to incorporate his company can be effectively mitigated by the fast and smooth procedure, guaranteed by the state. And vice versa, a small number of the procedures could take up a significant amount of time provided the decision-making system is not efficient enough.

Among the researched jurisdictions in relation to the time necessary to start up a business, the obvious leaders are the USA and Singapore, where it takes less than a week. Among the selected Eastern European Countries with economies in transition, surprisingly, the Russian Federation is the leading country with only 7 procedures and 28 days required to start up a business. These statistics have even outrun Poland, which is now a member of the European Union and supposed to be having quite an attractive business regime—but its ranking is the worst. And, unsurprisingly, the most complicated procedure exists in Belarus, where the term for business registration is more than 2 months with 16 procedures to comply.

As the jurisdictions, traditionally providing for a more attractive regime of doing business have the smoothest procedure of starting up a business, any CIS country establishing Free Zones should attempt to attain at least the above mentioned standard. Improving timings could be done by either simplifying the registration procedure and reducing the number of documents to supply, or by introducing the principle of a 'single window,' when only one institution is in charge of dealing with registration of residents, co-operating and sharing the documentation with all other interested or affected institutions and taking the burden off the investors.

### 3. Dealing with licences

Updated ranking for this category is no longer provided by the World Bank, so the table relies on the 2006 statistics. What notable is that both the number of required days and procedures for obtaining necessary licences is ten or more times higher than the time to start up a business. This difference exists not only among the developing jurisdictions, but also among the developed ones. One could see it as a serious detriment in terms of attractiveness of the regime, as the investor might be ready to wait for a month or so to register his business, but will hardly consider waiting for the year and a half to obtain all the required licences and permissions from the state.<sup>126</sup>

To be fair, one has to admit that licensing is a long and costly process for the developed economies too. In traditionally popular investment countries, like the USA and Japan, it takes 69 and 96 days respectfully, and even in the UK and Ireland the situation does not look very optimistic (115 days and 181 days). But still, when it comes to Eastern European Countries with economies in transition (where Ukraine is a happy leader, with 'only' 242 days for obtaining the licences) such long and often unreasonable waiting time is nullifying all other potential advantages of the preferential business regime offered by a Free Zone. Again, the link between the number of procedures and number of days is not direct, when to get through 25 procedures in Poland takes up to 322 days and only 22 procedures in Russia could take up to 531 days.

Reducing the time spent on licensing is something the countries should pay due attention to while establishing a Free Zone, as a successfully operating preferential business regime is clearly not compatible with such extended time. This could be effectively improved by either reducing the actual number of activities requiring a licence within a Free Zone (selectively liberalizing the regime, expanding the number of activities, where licence is not required) or simplifying and smoothing the procedure of obtaining the licence.

Extensive use of this preference could bring certain risks of lesser state control, however, even the simplified licensing procedure would ensure that the government is fully in charge of the business activities within the Zone.

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<sup>126</sup> A Shekhovtsev, M Shestakova, A Gromov, 'Free Economic Zones: World Experience and Perspectives in Russia' (2000) 10 *Economic Issues* 105

#### **4. Registration of property**

Similar to licensing, ranking here reveals the above discussed tendency when more prosperous countries are ranked higher. The number of procedures and duration between the developed countries and countries in transition also differ significantly. Property registration could take between 9 days (Singapore) and 39 days (Ireland) in well developed countries, and in the developing the number of days could reach up to 231 (Belarus). Seemingly out of range here among the developed countries are Japan, China and Ireland, where procedures, time and cost to transfer commercial real estate (as well as to obtain construction permits, inspections and utility connections) are higher than in other alike states.

Comparing the time necessary to register the property in the developed countries with the category of starting a business, one would find that the number of procedures and days in both categories is similar (ranging between 4 and 8) and the duration of the procedures is up to a month. But this similarity is not mirrored in the countries with transitional economies, as it takes up to 3 times longer to register the property than to start up a business (look at the notorious example of Poland: 31 days for business start up compared to 197 days for property registration).

This discrepancy alone can give reasons to conclude that Eastern European countries in transition face significant state over-regulation of business, when even it could be fast and easy to get established in the above countries, the actual starting point of business operation could well be delayed.

Another non-related, but interesting observation is the difference in number of days for property registration between a country with planned economy (China) and a Free Economic Region within this country (Singapore). Both have only 3 procedures required for property registration. But in China registration takes up to 32 days, and in Singapore—only 9. This example once more illustrates the direct relationship between reducing the time spent on bureaucratic procedures in a Free Zone with general attractiveness and thus the sustainability of the regime.

## 5. Paying taxes

Low taxation is traditionally one of the key features of any preferential business regime in a Free Zone. Indeed, to attract investors, the government setting up a Free Zone should ensure that it does not only secure the effective tax exemptions and preferences, but also provides for an easy to use and understand system of paying the tax.<sup>127</sup>

In analysing the data provided by the World Bank Group, this category focused on the Taxation Rank allocated to each country, which comprised the number of tax payments required, time to prepare and file tax returns and to pay taxes, as well as total tax as a share of profit before all taxes borne.<sup>128</sup> Taxation rank is convenient for this analysis, as it is not merely a comparative indicator in terms of taxation level in the selected jurisdictions, but it also shows the extent to which the system of tax payment is effective and investor-friendly.

As above, there is definite difference between the developed countries and CIS (with only exception of Japan, ranked at 112). Important to note that the paying taxes rank, attributed by the World Bank, does not necessarily depend on the number of payments required by a jurisdiction per year.

As an illustration of the above: Ireland, Switzerland, Singapore and the UK, are ranked at the top by the World Bank (between 3 and 16) and also have a very reasonable number of tax payments per year (between 7 and 16). USA and Japan, even though having low amounts of tax payments (10 and 15 respectfully) are ranked as 46 and 112.

This makes it possible to suggest that there is no direct relationship between the number of tax payments and overall tax burden in the State, thus these categories should be accounted for separately. However, there is still a direct link between tax level and overall attractiveness of the preferential regime. Considering CIS jurisdictions, the highest rank is allocated to Russia and the lowest is shared by Belarus and Ukraine.

The need to reduce the overall tax burden and introduce special tax incentives in a Free Zone have been previously stipulated and requires no further explanation. The paying taxes rank indicator is self-evident: the lower the country is ranked, the less attractive for investors it is (provided all other conditions are equal, which by itself is hardly possible to achieve). What is worth noting is the number of tax payments per year, as this reveals over-regulation of business regime in general and of taxation in

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<sup>127</sup> M Stewart, 'Global Trajectories on Tax Reform: The Discourse of Tax Reform in Developing and Transition Countries' (2003) 44 *Harvard International Law Journal* 139, 151

<sup>128</sup> <<http://www.doingbusiness.org/documents/DB09Easeofdoingbusinessrankmethod.pdf>> accessed 23.09.2008

particular. Also it speaks for the level of bureaucracy, which is always a detriment to investors as it is time and resources consuming.

In terms of tax payments per year, an infamous leader is Belarus (125), followed by Ukraine (98), China (44) and Poland (43). Comparing the number of tax payments in transitional countries with world leading economies (only 7 for the UK), the difference is striking. It maybe that the countries in transition have more liquidity problems and become more desperate for frequent payments. But any investor will think twice whether to invest into a jurisdiction, where just to pay taxes in a given year one needs performing at least 125 operations.

The simplicity of the tax payment system is crucial, as it speaks for the attractiveness of investment regime. A good way to reduce the number of payments is to minimize the overall tax burden in a Free Zone (only possible to a certain extent). In doing this the host country reaches two goals: ensuring that the Zone is attractive tax-wise and providing for the transparent and easy to follow tax paying system. Another option is to introduce a special tax office,<sup>129</sup> which would implement a simplified taxation procedure. The actual solution here depends on the strategy of the host country and the limits it is wishing to set in competing for investments.

## **6. Enforcing contracts**

Under contract enforcement the main ranking takes into account procedures, time and cost to resolve a commercial dispute. Even though this feature might seem of minor importance, a wise investor would not underestimate this indicator, since effectiveness of contract enforcement reveals the sustainability of business regime—without the ability to easily and smoothly enforce a contract, no business can effectively operate.

The results for this ranking is the most surprising: some of the CIS countries (namely, Belarus and Russia) are ranked even better than some of the developed economies (UK and Ireland) which suggests that the concerns about legal certainty and protection by law in transitional economies might have been overly exaggerated. Once again, the number of procedures does not necessarily correlate with the number of days it takes (19 procedures in the UK and 28 in Belarus take approximately the same time).

One, however, should be careful not to blindly rely on contract enforcement rank as a sole indicator of the efficiency of the preferential business regime. Surely, these statistics alone do not give the right to proclaim Russia and Ukraine to have more efficient business regime than the USA or Japan (as the whole combination of facts and statistics suggests the opposite).

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<sup>129</sup> More on this see *n* 21, pp.45-48.

Besides, fast contract enforcement can become a double sided argument when it comes to investments and sustainability of business regime. From one side, it is certainly good and effective for a company to be able to smoothly enforce a contract: this indicates efficiency of administrative and judicial systems. But from another side, it could indirectly speak of insufficient investor protection,<sup>130</sup> as overly easy contract enforcement might prompt the investors to think they might be overly exposed to liability and judicial procedures.

One argument is beyond doubt: for a Free Zone to succeed, it should provide for an effective business regime, elements of which would not be limited just to contract enforcement, but also include other features, like administrative, economic or regional incentives.

## **7. Closing down a business**

Any investor when starting up an investment project prefers to have a clear idea how easy and fast it is possible to wind up in case he decides to relocate the funds (due to change in a business strategy, cancellation of a preferential regime, or any other reason). Even though initially Free Zone's priority would be to provide fast and efficient registration and to offer competitive preferences, one should bear in mind that effective legal regulation of an escape from the Zone might be as important as entrance for the potential investors. Hence, the data on closing down a business, prepared by the World Bank Group is analyzed.

The main data for the ranking here was the recovery rate in bankruptcy which is logical, but not too informative. This category looks at the number of years it takes to legitimately wind up a company in the researched jurisdictions. Even though this data might be somewhat outdated (2006), it can still provide a perspective on closing a business.

Understandably, here one sees the same tendency as for starting up a business: developed countries, such as Ireland, UK, Japan and Singapore, generally providing for fast and easy company formation, also secure a smooth winding up procedure (usually taking up to a year). In CIS business wind up requires 3 years or more, with Belarus (5.8 years) being an infamous leader.

Such long terms of closing down a business are clearly incompatible with sustainable preferential business regime in a Free Zone. One can understand the desire of the developing countries to attract more investors, and to provide for the relatively easy procedure of starting up a business. But game rules should be fair: reasonable

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<sup>130</sup> S Shuleiko, *Institutional Factors in the System of Foreign Investments of National Economy (Conceptual Analysis)* (Gomel, Belarus 2001) 128



conditions for getting residency in a Free Zone should be complemented by straight forward procedure for leaving it. The main idea behind this as follows: a potential investor could find allowing 69 days for starting up a business (taking Belarus as an example) acceptable; and even dealing with licences in just less than a year might also be OK; however, when to wind up it takes almost 6 years, such a duration is seen totally disproportional.

For a sustainable Regulatory Free Zone Model the only recommendation here is to ensure minimization of bureaucratic and administrative barriers in performing all the required operations: investors need to be assured that they can leave the Zone as fast and as easy as they have entered.

## **8. Protecting investors**

A key indicator for any business is the investor protection rank. Here the World Bank has accounted for the disclosure, director liability and ease of shareholder lawsuits index.<sup>131</sup>

In general, investor protection rank correlates well with other discussed above indicators. The developed countries, providing for more appealing doing business regime have been given a higher rank (between 2 to 12). The only outsider is Switzerland, ranking of which seems a gross mistake: strangely, this jurisdiction, renowned for its bank secrecy and low tax regime, has received a low investor protection rank (164), thus being ranked way below many CIS. This could be due to the low disclosure procedure. However, Switzerland is of marginal interest here as this research focuses on CIS and Eastern Europe.

A leader in this group is Poland, which was ranked 38. Probably because it had recently joined the European Union, Poland surely used the chance to reform its legislation and strengthen investor protection. Belarus and Ukraine, in contrast, were ranked fairly low, which is not a surprise remembering the difficult economic and political situation in both countries. Russia is seemingly doing better, even though the rating could still be higher.

Looking at the researched jurisdictions and all the above discussed categories, one has to note that the investor protection rank, when it comes to its effect and use is more of an image type category rather than a solid fact. Indeed, the better the investor protection rank is, the safer investors feels. But does it really depict the effectiveness of the legal regulation of the preferential business regime? Perhaps, not.

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<sup>131</sup> <<http://www.doingbusiness.org/documents/DB09Easeofdoingbusinessrankmethod.pdf>> accessed 23.09.2008

Summarising the above discussion it is submitted that sustainability of a Free Zone directly depends on successful legal regulation of preferential business regime and its elements, discussed above. To attract the investors, a state setting up Free Zones should provide an operational Zone model with not only transparent, stable and attractive preferential doing business regime, but also to secure bureaucracy-free procedure and effective co-operation between governmental officials and investors.

Information on ease of doing business in the World Bank report and its ranking are definitely of a cumulative nature, providing just an indication of not only appropriateness and suitability of the jurisdiction to host potential investments, but also outlining the key structural parts of the preferential business regime, which have to be secured by the Free Zone.

As stated, in absence of the opportunity to analyze every existing type and model of a Free Zone worldwide, this research have focused on some examples from the developed, developing and planned economies and outlined the successful elements of Free Zone Modelling, which are to be further utilized while establishing a sustainable Regulatory Free Zone Model for CIS. But before that, the subsequent chapters will look at International Offshore Financial Centre as a Free Zone Model and Free Zone development in the target region.

## **Chapter 3. The International Offshore Financial Centre as a Free Zone Model**

### **3.1 Introducing “Tax Havens”**

### **3.2 “Tax Havens in British Overseas Territories and Crown Dependencies**

#### **3.2.1 British Overseas Territories: Gibraltar and British Virgin Islands**

#### **3.2.2 Crown Dependencies: Isle of Man and Jersey**

### **3.3 European Countries Implementing Low Tax Regime**

#### **3.3.1 Ireland**

#### **3.3.2 Cyprus**

#### **3.3.3 Switzerland**

This Chapter will analyze various Free Zone Models and look at the successful elements of legal regulation (especially preferential business and taxation regimes) of International Offshore Financial Centres—a very unique Free Zone model, which has greatly improved the economic situation in most of the host countries. Widely established throughout the world, these “Tax Havens”, offering flexible and very advanced preferences and providing for an effective easy-to-follow legal regulation, became very popular among investors.

What are the key regulatory features of the preferential regime in International Offshore Centres, which are so appealing to foreign businesses? What do these Zones have in common? And how can their approaches to legal and political regulation be utilized in the modelling of a preferential regime? What makes such a regime sustainable?

Traditionally, International Offshore Financial Centres as a model of business environment, are under-represented in CIS and Eastern European Countries in transition, as only a few of these exist. This chapter explores that species of Free Zones to see what can be borrowed and incorporated in the Regulatory Free Zone Model for CIS.

To be more specific, this chapter will consider the successful experience of some International Offshore Financial Centres from the British Overseas Territories and Crown Dependencies and focus at certain European Union countries implementing a favourable tax regime. But as always, it first looks at the definition and a brief history of these Zones.

### 3.1 Introducing “Tax Havens”—Definition and History

Unsurprisingly, virtually every country in the world is interested in attracting foreign investors and businesses, advancing revenues and boosting the economy. To achieve that goal there exist plenty of different schemes, not the least popular among which is an establishment of an International Offshore Financial Centre. This type of a Free Zone, also known as a ‘Tax Haven’, was initially popular mostly among small or island-countries, but is now more and more introduced by jurisdictions worldwide.

A “tax haven” is a rather controversial term, as there is no internationally adopted definition of this type of a Free Zone. As a starting point, the definition provided by the Organization for Economic Co-operation and Development (OECD), an intergovernmental organization, dealing with global economic and social policies, is looked at: *tax haven is a jurisdiction actively making itself available for the avoidance of tax, which would otherwise be paid in relatively high tax countries.*<sup>132</sup> From that definition one can outline the most significant feature of Tax Havens, as stipulated by the OECD: imposition of substantially lower or zero tax on undertakings.

Ginsberg<sup>133</sup> suggests that the term “Tax Haven” should be applicable to three types of jurisdictions:

- First, the countries which impose no tax at all (so-called “tax paradises,” like ones in Bahamas or Bermuda).
- Second, the countries where taxes are levied only on internal taxable operations and not on profits from foreign sources (such as tax shelters in Hong Kong).
- And third, countries where special tax privileges are limitedly granted to certain types of companies and undertakings (Isle of Man or Liechtenstein).

Notably, this commentator also suggests tax rates to be the key determining feature of an Offshore Zone. However, other researchers<sup>134</sup> see International Offshore Financial Centres as a much more complex business environment than just “Tax Havens.”

A classic Offshore Zone in addition to low or zero taxation (which, beyond doubt, is one of its major distinguishing features) also introduces effective bank secrecy laws, provisions on currency exchange and transfer, simplified or free accounting, easy incorporation and various other preferences.

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<sup>132</sup> ‘Harmful Tax Competitions: An Emerging Global Issue’ (OECD Report 1998)  
<<http://www.oecd.org/dataoecd/33/0/1904176.pdf>> accessed 28.08.2008

<sup>133</sup> A Ginsberg, *Tax Havens* (Institute of Finance: New York 1991) 3

<sup>134</sup> R August, *International Business Law: Text, Cases and Readings* (Prentice Hall, New Jersey 2000) 734

There is certainly more than one way to define a Tax Haven and various jurisdictions utilize diverse approaches. Some countries, like Germany, Australia and Japan, instead of defining a Tax Haven regime simply compile a non-exhaustive list of countries offering alike preferences, merely referring to such territories as low-tax countries.<sup>135</sup> The problem with such definition is its legal certainty: as the status of countries frequently changes due to amendments to the regime, to keep the definition up to date, one has to adequately modify the list in a timely manner. Another approach, which has been followed by other OECD jurisdictions, is to simply describe a Tax Haven as a state or territory that imposes taxes on profit or income which are substantially lower than in a taken high-tax country.<sup>136</sup> But then what would be a difference between Tax Havens and low-tax jurisdictions?

For the reason of simplicity, incorporating the cumulative definition of a Free Zone from Chapter 1, in this section Tax Havens (or International Offshore Financial Centres) will be referred to any fiscally attractive jurisdictions providing favourable taxation and business operation regime to foreign undertakings on its territory.

This definition, even though being not as detailed as the cumulative one, still fully fits into it, by including the most important features of the classical Tax Havens: a special preferential (financial) doing business regime available for certain undertakings (exempt companies), engaged in business activities abroad. All other elements are optional and do not necessarily exist. For example, such a regime can be established for an identified or unspecified period, on island jurisdictions (Isle of Man, British Virgin Islands) and on isolated territories within the country (Offshore Zones in Russian Federation); the exempt companies can be totally free from certain taxes (Gibraltar) or charged a reduced rate (Ireland); accounting may or may not be required; company creation rules within the Zone could be simplified or normal.

Discussing a definition of a Tax Haven, the main features of this Free Zone Model offered by Barry Spitz shall be noted:<sup>137</sup> the classical Tax Haven besides zero taxation on income and capital, also provides for bank and commercial secrecy (within certain limitations by the OECD rules on harmful tax practices (unlawful tax evasion) and money laundering), absence of exchange controls, presence of an active banking sector, good communications, an appearance of political and economic stability, a favourable disposition towards foreign capital, as well as reduced rates. All of the above are the vital elements of a sustainable preferential regime offered by the Tax Havens

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<sup>135</sup> C Doggart, *Tax Havens and Their Users* (Economist Intelligence Unit, London 2002) 11

<sup>136</sup> M Hampton, *The Offshore Interface: Tax Havens in Global Economy* (MacMillan Press, USA 1996) 25

<sup>137</sup> B Spitz, *Offshore strategies* (Tolley, UK 2001) 4

which will be discussed in this chapter while analyzing the Free Zone models of this type introduced by the British Overseas Territories and Crown Dependencies.

But first one needs to briefly look at the historical development of Tax Havens. Being quite a distinct model of Free Zones, history of these differs from the general historical development of all Free Zones.

Unsurprisingly, the idea of offering a partial or total exemption from tax is not a very modern one. Charles Adams, to put tax havens in proper perspective,<sup>138</sup> suggested to go back 3500 years to the Book of Joshua, even to the Books of Moses, where the Lord ordered the Children of Israel to set aside cities of refuge, where people could gain personal and financial asylum from the punitive laws of Moses. It is obviously impossible to clearly identify something even slightly resembling the classical Tax Havens at that time, but other countries, like Switzerland, dating back to the Roman times, have historically offered alike services and acted as a shelter for capital flight.<sup>139</sup>

In Europe, a favourable regime, which is now known as a Tax Haven, appeared and developed in many shapes and sizes. In the Middle Ages, the City of London exempted merchants of the Hanseatic League from all their taxes. Flanders in the 15<sup>th</sup> century also eliminated most of its overseas duties, which attracted English wool sellers. The Netherlands in 16<sup>th</sup> -18<sup>th</sup> centuries imposed significantly low duties and restrictions on merchants engaged in trade.<sup>140</sup> Famous European Free Towns and Cities (such as Hamburg, Marseilles, Gibraltar), where goods could be stored, manufactured and consumed duty-free by the resident population, became strong in the 18<sup>th</sup> century, as well as Free Ports of Rotterdam and Bremen. Today many of those countries and territories have transformed into classical Tax Havens and other types of Free Zones.

Modern tax shelters appeared comparatively recently, less than a century ago. In the 1930's wealthy Canadian and US citizens started to use the Bahamas for private offshore trusts and holding companies to protect their assets. Due to vague and controversial definitions, there is no single opinion on which Zone can officially be considered to be the first modern Tax Haven. Some commentators, like Doggart, suggest Switzerland to be the one,<sup>141</sup> since long before World War II its banks absorbed assets from many countries. Due to the political stability and neutrality, as well as stable currency, this country became a popular place for capital storage. However,

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<sup>138</sup> C Adams, *A Historian Look at Tax Havens* (2002) <<http://www.lewrockwell.com/orig2/adams2.html>> accessed 28.08.2008

<sup>139</sup> *ibid.* 136, p.17

<sup>140</sup> R August, *International Business Law: Text, Cases and Readings* (Prentice Hall, New Jersey 2000) 734, 736

<sup>141</sup> C Doggart, *Tax Havens and Their Users* (Economist Intelligence Unit, London 2002) 1

following this view, Switzerland could hardly be considered a classical Tax Haven or tax shelter: rather it should be classed a low tax jurisdiction.

Few classical offshore territories have developed in pre-World War II times, but many more appeared after the World War II, giving way to the rise of money laundering techniques and secret banking after mid 1960's. Currently there are more than 50 jurisdictions worldwide offering favourable taxation regime as a Tax Haven. Byk suggests grouping them by the type of host countries.<sup>142</sup> This includes:

- Industrially Developed Countries, hosting offshore centres: Australia (Sydney), Austria (Innsbruck), UK, Greece, Israel (Haifa), Ireland (Shannon), Cyprus, Luxembourg, USA, Switzerland and Japan.
- New Industrial Countries and Countries with high scale economy: Bahrain, Brunei, Hong Kong, Jordan, United Arab Emirates, Singapore, Tai Wan.
- Developing Countries: including but not limited to Andorra, Bahamas, Barbados, Virgin Islands (US and UK), Guernsey, Grenada, Madeira, Malta, Monaco, Lebanon, Puerto-Rico, Seychelles Islands, Surinam and Jamaica.
- Post-cominunist countries: Cuba and Russian Federation.

This list, although not exhaustive, is seemingly wide and includes not just the classical Tax Havens, but also the countries implementing low tax regime. Besides, the number and rank of the host countries is in constant modification, as the regime is subject to ongoing changes.

Having CIS as the target recipients, the findings of this chapter should relate to them. For consistency, this research focuses on Tax Havens of similar location and jurisdiction, studying International Offshore Financial Centres which are either situated in Europe or which followed a European model of development (British Overseas Territories and Crown Dependencies). Plus a representative number of other European countries implementing low tax regime is looked at. Such a selective analysis allows to distinguish the best proven ways of legal regulation of the successful Tax Havens, to modify and apply those in a sustainable Regulatory Free Zone Model for CIS.

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<sup>142</sup> n 21, pp.19-25

## 3.2 “Tax Havens” in British Overseas Territories and Dependencies

### 3.2.1 British Overseas Territories: Gibraltar and British Virgin Islands

Many of the dependencies of advanced industrial nations became the host areas for non-resident global financial accumulation. This section looks at two types of offshore jurisdictions based on English law and traditions: British Overseas Territories and Crown Dependencies.

The number of British Overseas Territories which can be classified as Tax Havens is rather extensive and includes Anguilla, Bermuda, the British Virgin Islands, the Cayman Islands, Gibraltar, Montserrat, the Turks and Calicos Islands. Offshore jurisdictions within British Crown Dependencies are Isle of Man, Jersey and Guernsey. The legal regulation of the preferential business regime for these Offshore Zones is quite common, so this research will study two examples of the Overseas Territories (namely, Gibraltar and British Virgin Islands) and two of the Crown Dependencies (Isle of Man and Jersey).

Similar historical background, political and economical situation, legislation and judicial system, the rules of business organization of the above International Offshore Financial Centres justify analyzing them together. What has to be accounted for is that even though most of these Zones fall under the same classification category (and can be classified as low (rather than zero) tax financial centres, offering reduced tax rates, special tax exemptions, incentives and privileges as well as very good financial and professional infrastructure), there are still certain differences in legal regulation of the preferential business regime they offer.

The development of the above territories into International Offshore Financial Centres became possible after the 1970's. Two pieces of the UK legislation contributed to the boost of the favourable tax regime on these territories: changes made to the Sterling Area in 1972 and Lifting of Exchange Control in 1979.<sup>143</sup> These gave those small island countries certain freedoms in deciding how to further develop their economies, being in recession at that moment. Realizing that overly high tax burden was causing serious economic problems, Gibraltar and BVI decided to shift to low-tax

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<sup>143</sup> R A Johns, C M Le Marchant, *Finance Centres: British Isle Offshore Development Since 1979* (Pinter Publishers, London 1993) 8, 13



welfare states and started the offshore experiment,<sup>144</sup> which resulted in tremendous GDP and investment increase in less than ten years.<sup>145</sup>

One of the well-known International Offshore Financial Centres is Gibraltar, situated between the two continents, Europe and Africa. Conquered by Britain in 1704, this self-governing "Rock" has reached political and economic stability in the 1960's and after adopting Companies (Taxation and Concessions) Ordinance<sup>146</sup> has provide for a special tax regime for international businesses.

Being a sovereign territory under its 1969 Constitution<sup>147</sup> (preamble of which assures that Britain will never enter into arrangements under which the people of Gibraltar would pass under the sovereignty of another state against their freely and democratically expressed wishes), Gibraltar retained full control over its internal affairs, with responsibility for external affairs and international security given away to the UK. However, the provisions of the Constitution do not alter the special international status of the island.

One of the most distinguishing Gibraltar's features, making it unique and different from other Britain-dependent offshore territories, is its relationship with the European Union. The United Kingdom joined the EU in 1973. As stated in Article 299 of the European Community Treaty,<sup>148</sup> the Treaty applies not only to the United Kingdom of Great Britain and Northern Ireland (art. 299, sec 1), but also to European territories whose external relations a Member State is responsible for, i.e. all British Crown Dependencies and Overseas Territories (art. 299, sec 4). So, theoretically, Gibraltar as a British Overseas Territory should be a part of the European Union and be subject to its provisions not only on free movements of capital, services and persons, but also to strict tax regulations, compliance with which is hardly possible for a classical Tax Haven.

Fortunately for Gibraltar, its situation is different. As full application of the EU law, prompting compliance with common custom tariffs, taxation and other policies, would have effectively nullified Gibraltar's status as an offshore territory, Article 28 of the Act concerning the Conditions of Accession and the Adjustments to the Treaties (which covers the accession of the UK, Denmark and Ireland)<sup>149</sup> provides that even though Gibraltar holds an EU Member State status, there are certain exceptions from the

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<sup>144</sup> T Congdon, *Towards a Low-tax Welfare State* (Politeia, Italy 2002) 3, 6

<sup>145</sup> T Johns, 'The Continuous Culture Of Offshore Financial Centre Development' (1996) #96/22 Working Paper Series, Keele University, Department of Economics. pp.10-12

<sup>146</sup> In 1967

<sup>147</sup> Full text at <[http://www.gibraltar.gov.gi/constitution/gib\\_constitution.pdf](http://www.gibraltar.gov.gi/constitution/gib_constitution.pdf)> accessed 28.08.2008

<sup>148</sup> 'Treaty establishing the European Community (consolidated version)' *Official Journal*, C 325, 24.12.02.

<sup>149</sup> OJ, English Special Edition (27 March 1972), p. 5

Community measures with respect to its territory. According to the Act, the Common Agricultural and Fisheries Policy, Harmonization of Turnover Taxes (Value Added Tax) and Common Custom Tariff do not apply in Gibraltar, thus bringing it outside of the EU Customs Territory.<sup>150</sup>

Accordingly, Gibraltar, being a separate legal jurisdiction, is not a separate Member State (its membership derives as part of the Member State UK), but the island is greatly advantaged by its special status within the EU. All economically beneficial European Community Treaty provisions, such as free movements (capital, services and persons), freedom of establishment, common monetary policy (but not the Euro zone) do apply to Gibraltar,<sup>151</sup> but the EU policies on customs and taxation do not. These provisions make Gibraltar unique and especially attractive as an investment territory for businesses across the European Union.

Next, additional incentives offered by Gibraltar to businesses operating within its territory are analyzed. What is interesting to see is how the Government, while complying with the guidelines and requirements laid down by most of the EC Directives, managed to create a framework of special legislative provisions which significantly enhance Gibraltar's competitiveness in investment attraction. Its elements of success, making this Model of a Free Zone sustainable includes the following.

First is a simplified incorporation procedure, which plays an important role in business development. As discussed in Chapter 2, in some CIS countries, like Belarus, in order to start a business, the investors should comply with 16 procedures, which takes up to 69 days and costs approximately £500GBP, not mentioning an extensive number of required documents and additional financial expenditure. In a contrast, a company in Gibraltar can be incorporated within 3 working days once the selected name is approved by the Companies Registrar. Complicated incorporation is a serious downfall in sustainability of a Free Zone, as potential investors when choosing the location will hardly be willing to wait for months before being able to start operating effectively.

Another element of success, which is often the main feature of International Offshore Financial Centres as Free Zone Models, is preferential tax regime. Gibraltar's taxation legislation is modelled on the United Kingdom, but contains various provisions to strengthen its position as an attractive Offshore Financial Centre. Similar to many other Tax Havens, Gibraltar enforces a dual approach to residential taxation, one affecting local tax residents, and another applied to those individuals or companies,

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<sup>150</sup> A Ginsberg, *Tax Havens* (Institute of Finance, New York 1991) 181, 182

<sup>151</sup> Note some restrictions in the free movement of goods due to Gibraltar's exclusion from the common customs territory

which being registered on the territory, mainly do business abroad and are partially or totally exempt from tax.<sup>152</sup>

For the latter category, Gibraltar offers significant tax advantages, which may be summarized as follows: no capital gains tax, dividends and interest income is tax free, no stamp duty on fund transactions, no tax on asset value, no capital acquisitions tax, no VAT applicable to managers. Exempt companies pay a flat filing fee and qualifying management companies pay 5% fixed rate of tax. Such taxation regime is significantly lower than in ordinary high tax countries, and as a result of its introduction in the early 1980's, Gibraltar faced an increase in number of registered companies from 2,000 in 1985 to 40 000 by the early 1990's.<sup>153</sup> This speaks for the successful legal regulation of the preferential regime.

One of the specific types of companies used on the island for offshore business (due to exemption from all income tax and stamp duties) is exempt companies.<sup>154</sup> Gibraltar Companies Ordinance, the main document, regulating the creation and operation of such companies, is based on the new UK Companies Act.<sup>155</sup> There can be three different types of exempt companies: resident in Gibraltar, non-resident, and branches of foreign undertakings. In order to qualify for that preferential status, the company cannot be owned by a Gibraltar resident and should refrain from doing business with the latter, as no resident should be able to benefit from an exempt company.<sup>156</sup> This is also one of the distinguishing features of the dual taxation approach, aimed at attracting foreign rather than domestic investors.

The status of an exempt company is guaranteed by the Exemption Certificate, which exempts it from any local taxes and duties (compare this with a standard tax of 35%, usually levied in non-offshore jurisdictions).<sup>157</sup> The only charge exempt companies have to pay is a fixed tax of £200 British pounds (non-residents), £225 (residents), or £300 in the case of a registered branch of an overseas company.<sup>158</sup> Once again, that is an incredibly low cost of running a business, which cannot be offered in a high tax country.

It may occur that by allowing such a regime the government loses a lot of money from uncollected taxes. However, the reduction in income for the Inland Revenue can be well compensated by an increasing number of companies, paying a fixed yearly rate.

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<sup>152</sup> Spitz and Clarke, *Offshore Service* (Tolley Lexis Nexis, UK 1991-2003) Binders 1-3, GIB. 45

<sup>153</sup> A Ginsberg, *International Tax Planning: Offshore Finance Centres and the European Community* (Kluwer International, London 1994) 61

<sup>154</sup> B Spitz, *2000 International Tax Havens Guide* (Harcourt Professional Publishing, USA 1999) 393

<sup>155</sup> n 153, binders 1-3, GIB 385-468

<sup>156</sup> *ibid*, binders 1-3, GIB 369-381

<sup>157</sup> Income Tax Rates of Tax Rules 1989, sec. 6(1)

<sup>158</sup> Gibraltar Companies (Taxation and Concessions) Ordinance, s.10 (1).

The higher this number is, the more revenue the government gets, so the local authorities are directly interested in attracting as many companies as possible, which also effectively eliminates bureaucracy and unnecessary delays in registration.

As mentioned above, to establish an exempt company, any investor is expected to input a certain authorised capital. In most of the high tax countries this is traditionally quite a substantial sum of money, used to guarantee the credibility of company's owner and its performance to potential creditors. However, in Gibraltar this requirement is basically waived: the necessary capital share minimum is only £100,<sup>159</sup> which allows for fast, easy and cheap company formation.

Another element of success is a stability of legal regulation. When the legislator constantly changes the legal status of investors introducing new taxes or non-tax payments, it creates legal uncertainty, as investors want to be assured of safety of their capital. In Gibraltar, the principle of legal certainty is legislatively guaranteed, thus any company upon incorporation is issued a Tax Exemption Certificate for a period of 25 years, which guarantees stability of legal regulation and non-introduction of any new fiscal requirements.

Other examples of legal certainty could also be found in domiciliation law. For instance, if the company has domiciled in Gibraltar under a particular Regulations, these Regulations will continue to apply even when the new version of law will be adopted, so retrospectively of the law is out of question.<sup>160</sup> This very important principle was recently introduced in some of the CIS;<sup>161</sup> however, the government there fails to effectively enforce it.

The low administration and formation costs of the exempt company made it an ideal vehicle for such types of businesses as property holding company, an investment holding company, sales agency company, and became of particular benefit to investors, who trade between the two high tax jurisdictions, or internationally.<sup>162</sup> Moreover, an exempt company can be managed and controlled either from Gibraltar or from abroad without affecting its tax exempt status, which gives investors flexibility. There are no restrictions as to the nationality or residence of its directors too. Thus, undoubtedly, an exempt company has a potential to become a leading form of business organization within an International Offshore Financial Centre.

On a final note, as noted above, an exempt company in Gibraltar is not the only possible way of business organization taking advantage of the preferential business

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<sup>159</sup> Gibraltar Companies (Taxation and Concessions) Ordinance, s.3 (b).

<sup>160</sup> Companies (re-domiciliation) regulations 1996, sec.1

<sup>161</sup> On discussion of Belarus see Chapter 4

<sup>162</sup> <[http://www.gibraltar.gi/finance/gibraltar\\_exempt\\_finance.asp](http://www.gibraltar.gi/finance/gibraltar_exempt_finance.asp)> accessed 28.08.2008

regime. As a general rule, an exempt company is not allowed to engage in business within Gibraltar territory. However, in a case where an investor wants to do some business on the Rock, or a foreign jurisdiction requires that a certain percentage of tax on profits is still to be levied and paid locally, there is available another type of low taxed company to be created—a Qualifying Company. On all business within Gibraltar, such a company pays a standard high tax (35%), but any non-residential business is taxed between 2 and 35%, depending on the sort of business and agreement with the local authorities. This provision gives investors the ultimate flexibility in terms of choosing what kind of activities to engage in.

In addition to exempt company, a qualifying company as a form of business organization could be well used by many Free Zones in CIS. Often the government setting up Free Zones would require the residents to perform export-oriented activities (say, export manufacturing); then the companies would be exempt from tax when they produce goods for export. However, if the company wishes to sell some of its products within the country, they might be allowed to do so on a condition that they are taxed at the nation-wide rate.

To summarize, the important advantages of International Offshore Financial Centre Gibraltar are as follows: significantly low taxation, fast and cheap process of incorporation, legal and political certainty, as well as special relationship with the European Union. Since all above preferences are granted only to companies owned by non-residents of Gibraltar, it is submitted that this Model is mainly targeted at foreign investors and should be used very carefully when the government is also hoping to attract the domestic ones.

Next British Virgin Islands—another British Overseas Territory famous for its political and economic stability will be looked at. Favourable location in the Caribbean, well-developed tourism and special doing business regime had made BVI one of the most successful Tax Havens. By the beginning of this millennium over 900 vessels, 1,700 mutual funds, 70 general trustees, 190 insurance companies and over 300,000 of other companies were registered there.<sup>163</sup>

Similar to Gibraltar, British Virgin Islands also impose significantly high taxes on income of domestic origin. But unlike Gibraltar (and most of other traditional Tax Havens) resident and domiciled BVI companies are liable to pay income tax even on their worldwide income. Such provision is not typical for a jurisdiction positioning itself as a Tax Haven and after looking at its income tax rates, one would doubt it is a

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<sup>163</sup> R Mathavious, 'Regulation in the British Virgin Islands' in N Courtis (ed), *Financial Regulation in Offshore Centres* (Central Banking Publications, London 2001) 27

Tax Haven at all. Such conclusion, however, is premature, as variable taxation is only one of the elements of BVI success.

The publicised rates of personal income tax (up to 20%) may be, indeed, confusing. This, however, only applies to domiciled resident companies. When it comes to resident foreign companies and companies not domiciled in BVI, they are only taxed on income arising within the territory (alike in Gibraltar) and benefit from the low tax regime on any income from the activities abroad. The general low tax regime includes exemption from capital gains, gift or estate taxes.

As foreign investors are always interested in the regimes imposing the minimum taxation, it is vital for an offshore jurisdiction to provide for the creation of some kind of tax exempt companies. Like Exempt and Qualifying companies in Gibraltar, the BVI government has also considered introducing similar types of undertakings. It was International Business Ordinance 1984,<sup>164</sup> which brought BVI under a "Tax Haven" umbrella by introducing International Business Companies (IBC), which are exempt from income tax (sec.111). To qualify for the IBC status, a company should not own an interest in real property located in BVI (except lease) and not carry out business as banking, insurance or re-insurance company (sec.5).

Similar to Gibraltar, incorporation of an IBC in BVI is simplified—it can be registered in just one day. But there are certain conditions to be fulfilled which are more burden-some than in Gibraltar. First, there is a minimum capital required for incorporation—50 000 USD (contrast with 100 GBP in Gibraltar). Second, an IBC must have a registered agent in the territory, which is licensed under the Banks and Trust Companies Act 1990.<sup>165</sup> Having a director is required as well, but the secretary is not obligatory.

Hence, one can see some additional criteria in comparison with Exempt or Qualified companies. How does that affect Free Zone's sustainability? Registered capital and licensing requirements on one hand could be a positive element, since it serves as a guarantee of creditability and operation of a BVI company. On the other hand, it imposes certain regulatory requirements on foreign investors, making it more difficult to register an IBC. However, these difficulties are well compensated by low taxation and other preferences, making this type of companies rather popular. The experience of International Business Companies might be of use for CIS, where state regulation of business remains quite intense.

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<sup>164</sup> n 153, Binders 1-3, BVI 351-435

<sup>165</sup> *ibid*, Binders 1-3, BVI 441-454

In addition to low tax, another important advantage of IBC in British Virgin Islands is maximally simplified (or rather, withdrawn) accounting process: accounts are not obligatory and do not have to be filed anywhere, as well as an annual return. In a majority of Eastern European countries in transition, accounting is a very complicated and bureaucratic procedure (thus necessity to employ a number of accountants and book-keepers), and for the investors such a preference would certainly be a serious incentive. Even though one can hardly see a traditional jurisdiction of CIS to totally relinquish the accounting requirement, the simplification of that process is by all means vital.

Another feature of the preferential regime is annual license fee which an IBC has to pay in return for the tax exemption status. It is not much higher than the one in Gibraltar—the amount varies from 300 USD (when the capital is less than 50, 000USD) to 1, 000 USD for undertakings with larger capital. These payments, even though being higher than in Gibraltar, still seem fairly reasonable, especially when comparing to other International Offshore Financial Centres such as the Isle of Man.

Another advantage, specific to International Business Companies is that they are a very mobile type of undertaking. An IBC, established in BVI, can continue in another jurisdiction as a foreign company; and vice versa, a company incorporated in another jurisdiction may continue as an IBC (as long as the foreign incorporation law permits).<sup>166</sup> Such provisions allow IBC to change jurisdictions without going through the liquidation process, which, in some jurisdictions, can be very long and costly.<sup>167</sup>

The Act also contains provisions<sup>168</sup> allowing foreign companies to lodge Articles of Continuation on a provisional basis, which allows the company to continue in BVI right after receiving a notice from a specified person. Such a provision enables foreign companies which are concerned that they may have to relocate very quickly, to do so in a very short space of time. Thus, the guarantee for company mobility and property rights is obviously a very attractive incentive for foreign investors; being combined with low taxation and easy establishment procedure made BVI such a successful offshore territory.

Analyzing the advantages of the preferential regime in BVI, one should not think that there is absolutely no control over IBC activity. The government widely uses licensing as a control mechanism. In addition to the necessity to use registered agents, a trade license is also required by any entity doing business within the territory (except

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<sup>166</sup> BVI International Business Ordinance 1984, sec.84-88

<sup>167</sup> see Chapter 2.4

<sup>168</sup> Section 85

for an offshore corporation which does no business in the BVI). For property purchase in the BVI, any foreign national must also obtain a non-belonger's landholding licence.

As stipulated above, BVI, being an Overseas Territory of the United Kingdom, is also an associate member of the European Union. But unlike Gibraltar, BVI is not subject to EU Regulations and does not enjoy the special relationship with the Union. However, the British Virgin Islands can receive financial assistance from the EU and benefit from the duty-free access to the Union's market.

Comparing the two jurisdictions, Gibraltar and the BVI, it is submitted that the successful components of the preferential business regime are quite different between the two. Indeed, Gibraltar offers a greater extent of preferences for the exempt companies, both in terms of tax exemptions and the annual fee, whereas BVI charges more. Plus, BVI government imposes more control over the International Business Companies, particularly through licensing and imposition of the minimum capital requirement, compared to Gibraltar.

Application of a combination of the above preferences, however, may become useful to CIS, as while introducing regulatory and fiscal preferences in the Free Zones, the government would still want to control formation and operation of the resident companies.

### **3.2.2 Crown Dependencies: Isle of Man and Jersey**

The next section looks at the preferential business regime offered by the Offshore International Financial Centres in the two British Crown Dependencies, Isle of Man and Jersey. Noting the distinguishing features, the successful regulatory elements which can be of use for our Proposed Free Zone Model will be analyzed.

Isle of Man is situated in the centre of the British Isles between the Republic of Ireland and the United Kingdom in the Irish Sea. The Isle is a self-governing British Crown Dependency, not part of the UK. The political situation of the Isle is similar to BVI: unlike Gibraltar, the Isle also has no special relationship with the EU as it is not a member of the Union. The Isle of Man is within the EU's common customs tariff barrier for the purpose of trade in industrial and agricultural products, but it is outside the Community scope for all other aspects of the Treaty of Rome and subsequent treaties.<sup>169</sup> Thus, the country enjoys free trade as far as agricultural and industrial products are concerned, but it is not limited by the European Union in regards to its fiscal policies.

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<sup>169</sup> n 153, Binders 1-3, part II, 1991-2003, IOM 3



Similar to any successful offshore jurisdiction, the Isle of Man is politically stable. Tynwald, the Island's bicameral legislature, makes its own laws and oversees all internal administration, fiscal and social policies. The UK laws apply in all cases not covered by local legal acts. Isle of Man has its own tax system, which is totally independent from the United Kingdom. But (and only) with the UK the Island signed a double-taxation treaty, effectively eliminating the double taxation between the two territories (except tax on dividends and expenditure interests).<sup>170</sup>

Rapidly growing, the International Offshore Financial Centre in the Isle of Man is regulated by Financial Supervision Commission, responsible for licensing and supervising banks, investments businesses, collective investment schemes and building societies and the Insurance and Pensions Authorities, supervising insurance business and pension's managements.<sup>171</sup>

Previously, companies were liable to tax at 18% on the whole taxable income. However, in 2006 the new Companies Act was passed, which introduced favourable conditions for incorporation and operation of IOM companies. In particular, the Act provided for no requirement to file public accounts, no authorised share capital, no distinction between private and public companies, no requirement for annual general meetings and allowed the companies to have a single director.<sup>172</sup> Coupled with the introduction of zero Corporation Tax (apart from banks and property developers), absence of stamp duty, estate duty or capital gains tax, this new legislative development is set to attract international business.

In addition to traditional types of companies (limited by shares/guarantee and unlimited companies), IOM legislation provides for creation of other types of undertakings: exempt and international companies which benefit from the favourable tax treatment, specifically appealing to foreign investors.

As with Gibraltar, Isle of Man provides for the creation of exempt companies under the rules predating Company Act 2006.<sup>173</sup> Such a company pays a low fixed annual fee and is exempt from the rest of the tax. An exempt company must have at least one director—a resident in the Isle of Man, but no longer requires to have a professionally qualified secretary.<sup>174</sup> Similar to other Offshore Zones, no Manx resident should be beneficially interested in the shares of an exempt company.

Limited Liability Company Act 1996 has also provided for the establishment of limited liability companies, which are exempt from tax when engaging in any lawful

<sup>170</sup> A Ginsberg, *Tax Havens* (Institute of Finance, New York 1991) 144, 145

<sup>171</sup> C Doggart, *Tax Havens and Their Users* (Economist Intelligence Unit, London 2002) 220

<sup>172</sup> Full text at <<http://www.ils-world.com/location/im/introduction.shtml>> accessed 22.09.08

<sup>173</sup> Income Tax (Exempt Companies) Act 1984

<sup>174</sup> B Spitz, *2000 International Tax Havens Guide* (Harcourt Professional Publishing, USA 1999)

trade or business except banking, insurance or investment. LLC are taxed at the same rate as exempt companies.

Exemption from tax is also given to international business companies, investment holding and shipping companies<sup>175</sup> if the income derives outside the Island (subject to a yearly fee of £1200).

The wide list of company types which can be created within the Manx jurisdiction is completed by introducing an innovative and very promising type of company for umbrella investments—protected cell companies. The first legislation on protected cell companies were pioneered in Guernsey in 1997.<sup>176</sup>

The idea behind protected cell companies is to introduce such a form of legal entity in which separate classes of shares (sub-fund options for investments) are legally distinct from each other and from the assets of the whole company. Insolvency of one cell would not allow the action against the assets in other sub-funds (cells), thus preserving the whole company. This very attractive form of business organization, specifically targeted at investment businesses, has already been provided for by a few of the International Offshore Financial Centres. In addition to umbrella investment funds, this type of company can also be used for life assurance, hedge-fund management or any multi-national companies, who want to separate and protect the parent company.

Discussing the successful features of legal regulation of the preferential business regime, fast and simple incorporation procedure in the Isle of Man have already been touched upon. The fact that a company can be registered in one day does not imply that such procedure is unsupervised by the state. Like most of the offshore jurisdictions, for certain businesses (such as an investment business) to operate within the island, the government requires a licence. Under Section 3 of the Investment Business Acts 1991 to 1993, applicants for an Investment Business Licence must have an established track record of at least three years profitable operation, and ownership and management must be acceptable to the Financial Supervision Commission.

Investment businesses are required to adhere to a number of other regulatory codes which cover all aspects of their business and are required to submit financial reports to the Commission at either quarterly or half-yearly intervals, dependent upon the type and level of business conducted. Licensing and supervision of specified services providers to corporations is regulated by the Corporate Service Providers Act 2000. This provision concerns a wide range of corporate workers from a director to a secretary who must possess a licence, issued by the Financial Supervision Commission.

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<sup>175</sup> As of International Business Act 1994

<sup>176</sup> More online at <<http://www.ils-world.com/location/in/introduction.shtml>> accessed 2.09.08

Summarising the above, it is submitted that in organizing an International Offshore Financial Centre, the IOM has set a special target—attraction of financial companies, engaged in investment business. To ensure competitiveness and sustainability of the Centre, the government has tailored the legal regulation of the preferential business regime to specifically fit these objectives, thus introducing some progressive forms of business organization like cell companies. However, being a complex “Tax Haven” the preferences of this jurisdiction do not end here.

Another distinguishing feature of the Isle of Man, contributing to its success—is Manx’ offshore port, the only off-shore port in Europe, providing for direct imports and exports into the Euro Zone outside the usual custom procedures. Under the Free Port Doctrine, a Free Port is characterised by its whole harbour plants being outside the Customs barrier. Usually within the Free Port all maritime traffic operations (incorporation, storage, negotiation, manufacture and reshipment of goods) take place duty-free or with minimum Customs control.<sup>177</sup>

Free Port in the Isle of Man makes it possible not only to freely move the goods between the Isle, EC and non-EC countries without paying any customs and duties, but also to manufacture, produce and store such goods tax free, since the taxes are only paid upon the goods’ entrance to the country of final destination.<sup>178</sup> This relatively young Free Port offers warehousing, manufacturing and distribution facilities, as well as a reduction of maximum income tax to 20%. Free Port in Isle of Man is like having a Free Zone inside the offshore, which is unique and opens up new opportunities for the investors.

As one sees, the Isle of Man is a unique “Tax Haven” which offers a combination of preferences specially tailored to suit the needs of not only investment businesses through exempt, IBC or cell companies, but also of anyone engaged in import/export activities via the Manx’s offshore port.

Next the positive example of Jersey, the largest of the Channel Islands, is considered.

Jersey is also a British Crown Dependency located near France. Even before the UK accession to the EU, Channel Islands of Jersey, Guernsey and Sack had been already recognized as leading European tax sanctuaries due to their special ties with Britain, accessible commercial facilities, rules on the low taxation and easy incorporation.<sup>179</sup> Guernsey is also a Tax Haven offering a number of very attractive tax

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<sup>177</sup> F Trampus, *Free Ports of the World* (E.U.T., Italy 1999) 40, 41

<sup>178</sup> B Spitz, *2000 International Tax Havens Guide* (Harcourt Professional Publishing, USA 1999)

<sup>179</sup> A Ginsberg, *Tax Havens* (Institute of Finance, New York 1991) 125

advantages, but it is less developed and not as popular as Jersey, thus this thesis does not focus on it.

What are the main factors influencing Jersey's development into a successful International Offshore Financial Centre? Hampton suggests to distinguish them into "internal" and "external."<sup>180</sup>

The transition from agricultural economy to offshore-like activities started in Jersey in the 1950s, when the island experienced dramatic growth of tourism after World War II. At that time some wealthy immigrants had moved to Jersey due to a sunny climate, lower direct taxation and advanced banking system on the island, which stimulated the rapid development. Among the internal factors favourable geographical location, historically stable and low taxation (direct tax rate of 20% was introduced in 1940 and has never changed since), high level of banking and commercial secrecy and well developed financial infrastructure can be highlighted.

External factors include the redefinition of the Sterling area in 1972 (this factor really influenced all Offshore Zones in British Protectorate), lifting up exchange control in 1979 and global changes throughout the world (Gulf War, destabilization in Hong Kong in the 1980's, technological changes in communications, etc.). These factors indicate, but do not fully explain the formula of Jersey's success.

According to Colin Powell, Chairman of the Jersey Financial Services Commission, the country has historically enjoyed economic success, securing absence of public debt, full employment and high income per capita. Currently, most of the island's national income (over 60%) is gained from the financial industry, comprising the taxes from banks and other financial services. Jersey's economy is still growing with about 3, 000 new companies register a year (the current number of registered companies had reached 30, 000).<sup>181</sup>

Same as the Isle of Man and BVI, Jersey is not a member to the European Union, but it benefits from its common custom tariff: it has to apply the tariff when importing goods inside its territory, but does not have to apply it when exporting. According to Protocol 3 of UK Accession treaty,<sup>182</sup> EU laws on fiscal harmonization do not apply to Jersey.

As with most Tax Havens, Jersey imposes the income tax of 20% on residents, who are liable to be taxed on any income, regardless of its origin. Similar to the Isle of Man, non-residents pay income tax only on income received from doing business on the

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<sup>180</sup> M Hampton, *Offshore Finance Centres in Small Island Economies: Can the Jersey Model be Replicated by Other Havens?* (3<sup>rd</sup> ed. MacMillan Press, USA 2000)

<sup>181</sup> C Powell, 'Jersey as a Financial Centre' in N Courtis (ed), *Financial Regulation in Offshore Centres* (Central Banking Publications, London 2001) 66, 67

<sup>182</sup> n 153 Binders 1-3, part III, 1991-2003, JER 809-811

island. Typical to any offshore jurisdiction, the taxation regime in Jersey provides for favourable tax treatment of certain companies: exempt, international business companies and foreign incorporated investment companies. Additionally, tax authorities can grant concessions to tax-paying entities, for example, to trusts whose beneficiaries are non-residents.<sup>183</sup>

The Income Tax Law (Art. 123(a)) provides that a company incorporated in Jersey is to be regarded as resident for the tax purposes even in cases when it is merely managed and controlled in the Island (for instance, when the board meetings are held in Jersey), and even if the company predominantly does business abroad. Thus, if not the special preferential regime, exempting some companies, all Jersey residents would be liable to pay full taxes.

To qualify for tax exemption, a company must certify to the Jersey Financial Services Commission that no Jersey residents receive any benefits from its activities and to pay an annual £600 exemption company charge. Unless it carries out a trade through an established place of business in the Island, such a company is not only exempt of income tax, but it also does not have to submit tax returns and file the accounts.<sup>184</sup> The effect of this legislation is that the company can function (i.e. contracts can be concluded) in the Island without any tax being levied, unless the undertaking actually processes and sells goods in Jersey, in which case normal income tax apply. Such provision stimulates incorporation of non-resident companies in Jersey jurisdiction.

Another form of preferential regime within this Offshore jurisdiction is International Business Company.<sup>185</sup> For such a company, tax exemption is provided on profits arising from its international business. The rate is flexible and depends on the actual income, ranging from 2% on income up to £3 million to 0.5% on earnings over £10 million. Even though this is not, strictly speaking, a totally tax-free income, the rate is more than just preferential. This provision brings Jersey under a classical International Offshore Financial Centre category, where the larger the capital turnover is, the bigger profits could be earned. The same as in other offshore jurisdictions studied, this abnormally low rate only applies to profits gained from doing business abroad, as the national profits are taxed at 30%.

It is also worth noting that the term “international business” for these purposes is interpreted very widely. For example, even the interest earned on Jersey bank deposits would be treated as an international business. Conditions for qualifying for these

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<sup>183</sup> Jersey Tax Law, Art. 123

<sup>184</sup> *n* 153, Binders 1-3, JER 22, 24

<sup>185</sup> Regulated by Jersey Tax Law, Art 123 (b)

concessions are quite similar to exempt companies in other jurisdictions, i.e. no resident of Jersey should have interest in the company. The company should have also been nothing but an IBC within the year prior to assessment. And it should pay in advance a fixed tax amount of £1200. In granting the exempt status the government is trying to be as transparent as possible. Thus, to ensure that the decision of the Comptroller on granting an IBC status is not discretionary and corrupt, there is a Commission of Appeal, where the company can complain within 30 days should the status be unlawfully refused.

The third type of companies eligible for the similar range of preferences as exempt or IBC is foreign incorporated investment companies. Such a company cannot internally trade at all and should be beneficiary owned outside of the Island.

Analyzing the above, one should admit that preferential regime of doing business in Jersey has many common features with other discussed above "Tax Haven" jurisdictions. This includes the range of companies to be created, low tax on foreign business, simple and cheap incorporation. However, some distinguishing features, specific to this jurisdiction, make it stand out among other similar offshores, namely the decreasing tax rate in accordance with the gained profit and perfectly developed banking system. In addition to legislative stability, predictable political and economic situation and well organized legal regulation of the preferential business regime, all these made Jersey one of the most successful International Offshore Financial Centres.

Summarising, this section looked at some preferential business regimes in the form of International Offshore Financial Centres offered by the British Overseas Territories and Crown Dependencies and identified both positive and negative elements of its legal regulation, affecting the sustainability of the Zones. And even though each "Tax Haven" has its own noted specific advantages, the general features (impacting the success of the Zones) are summarized below. With proper modification these should be taken into account when creating a Regulatory Free Zone Model for our target jurisdictions.

1. Economic and political stability of the region, complimented by legal certainty and regulatory transparency;
2. Well-structured, objectives-tailored preferential business regime, offering significant concessions in tax and non-tax payment to certain non-resident undertakings engaged in business abroad (exempt companies, IBC);
3. Creation and management of such undertakings to be maximally simplified: this includes, but is not limited to, fast and easy registration, minimum authorised

capital, low-cost operation, simple or no accounts holding, possibility of management from abroad.

4. The host jurisdiction is to have a well developed infrastructure, including banking and communication systems. However, in lieu of measures combating money laundering and harmful tax competitions, banking sphere regulations should comply with the OECD rules.<sup>186</sup>
5. Host countries should exploit other available opportunities and unique features, such as location, tourism or a special relationship with the European Union or consider providing other unique business advantages (such as cell companies).
6. Licensing and other control mechanisms (i.e. registered directors, minimum share capital, notifications, etc.) should be used restrictively and only when absolutely necessary.

### **3.3 European Countries Implementing Favourable Tax Regime**

The above discussion focused on British Overseas Territories and Crown Dependencies as International Offshore Financial Centres. However, in and around Europe these small island jurisdictions are not the only countries implementing favourable tax regimes—many other European countries follow.

As discussed in Chapter 2, majority of European countries have undertaken the experiment of establishing the Free Zones on their territory. But some of the countries instead of (or in addition to) creating specific Free Zones, have chosen to implement a favourable or low tax regime on the whole territory. The list of such jurisdictions is extensive and includes, but is not limited to: Cyprus, Malta, Ireland, Switzerland, Netherlands, Liechtenstein and Luxembourg. The elements of success and sustainability of the regime in these countries differ from International Offshore Financial Centres and other Free Zones; thus this section specifically focuses on it.

The choice of the researched jurisdictions is not accidental. To draft a Regulatory Free Zone Model for CIS some low tax European jurisdictions had to be analyzed. But which countries to choose? All of them are diverse. The size differs significantly, with some being relatively large (Netherlands, Switzerland), others very small (Liechtenstein). Another distinguishing feature is the membership in the European Union, as all EU Member States follow the same custom and tax policy, affecting the preferential business regime they offer. Some of the above countries are long-term members of the European Union (Ireland, Netherlands, Liechtenstein and

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<sup>186</sup> To be discussed in Chapter 5

Luxembourg), some have recently acceded (Cyprus) and some traditionally prefer to remain outside the Union (Switzerland).

For a fuller understanding of various types of the regime, this section analyzes one long-term Member of the European Union (Ireland), one country, which has recently acceded the EU (Cyprus), and one which is neither a member nor planning to join (Switzerland).

How could these countries having a different status, situation and legal opportunities managed to create and preserve the low tax preferential business regime? What are its successful elements? How can those be utilized in the Sustainable Regulatory Free Zone Model? These issues are considered throughout the discussion below.

### **3.3.1 Ireland**

The Republic of Ireland, renowned for its low tax rates, is a full-scale member of the European Union, having joined the same year as the United Kingdom, 1973. Currently the country does not have exchange control and, unlike the UK, it also participates in the single currency agreement, being a part of the Euro zone.

Ireland was already referred to when discussing Free Zone “Shannon,” which pioneered this type of business environment. However, this section looks at a country-wide regulation of business regime, applicable to all undertakings, not just the Free Zones. Being an EU member, Ireland has to abide by the EU rules on doing business and common fiscal provisions. However, many businessmen still see Ireland as a low tax onshore jurisdiction, which can be as popular as many Offshore Zones.

Starting up a business and its operation in Ireland is not oversimplified and is being thoroughly controlled by the government. Individuals wishing to carry on business other than an employed person must obtain business permission from the Department of Justice and Law Reform. There are a number of restrictions to abide by, such as a minimum capital amount of approximately 380,000 Euro, which is to be set aside as a deposit and transferred to the state. However, as discussed in Chapter 2, the conditions of starting up a company in the Republic are still more favourable than generally in the region. To set up an Irish company, the investors must perform only 4 procedures: to file an application with a registrar, to find an office, to make a company seal and to register for taxes and employment. This takes around 19 days and costs around 3,100 Euro.<sup>187</sup>

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<sup>187</sup> further on this at <<http://www.formacompany.com/fees/ireland-company-formation-fees.html>> accessed 24.09.2008



Irish company formation rules are in line with the European Union and remain simple. Every company must also keep proper books of accounts ready for inspection and must file annual report. Taxation of individuals is moderate and varies depending on income and activity, maximum 48%. As in most of the Offshore Zones, non-Irish resident companies are liable for taxation only of Irish based sources of income<sup>188</sup>.

Compared to the researched International Offshore Financial Centres, where income tax is minimal and most other taxes (like capital gain or certain stamp duties) are not being levied at all, in Ireland one sees a significantly increased tax burden. Even though there are some exemptions available, as to withholding taxes (for example, for EU residents) and certain special tax regimes can also be applied to patent royalties, artistic earnings and some shipping activities, one might think that considering overall tax rates Ireland could hardly be classified as a "Tax Haven."

But, why is Ireland positively perceived by the investors and considered to be one of the most attractive world jurisdictions? There is a combination of reasons. First of all, the overall tax level in Ireland is still significantly lower than in most countries throughout Europe. Secondly, it is actively being complemented by a wide range of other complex incentives. Among those incentives one can name a vast number of double tax treaties; the country concluded over 40 with various countries, including CIS, Central and Eastern Europe. In cases, where there is no double tax treaty with the country, there are other special provisions in Irish Tax Acts which allow avoiding double taxation.

Nation-wide favourable business regime makes Irish Free Zones even more appealing to the investors. "Shannon" was already mentioned, being a Customs Free Zone it further guarantees a preferential tax rate of 10% to all resident companies. Plus, "Shannon" is not the only Free Zone in the Republic: a Free Port of Cork opened in 1989.<sup>189</sup>

Concluding, it is submitted that even though Ireland cannot be perceived as a classical "Tax Haven", its phenomenal popularity can be explained by a combination of factors, making the doing business regime attractive both, nation-wide and within the Free Zones. The considerable list of advantages includes (but not limited to) EU membership, overall low tax rate, other preferences for certain taxes and payments, extensive exemptions from rates, fast and easy incorporation, high number of double tax treaties, plus a variation of Free Zones within the country.

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<sup>188</sup> n 153, Binders 1-3, part II, 1991-2003, IRE10-12

<sup>189</sup> F Trampus, *Free Ports of the World* (E.U.T, Italy 1999) 45

### 3.3.2 Cyprus

The second European jurisdiction implementing a favourable tax regime to be discussed in this section is Cyprus, a Mediterranean Island, which became independent in 1960, but is still historically divided between Greece and Turkey. Cyprus is a relatively new European Union Member State, as it has joined the Union in 2004.

The special situation with Cyprus is that before the accession, the Island was a renowned International Offshore Financial Centre, offering all the related services to non-residents. After the accession the role of Cyprus as a "Tax Haven" has diminished, since now it has to conform to the EU legislation. Complying, the Cyprus government tried to keep a number of provisions attractive for foreign investors and did its best to modify the preferential regime in such a way for it not to directly contradict the principles of the Union and still remain attractive enough for existing investors not to relocate.

Development of the offshore business in Cyprus started in the 1970's and by the year 2000, more than 40, 000 offshore business entities were registered on the island. The essence of the preferential regime in Cyprus used to be a total tax relief for all companies, conducting business and gaining the revenue from abroad. And even though Cyprus did generally levy a corporate tax (20—25%) and a capital gains tax on worldwide profit of the corporations, 90% of income earned outside but remitted in Cyprus used to be exempt from such taxes.<sup>190</sup>

Personal income tax was varied between 0% and 40%. Non-residents are liable to capital gains tax only on disposals of property situated in Cyprus. Value Added Tax was introduced in Cyprus in mid 1992 (in due preparation for EU accession) and is imposed on provision of goods and services into the island. The initial rate was fairly low—only 10%, but has now increased to 15.0% to comply with the European regulations.<sup>191</sup>

The highlights of the existed preferential regime in Cyprus are summarised below. The legislation provided for the establishment of International Business Companies, which were the most widespread in the island. Numerous tax incentives gave them the opportunity to benefit from the special regimes and reduced taxation,<sup>192</sup> but after the accession the number of the available preferences remained low. Currently, to qualify for an IBC status, a company should achieve its objects outside Cyprus, plus all share capital is to be held by non-residents. Minimum capital for the creation of such a company varies from approximately £1,200 British Pounds, if the company does

<sup>190</sup> C Doggart, *Tax Havens and Their Users* (Economist Intelligence Unit, London 2002) 193

<sup>191</sup> n 153, Binders I-3part II, 1991-2003, CYR 22

<sup>192</sup> Exchange rates are taken from <http://finance.yahoo.com> accessed 15.11.2003

not intend to establish an office onshore, to approximately £12,000 British Pounds if a fully fledged office is to be established in Cyprus. Thus, the government seems to be keen to attract so-called 'virtual' companies, which do not establish an office on the Island, acting either through a representative or being managed distantly.

The number of preferences initially available for IBC was quite extensive and included: low tax on the net profit of 4.25%, lower taxation of employees (usually 50% of what is normal for locals, or even more if employees part of the time work outside the island), absence of exchange control regulations (IBC are exempted), possibility to import certain duty-free items (equipment, vehicles, etc), exemption from capital gain tax and social insurance contribution.<sup>193</sup>

However, since both the OECD and the EU have persistently objected to differential and "unfairly competitive" income tax rates offered to IBC, the government has committed itself to a programme of changes which had increased the tax rate applicable to offshore companies from 4.25% to 12% while the rate for onshore tax is reduced from 25% to 23%. This was achieved by 2006 and virtually nullified the Cyprus status as an offshore territory.<sup>194</sup>

Here one can clearly see the detrimental costs suffered by a country for becoming a member of the European Union. To comply, the government had to increase the tax burden and withdraw many preferences, which ultimately had a negative impact on further attraction of international businesses (and lead to re-location of some existing IBC). Certainly, the overall benefits from joining the Union cannot be disputed, and balancing, the government tried to retain at least some features of the past favourable regime. This experience is very valuable as it shows how a jurisdiction after losing its traditional preferences can still remain sustainable.

First of all, even the increased taxation in Cyprus is still lower than in many traditionally high tax countries, and the authorities are determined to keep it low. Second, following Ireland, the Cyprus government had already concluded an extensive number of double tax treaties (currently over 30). This includes not only countries of the European Union, but also countries with transition economy, from Eastern Europe, such as Belarus, Russia and Poland. The treaties provide for the different taxation rates with each country; for some the rates are higher, for some are very low, depending on the agreement with a particular state. Plus, the rules for the exchange of information between tax authorities are accordingly provided for.

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<sup>193</sup> n 153, Binders 1-3, part II, 1991-2003, CYR 41-42

<sup>194</sup> C Daggart, *Tax Havens and Their Users* (Economist Intelligence Unit, London 2002) 194

No doubt, that after accession to the EU, the ability of the Cyprus government to introduce favourable regimes for doing business became limited. But its experience shows that with careful regulation of the preferential regime, it is still possible to balance law obedience with attractive preferences.

### 3.3.3 Switzerland

The last low-tax jurisdiction looked at in this section is the only European country with direct democracy<sup>195</sup>—Switzerland. Historically Switzerland remains outside any wars and unions. This can be explained by the principle of armed neutrality, being observed from the 15<sup>th</sup> century, which guarantees the country's non-participation in any political alliance. Thus, Switzerland it is not a member to the EU. But this "isolation in the heart of Europe" has not proved to be an economic disadvantage.<sup>196</sup>

Similar to the Republic of Ireland, there is a combination of factors making Switzerland attractive for foreign investors, with low tax being the main one. The federal income tax rate varies between 0% and 11.5%, and profit tax rate for corporate bodies amounts only to 8.5%. Different associations and foundations, unlike corporations, are subject to even more preferential tax rate of 4.25%.<sup>197</sup> Thus, Switzerland can be considered if not a "Tax Haven," but a low tax country.

Imposition of a low tax may at first seem to be the major incentive for the investors. However, due to a three-tier tax system (i.e. taxes are being imposed on the federal level, by individual cantons and by the communities), the location within the country plays a very important role. Indeed, even though the federal taxes are the same, cantonal and municipal tax rates can vary dramatically between the cantons. Doggart notes that harmonization of cantonal and municipal taxes is still in progress (currently the tax burden varies between 14% and 30%). This effectively divides Switzerland into regions with less and more preferences.

Analyzing the Swiss tax system, one notes that it differs from a classical "Tax Haven," as most of the taxes, common to high-tax jurisdictions and usually absent in offshores, are still present in Switzerland. These include income, capital, and withholding taxes, land tax, inheritance and gift taxes and stamp duties. Federal VAT was introduced in 1995 and remains quite low, 7.5% and even lower for food, medicine,

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<sup>195</sup> All the population of some cantons in Switzerland instead of electing representatives into governmental structures still gather together once a year to decide on major political issues

<sup>196</sup> Switzerland was having the highest GDP in the year 2000.

<sup>197</sup> *n* 153, Binders 1-3, part III, 1991-2003, SWI 11-12

books and newspapers—2.3%.<sup>198</sup> What matters is that the overall tax burden imposed by the state is still lower than in the neighbouring countries.

In Chapter 2 the ease of doing business in respect to this jurisdiction was looked at. Some of the rankings (namely, starting up a business or protecting investors) are not impressive. So, what is the Swiss formula for attracting investors? Once again, there is a combination of features.

Tax exemptions are still widely used. All newly established companies can benefit from cantonal and communal tax exemption for a period of up to 10 years. When full exemption is not possible, partial exemption may apply. Virtually full tax exemption is also available for holding companies, depending on the investments, activity and business.

Permanent foreign companies (or companies having at least 20% shares of another company) can also receive the reduction of net profit tax. Long term financial investment companies (working in the sphere of holding and management) are totally exempt from profit tax on some incomes if the income from that activity comprises at least two-thirds and no other commercial activity is exercised.

Management companies, known as domiciliary or “base” companies, can benefit from tax reductions at the cantonal level, if they are not engaged in any commercial or financial activities or only do incidental business in Switzerland. The reduced taxation can apply for all foreign business, but the Swiss part of business is taxed normally.<sup>199</sup>

Simplified company formation is another incentive for the investors. However, Swiss company law, being codified, is characterized by the use of more restricted legal concepts than is typically found under the English common law. So-called adherence to a specific organizational form or type, allows only a limited number of different forms of companies and partnerships, as defined by the applicable portions of the civil code.<sup>200</sup> Registration can be done within 48 hours. Re-domiciliation is allowed by Swiss law, which makes it possible for the company to retain previous status from another country.

Flexible taxation, which is generally lower than in most of the high tax countries, in addition to easy incorporation is not the only attracting feature for foreign investors. The famous Swiss banking system plays its role. Even though recently due to anti-money laundering legislation, banking secrecy is not observed as strictly as it used to be, Swiss banks still manage at least one-third of the world funds. The concept of fiduciary accounts, where banks act as trustees for private clients' deposits, was also

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<sup>198</sup> B Spitz, *2000 International Tax Havens Guide* (Harcourt Professional Publishing, USA 1999) 647-648

<sup>199</sup> C Daggart, *Tax Havens and Their Users* (Economist Intelligence Unit, London 2002) 235

<sup>200</sup> B Becchio, et al, *Swiss Company Law* (2<sup>nd</sup> ed Kluwer Law International, London 1996) 7

practically invented by the Swiss. Strong financial institutions, present in Switzerland, are a typical element of a successful offshore jurisdiction. This unique combination of an on-shore regime and some offshore-like types of preferences indeed makes the country an innovator in offering a sustainable business regime. Some more consideration of the Swiss banking system in respect of bank secrecy and transparency of the regime will be done in Chapter 5.

The preferences, however, does not stop there. In addition to the above, Switzerland has more Free Ports and Free Zones within its territory than most countries in the world, as there are 19 established Free Zones. Goods may be warehoused in the Free Zones for an unlimited period without being subject to Swiss customs duties. Two biggest airports, Geneva and Zurich, also house Free Port areas.

Last, but not least, similar to Cyprus, Switzerland is also one of the leader-countries on the number of dual income tax treaties—over 50, which even includes Russia and Belarus. Once again, the treaties allow accounting for the tax paid in one of the countries. In the case of a conflict between the domestic law and treaties, the treaties prevail as a part of international law superior to the domestic one.

Considering the Swiss experience above, one notes a combination of successful elements of legal regulation of the preferential regime in that country, which can be further of help to us in drafting a Free Zone Model for CIS: variably low taxation, well developed banking systems and financial institutions, safety and secrecy of financial transactions, wide availability of Free Zones and Ports, well developed network of double-taxation agreements, political and economic stability, and finally, convenient geographical location in the centre of Europe.

In summary, this section analyzed the European Countries offering preferential regime of doing business: Ireland, Cyprus and Switzerland. These countries represent different groups in terms of the EU membership and provide for different incentives to foreign investors. During the analysis this research came across some similarities and difficulties. The following successful elements of the above jurisdictions' regime should be accounted in creating a Sustainable Regulatory Free Zone Mode for CIS:

1. Membership in the European Union, even though being very advantageous in terms of political and economic development, imposes certain restrictions in applying tax rates and granting tax exemptions, as common customs policy is to be observed.
2. European countries, unlike offshore territories, have to maintain higher tax rates. Thus, to attract foreign investors, a flexible combination of other preferences

and concessions should be secured—ranging from fast incorporation to efficient banking system.

3. Wise use of double taxation treaties and other instruments aimed at lowering taxation between the countries plays a positive role in attracting investors.
4. Political and economic stability and well developed financial and banking sector could compensate other minor disadvantages and restrictions of the regime.

Concluding the findings for Chapter 3, International Offshore Financial Centre as a Free Zone Model had been analyzed, drawing on the examples from the British Overseas Territories and Crown Dependencies. Considering the sustainable elements of the above preferential business regimes, the positive examples of its legal regulation have been outlined, which with proper modification will be accounted for in a proposed Regulatory Free Zone Model in Chapter 6. In addition, a selection of European countries implementing a favourable regime had been looked at and their formula of success was assessed. Before drafting the Model, in the following chapter the operation of Free Zones in CIS will be discussed.

## **Chapter 4. Development of Free Zones in the Commonwealth of Independent States**

### **4.1 Free Zones in Post-Soviet Countries**

#### **4.1.1 General Issues**

#### **4.1.2 Experience of the Russian Federation**

#### **4.1.3 Free Zones in Ukraine**

### **4.2 Establishment and Operation of Free Zones in Belarus**

#### **4.2.1 Goals, Objectives and Variety of Free Zones**

#### **4.2.2 Legal Regulation of the Preferential Business Regime**

### **4.3 Case Study on Free Economic Zone “Gomel-Raton”: SWOT Analysis**

After considering the essence, definition and types of Free Zones in Chapter 1, discussing various Zone Models operating in developed, developing and planned economies in Chapter 2, analyzing modeling a sustainable doing business regime and researching International Offshore Financial Centres as Free Zone Models (Chapter 3), this chapter focuses more specifically on the development of Free Zones in CIS, the target jurisdictions. This is one of the key sections of this research, as it helps to understand the specifics of the region, to consider how to adapt the borrowed or transplanted successful examples and features of legal regulation of the preferential business regime from developed economies into the Regulatory Free Zone Model for CIS developed in Chapter 6.

This Chapter focuses on the experience of Free Zones in CIS jurisdictions, namely Russia, Ukraine and Belarus—the countries which recently started to engage in Free Zone activities. Analyzing various problems of the emerging Zones in this region, special attention is paid to positive elements in its legal regulation. To enhance the understanding of the situation in the target region a case study on Free Economic Zone “Gomel-Raton,” is performed, in which the Strengths, Weaknesses, Opportunities and Threats specific to Free Zones in CIS will be outlined and discussed. This is done in a form of a general and legal SWOT analysis.



## **4.1. Free Zones in Post-Soviet Countries**

### **4.1.1 General Issues**

After the break up of the Soviet Union, 15 new countries appeared on the World Map. Each different in size, having diverse languages and culture, post-soviet republics have experienced one common thing—in the 1990's they all faced a severe economic crisis. Failure of the planned economy, lack of free market, political instability and uncertainty about the future lead to hyperinflation, decline in manufacturing and production, which resulted in sharp worsening of living conditions of the population and overall poverty. Experiencing severe economic decline but being inspired by the rise of democracy, the national governments of these countries started to restructure and reshape economic systems moving from the planned to market economy. This transition is not instant as one cannot rebuild the economy overnight: the shift takes years, sometimes even decades.

For one group of the post-soviet countries, which already became a part of the European Union (i.e. Latvia, Lithuania and Estonia), the transition went rather smoothly and did not take too long. For another group (including Russia, Ukraine, and Belarus) the transition period is far from being over and their economies are still highly transitional. This research, when mentioning the target jurisdictions, refers to the latter group of countries, members of CIS which are still in transition and have not become members of the European Union.

Here one should differentiate the term “post-soviet countries” with transitional economy from “post-socialist countries,” as each group of these states requires a different approach. Post-socialist countries of Central and Eastern Europe include Bulgaria, Czech Republic, Slovak Republic, Poland, Romania and Hungary. At the time of the USSR break down, the economy of these States was at a different level than of post-soviet countries (members of the USSR). Indeed, already from the 1970's, the countries of the Eastern Block were somewhat allowed to develop the private sector, to use new technologies and co-operate with the “Western Block,” attracting foreign investments even before the fall of the Berlin Wall. These countries also started to establish Free Zones much earlier than the former USSR: the first Free Zones appeared in ex-Yugoslavia and Hungary in the 1960's. That is why the transition of these countries went faster and smoother, and by now most of them have joined the European Union and their economy is no longer transitional.

On the contrary, Post-Soviet countries, being constrained by the Soviet Union, did not have such an opportunity, and only after the break up, many of them started to

establish Free Zones. For the Soviet Union itself, the idea of Free Economic Zones (which at that time were intended to be “Joint Venture Zones”) was quite an innovative one. It was only by the end of the 1980’s, that the Soviet government realized the necessity and benefits of creating Free Zones.<sup>201</sup> Even though the State policy concerning Free Zone establishment was finally adopted by the USSR Council of Ministers in the Decree #1405 of 2 December 1988,<sup>202</sup> the actual emergence of the Zones was halted by the breakup of the Soviet Union. Thus, each of the newly established independent post-Soviet states, facing serious economic breakdown, had to adopt its own related legislation and approach.

First among the Post-Soviet republics to adopt a special law “On Free Economic Zones” in 1990 was Kazakhstan. The initiative was supported by the Russian Federation, which in 1991 passed a number of legal acts on establishing Free Zones throughout the country, from Kaliningrad to Sakhalin. A year later in order to improve regional potential, attract foreign investments and new technologies, the Republic of Belarus created the first Free Economic Zone, FEZ “Brest”. Moldova joined the club in 1993, adopting a law on “Free Entrepreneurship Zones.” Ukraine, the largest CIS State after Russia, was, perhaps, the last in establishing Free Economic Zones; they started operation only in 2000.<sup>203</sup>

Quite aside from the slow start, the development of the Free Zones in post-soviet countries was also delayed by constantly changing and unstable economy, continuously being in the phase of a crisis. As summarized by Ushakov,<sup>204</sup> a prominent specialist in international economic relations, attempts to establish Free Zones by the former Soviet Union countries faced difficulties due to a combination of reasons:

- Incompatibility of Free Zone concept with existing mechanism of nation-wide economic relationships;
- Lack of resources, often financial, for creating the infrastructure in such Zones;
- Vast amount of technological issues, slowing down Free Zones’ creation;
- Very passive interest of potential investors, fearing the command economy and not having real mechanisms to engage in active business on the post-Soviet market.

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<sup>201</sup> Which is unsurprising, as by 1990s over 200 Free Zones were already in successful operation in other countries of the developing world

<sup>202</sup> Anon, *The Challenge of Free Economic Zones in Central and Eastern Europe* (United Nations, NY 1991) 2, 60

<sup>203</sup> Y Druzik, *Free Economic Zones in the System of World Economy* (RUA Inform, Minsk 2000) 163, 165

<sup>204</sup> D Ushakov, *Offshore Zones in Russia's Tax Payers' Practice* (Jurist, Moscow 2002) 82, 83

These are some, but far from all of the reasons, adversely affecting Free Zone development in the target region. Thus, every state while making a decision on Free Zone establishment should bear in mind the reasons for the earlier failures and try to avoid the same mistakes. Before focusing on the case of Belarus, the following section discusses the experience of the two biggest CIS countries, Russia and Ukraine, to see how their Free Economic Zones evolved. Special attention will be paid to both mistakes and successful elements in legal regulation.

#### **4.1.2 Experience of the Russian Federation**

As already mentioned, the Russian Federation started the process of Free Zone establishment just before the break up of the Soviet Union, in the late 1980's. At that time the country looked at the concept of Free Zones as an element of fostering the state's external policy and establishing economic ties with foreign partners. Even though, the actual creation of the Zones was halted by the collapse of the Soviet Union, soon afterwards it was resumed.

In the early 1990's overwhelming majority of Russian Free Economic Zones due to political chaos and lack of central control almost totally fallen out of the scope of the Federal authorities. At these transitional times the local authorities enjoyed nearly absolute power to introduce a preferential regime of doing business and grant tax preferences on the whole territory of the region, rather than limiting it to some geographical or economic borders.

A vacuum in legal regulation of Free Zones lead to uncontrolled and unjustified use of the preferential regime, which inevitably has not only let to incapacity of the regions to deal with most of the announced projects, but itself contributed to economic instability and loss of revenues, plus scaring off potential investors.

In 1993 the Russian Parliament managed to prepare a law on "Free Economic Zones", but it was never brought to life due to a coup and change of government. As a result, some regions, desperate for economic reforms, continued the experimental introduction of Free Zones. Few of the Zones appeared to be successful and, with certain modifications, survived to the present. One of such Zones was Free Economic Zone "Nakhodka."

Established in the Eastern part of Russia, a long distance from Moscow, "Nakhodka" offered a favorable regime of doing business for companies with foreign capital (minimum amount of 30%). The key features of the regime included exemption from the profit tax for the first 5 years of operation and provision of the duty and custom-free regime for the imported and exported goods. Running a Free Port and

benefiting from a favorable location not too far from Korea and Japan, “Nakhodka” appeared to be very attractive for foreign businesses, interested in expansion to Russia, which, with no doubt, had a significant investment potential.

Now “Nakhodka” remains one of the most successful Russian Free Zones, combining over 4000 enterprises, many of which are foreign companies from over 20 countries.<sup>205</sup> With time, the legal regulation of the Zone advanced and “Nakhodka,” from being a simple Free Export Zone, has grown and transformed into a big complex territory, containing within the borders several Custom Free and Export Production Zones, few Processing Zones and a Porto Franco.

In 1996, reaching some political stability, the Russian Federation has resumed its attempts of improving the situation with Free Zones. This has resulted in an adoption of a number of legal acts regulating Free Zone activities, headed by the Law on “Free Economic Zones.” The Law introduced the definition of a Free Zone, provided some background for its administration and the regime and reduced the territory of most of the already established Zones to a reasonable figure of a few square kilometers. In addition, an effective system of regional and federal control over Free Zones’ activities was set up and the limits of the preferential regime were clarified.<sup>206</sup> Up to date, 11 regions of the country, comprising 13% Russia’s population, have received Free Zone status.

Analyzing the mistakes in legal regulations of Free Zones, it has been submitted that to effectively control its regime, the host state needs to limit the application of the preferences to geographically constrained territories (i.e. a town, district, enterprise or an island) and not to provide for an extensive application of the preferences country-wide. The host state should be very careful about over sizing the Zone, as this can have a negative impact on its sustainability. To illustrate this point Free Economic Zone “Amber” in Kaliningrad is looked at.

Free Zone “Kaliningrad” started its operation in 1991, but due to insufficient legal regulation and political uncertainty faced difficulties during the first few years of its development. In the very beginning, in a move to increase attractiveness of the region, the government unwisely extended the application of preferential regime to the whole Kaliningrad territory. Such unwieldiness led to extensive violations of the regime by the market players, resulting in the abuse of Tax Free Status while exporting the most common high-duty goods—cigarettes and vodka. Throughout the years, the government, in failing to appropriately regulate the regime, kept granting and

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<sup>205</sup> <<http://fez.nakhodka.ru/index2.htm>> accessed 05.10.2004

<sup>206</sup> *n* 206, pp. 85-86

withholding it many times, before finally deciding to limit its application to strictly confined geographic region by creating a Special Economic Zone inside Kaliningrad. Only after such downsizing and confining of the regime, could the Free Zone in Kaliningrad finally start benefiting from the other favourable unique regional features.

First, its geographical location. Kaliningrad, situated on the Baltic Sea between Lithuania and Poland, does not have a common border with the Russian Federation and benefits from its special status of an isolated Russian territory, being completely surrounded by the European Union. Such a location, apart from creating severe problems for its residents commuting to the Russian mainland, has also raised an increased business interest from European investors. Second, Kaliningrad enjoys a well developed system of infrastructure and communications, including a big port in addition to its rich natural resources, as Kaliningrad is the world famous region for production and export of amber.

The new Federal Law on the FEZ "Kaliningrad" provided for a better regulated preferential regime of business operations, particularly providing for a Duty Free manufacturing regime and allowing Custom-Free export of goods produced in the region. The provision had a positive effect and by the year 2001 more than 1400 enterprises were registered within the Zone, including 164 undertakings with foreign capital.<sup>207</sup> Most of the current enterprises are engaged in manufacturing high-technology equipment, which is being exported to Russia and abroad.

The Kaliningrad experiment shows how inexperience and inability to provide appropriate government regulation of Free Zones could damage the investment image of a country during the transition period in post-Communist Russia. During this initiative the authorities approved the establishment of short-term Zones of Economic Preference, which later on were modified into International Offshore-type Business Centres. One such centres was created and then inevitably ceased to exist in Ingushetia, a troubled Republic on the south of Russian Federation.

In 1994 the Russian Government issued an order to establish a Zone of Economic Preference "Ingushetia."<sup>208</sup> Initially, the Zone was meant to function for just one year, allowing registering of maximum 15 000 enterprises and offering significant tax concessions, administrative preferences and favourable doing business regime. For the one year of functioning within the Zone, the residents were freed from most of the local taxes and given huge incentives from many federational ones (which later on was arguably treated as an excess of powers exercised by local authorities). After the term

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<sup>207</sup> V Lednik, 'Will There be a Second Window Into Europe?' (2003) 15 *Russian Federation Today* 8

<sup>208</sup> #370 from June 19, 1994

of the Zone expired, businesses already established there were meant to either pay normal taxes and custom duties or be free to relocate.

A sceptical commentator might think that such an extraordinary short term of Free Zone duration would be a scare off for investors, preventing any significant capital inflow into the regions. Indeed, a reasonable businessman would rather choose a preferential regime with more stability and a longer term of operation. However, due to an unprecedented amount of preferences and the fact that the companies, established in other regions of Russia, were allowed to create subsidiaries within the Zone (and conduct most of the financial operations via it, escaping from tax), ZEP "Ingushetia" appeared to be very popular.

Operation of the Zone, however, did not please the local authorities, as while granting extensive tax preferences, the local budget of the Republic of Ingushetia was suffering huge financial losses. These losses were not accordingly compensated by the Federal Centre due to insufficient legal regulation and unclear division of fiscal policies.

The lack of control contributed to overall dissatisfaction with the experiment. Thus, failure to establish the appropriate revenue originating method for tax purposes made it practically impossible for the tax officials to effectively supervise numerous subsidiaries registered within the Zone. Besides, most of the undertakings were created in "Ingushetia" virtually and solely for tax evasion purposes, continuing to carry out 99% of their activity in the regions where the company's head office was registered. As put by Dr. Ushakov, "a one year term might not be long enough for good investors to come, but it is more than enough to carry out tax frauds and money laundering."<sup>209</sup>

Indeed, weakness of the regulatory control and non-imposition of tax in FEZ "Ingushetia" lead to another problem: it prompted the vast establishment of "one day companies." Such undertakings were created for just one or two transactions, solely focusing on money laundering and unlawful minimization of taxes. After the transactions went through, the companies were smoothly liquidated and organizers disappeared.

At this stage it was probably a good idea to terminate the Ingushetia experiment. But the government went further and despite the negative results of the first, proceeded with the second part. In 1996 a Federal Law "On International Business Centre "Ingushetia,"<sup>210</sup> passed, establishing in Nazran, the capital of the Republic, an International Business Centre which offered an offshore-type preferential doing business regime.

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<sup>209</sup> n 206, p. 94

<sup>210</sup> Full text in Russian at <<http://www.ingushetiya.ru/legislation/6.html>> accessed 15.02.2005

The key distinguishing feature of the new Centre was that it, being an on-shore Free Zone, has offered an abnormally preferential regime compared to International Offshore Financial Centres of the island jurisdictions. The highlights of the regime were as follows: 3 day incorporation, low authorised capital (1500 USD), exemption from all Federal and Local taxes, low yearly fixed fee. The term of duration of the new Zone was advertised to 20 years. This sounded too good but for one catch: because of the recent troubles in ZEP "Ingushetia," the preferences were only available for non-resident undertakings, not engaged in any business in the Russian Federation.

Creation of International Business Centre "Ingushetia" has started a short era of the offshore-type Free Zones in Russia. A few more were created, namely "Kalmykia" and "Altai," both established by 2000, offering similar preferences. On a short term, despite the fears of the sceptics, the experience of Russian Offshore Zones appeared to be a positive one, as thousands of residents, by paying the fixed fee, were bringing into the budget up to 10 million US Dollars yearly. But in a long term, lacking sustainability and comprehensiveness in legal regulation, Russian Offshore Zones had no future: the recent modification of the taxation system within the country factually lead to its elimination.

Before 2001 the overall national profit tax rate (of 35%) was divided in the following way: 11% to go to Federal Budget, 19% to regional budget and 5% to local. Newly created Offshore Centres were allowed to exempt the residents from some or all of the applicable taxes. In offshore Kalmykia Region, for instance, by eliminating regional and local taxes, the profit tax rate was successfully reduced from 35% to 11%, which was highly beneficial for foreign investors. In other Zones, like "Ingushetia," all of the applicable taxes were eliminated.

In 2001 this system came to an end with the new edition of the Russian Tax Code, where overall profit tax rate was reduced from 35% to 24%. In addition to that, the Federal Government restricted local authorities from giving the tax breaks by setting up the limit of possible tax reduction to only 4%. This virtually nullified the existing preferential regimes and the special status of the above territories which had to discontinue the registration of new IBC and eventually ceased to exist. Such a governmental move, despite the previous reassurance of the Zones' duration for 20 years, had a negative effect on foreign investments and overall investment image of the country.<sup>211</sup>

From the above examples one sees how poor planning and inappropriate legal regulation of the preferential business regime can endanger the whole process of Free

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<sup>211</sup> O. Rustamova, 'How do we manage FEZ?' (2001) 4 October *Russian Economy: XXI century* 32

Zone establishment. Certainly, a country in transition, such as Russia, should not blindly follow the examples of successfully operating Free Zones and transplant their legislation, but needs to modify it accordingly to fit the local conditions.

Undoubtedly, the establishment of Free Zones in Russia will be continued, as one cannot rely forever on the income from the excessive oil prices. Having in mind the clear tendencies to systematize the legislation, resulting in further centralization and strengthened Federal control over the process of granting tax preferences, it is clear that nothing like the above offshore-type Free Zones are likely to appear again.

What Russia needs is to establish the types of Free Zones which are most capable of achieving the set objectives without destabilizing the local situation. These Free Zones should be carefully planned, well drafted and properly regulated. And the Proposed Regulatory Free Zone Model drafted in Chapter 6 is set to help.

#### **4.1.3 Free Zones in Ukraine**

Ukraine is the second CIS jurisdiction whose Free Zones experience is analyzed in this section. After gaining independence from the Soviet Union, Ukraine regarded Free Zones as an instrument to open up the national economy for the world market and to attract foreign investments. In 1992 the country adopted a law “On Basic Principles of Creation and Functioning of Special (Free) Economic Zones.”<sup>212</sup> The law provided the background for Free Zone establishment and liquidation, as well as specified the types of the Zones to be created. The list is being extensive and includes Custom Free Zones, Porto Franco, Free Export Zones, Transit Zones, Free Warehouses, Technological Parks, and many more.

The first operating Free Zones in Ukraine appeared relatively recently, in 1998. To date, 11 Free Economic Zones and 9 Regions with Special Investments Regime have been established throughout the country. Aside from number, Free Zones in Ukraine do not cover a large territory—altogether they occupy only 0.2% of the land. The Regions with Special Investment Regime are significantly larger and altogether occupy 10.5% of the whole territory.<sup>213</sup>

Ukraine is unique due to the wide range of Free Zone types established. The most common and developed are looked at: Free Export Zones, Porto Franco and Tourism and Recreation Zones, with paying special attention to their distinctive features and regulatory aspects, affecting overall Free Zones’ sustainability.

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<sup>212</sup> Law of Ukraine from 13.10.1992 #2673-XII

<sup>213</sup> Information on Ukrainian FEZ can be found at <<http://www.investments.com.ua/sez>> accessed 28.08.2008



The First specific feature is that most of the Ukrainian Free Zones only invite the investment projects of a certain amount which varies a lot among the Zones depending on location and status. Thus, Free Zones, located in less developed regions, such as Chernigiv, (situated next to the board with Belarus), grant residency to companies investing between 200,000 to 500,000 USD. Special regime in Chernigiv Free Zone mainly favours tax free import of raw materials and grants exemption from land tax and profit tax for the first 3 to 5 years from the moment of registration. Similar preferences are offered by other less developed Free Zones (such as “Yavorov” and “Krakovets” in Lvov region, West of Ukraine).

Free Zones in more industrially developed parts of the country, such as Kharkiv, set the minimum sum for investment at 500,000 USD. But they also offer more advanced preferential business regime, which grants a full exemption from taxes (VAT, profit tax, import duties) for up to 5 years. Similar conditions are offered by Free Zone “Mikolaiv”.

Local Free Zones are of a very diverse nature and typology. Due to the large number of sea ports in Ukraine, Free Ports, or Porto Franco, is a widespread type of Free Zones. They, however, offer rather a modest range of preferences. Port “Crimea”, for instance, only allows a reduction of fixed profit tax to 20% and is exempt from obligatory sale of foreign currency to the state. “Interport Kovel” offers similar concessions, plus total exemption from the State Innovation Fund fee. Slightly more attractive conditions are offered by “Porto Franco” in Odessa, which allows total exemption from profit tax for 3 years and grants a discounted rate for the subsequent 3 years.

Another special type of Free Zone, which is not often present in many CIS, but is quite popular in Ukraine—Tourism and Recreation Zones. These Zones, such as Special Economic Area of Tourism Recreation Type “Truskavets,”<sup>214</sup> are being established in popular areas with good climate conditions to develop tourism and recreation resorts. Favours projects investing from half a million USD, the Zones offer tax preferences and exemptions from import duty on any recreational establishment.

Many commentators believe Tourism Zones to be highly prospective and the coming few decades are likely to see a proliferation of this type of Free Zones throughout the developing world. Agreeing with Harrison that an ideal Tourism Zone should be a “safe haven, offering the convenience, cost savings and risk avoidance of

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<sup>214</sup> Information on Free Zone “Truskavets” <[http://www.truskavets.ukrpack.net/index\\_full.htm](http://www.truskavets.ukrpack.net/index_full.htm)> accessed 11.10.04

operating in an efficient, modern, well serviced, administratively transparent and bureaucracy-free environment.”<sup>215</sup> Apart from Ukraine, this model of a Free Zone has not been yet utilized much in CIS, but its popularity is growing.

Analyzing the specific features of the preferential business regime in Ukrainian Free Zones, in addition to the minimum capital and diversity in types, one cannot avoid some analysis of the various terms of Free Zones’ duration which are quite distinct across the country. For instance, Special Economic Zone “Donetsk” and Special Zone “Azov” in Mariupol are created for 60 years, whereas FEZ in Chernigiv, Kharkiv and Crimea—for 30 years. “Porto Franco” in Odessa promises the application of the preferential business regime for only 25 years, when “Interport Kovel” and Special Tourism Zone “Truskavets” are in operation for just 20 years. Such diversity in terms of operation could probably be explained by aims and objectives set by the local governments, which dictates the necessity to attract specific (long or short-term) projects.

The host country, however, should remember that the term of Free Zone duration is one of the main decisive issues for foreign investors. A greater term of Free Zone operation provides better security for a long-term investment project, thus establishment of the Zones for just 20 years may scare off the investors. The other side of the issue is that a short-life Free Zone can be viewed as an instrument to attract short term investment projects, which might pay off quickly. Besides, what is good is for a declared long term duration of the Zone, when there is no guarantee that the government will not change their policies, like previously happened in Russia?

It is submitted, that diverse terms of Free Zones operation throughout the country should not necessarily be considered a negative factor adversely affecting sustainability of the regime. As noted from the experience of the UK Enterprise Zones: as long as initially there is some legal certainty and clear information about the guaranteed duration, investors are accordingly prepared.

Another specific feature of the Ukrainian Free Zones is that it does not require all activities within the Free Zones to be export oriented. Normally, the countries setting up Free Zones try to encourage manufacturing and production of goods and services for export, restricting the import of goods produced in FEZ into the country’s market. For the Ukraine, this is clearly not the case,<sup>216</sup> as “the Concept of Special (Free) Economic

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<sup>215</sup> H Harrison, ‘Tourisme Zones’ (2004) 02 June *FDI Magazine*

<[http://www.fdimagazine.com/news/fullstory.php/aid/672/Tourism\\_zones.html](http://www.fdimagazine.com/news/fullstory.php/aid/672/Tourism_zones.html)> accessed 28.08.2008

<sup>216</sup> A Pikhno, ‘Special (free) Economic Zones of Ukraine: myths and reality, parts I, II and III’ (2004) September 16-23. <<http://www.investments.com.ua/media>> accessed 8.08.2008

Zone creation”<sup>217</sup> nominates the supply of high quality products into the local market to be one of the main aims of the Free Zones. Thus, the country definitely appears to encourage not only export-oriented activities, but also Free Zone manufacturing for the local market which can be negatively viewed by other domestic enterprises.

Finally, another new and promising type of Free Zones has started to develop in the Ukraine recently: technological parks, aiming to commercialize scientific and research centres (left out after the break up of the Soviet Union) and promote high-tech manufacturing. During the last few years 8 technological parks were created, such as “Monocrystals Institute” in Kharkiv, or “Paton Institute” in Kiev. One of the specific features of Ukrainian technological parks, noted by B. Paton, the President of National Academy of Science of Ukraine,<sup>218</sup> is that the preferential tax regime is established not for the whole Technological Park, but only for the specific innovation projects within the institutions, after they pass through appropriate governmental revision. Such a selective application of the regime provides better opportunities for the government to control investment projects and to encourage specifically targeted investments.

Summarising the key features of the Ukrainian Free Zones, one should praise the country’s efforts in effective setting up and introducing appropriate regulation of so many diverse functional Free Zone types, capable of meeting the needs of any investor. Indeed, during the few years which passed since the first Free Economic Zones began to operate, the government managed not only to offer carefully drafted legislative background for Free Zones’ functioning, providing for the whole spectrum of concessions and preferences (like those in well developed countries), but also to further experiment with Tourism Recreation Zones and Technological Parks, successfully attracting investments into specific fields of economy.

## **4.2 Establishment and Operation of Free Zones in Belarus**

Culminating the discussion of the positive and negative elements of Free Zones creation and operation in CIS, the Free Zone experience of one of the most problematic jurisdictions (both economically and politically) in nowadays transitional Europe—the Republic of Belarus examine in detail below. After providing an insight into the general issues regarding Free Zones creation and legal regulation of their preferential business

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<sup>217</sup> Decision of the Cabinet of Ministers of Ukraine from March 14, 1994

<sup>218</sup> B Paton, ‘Technoparks in Ukraine: Results, Problems, Future Perspectives’ (2004) October 4. Available at <<http://www.investments.com.ua>> accessed 28.08.2008

regime, a case study on Belarusian Free Economic Zone "Gomel-Raton," has been conducted, summarizing the findings and ideas in the general and legal SWOT analysis.

Belarus, a relatively small country with a population of about 10 million, is situated in the centre of Europe and surrounded by Russia, Poland, Lithuania, Latvia and Ukraine. Before gaining its independence from the Soviet Union in 1991, the Republic of Belarus, often called "an assembly shop of the USSR" or an industrial "colony,"<sup>219</sup> mostly imported raw materials (especially fuel—oil and gas) from the Soviet Union and exported manufactured—TV sets, lorries, tractors, refrigerators, clothes and textiles. In addition to that Belarus had a developed agriculture, mainly growing vegetables and grains.

After the break-up of the Soviet Union, the traditional ties of Belarusian economy with the neighbouring regions were broken and the country faced an economic decline. Despite all attempts, the country did not manage to overcome the crisis in a short period of time, and the economy still remains deeply in transition, being stuck somewhere between planned regime to market. During the first few years of independence, most of the state enterprises appeared on the edge of bankruptcy; the cost of produced goods was rising due to high fuel cost and old technologies, which together reduced competitiveness of exported goods. The situation was worsened by hyper-inflation, with the rate in some years well exceeding 100%.

In addition to economic instability, the country was not very fortunate politically, as the first and so far the only 'elected' President (blamed by the international community for Human Rights violations and running a dictatorship in the country), instead of urgent reforms, favoured a regression to the social state and planned "quasi-market" economy. Choosing Russia as its main economic partner, Belarus did not fully open the economy for foreign investors and is facing continuous economic recession.

It is hard to briefly summarize all the reasons for Belarusian economic and investments crisis, as these are rather complex and complicated. Even though one of the major Belarusian problems appears to be the overall economic and political condition, triggered by the country's inability to smoothly shift from planned resource distribution into alternative sources of capitalisation,<sup>220</sup> the commentators note a combination of factors adversely affecting the inflow of investments:

- government over-regulation of economy
- insufficient protection of private property;

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<sup>219</sup> US Library of Congress, available at <<http://countrystudies.us/belarus/26.htm>> accessed 28.08.2008

<sup>220</sup> A Shpack, *Investment Activity in Agricultural Production* (Armita, Minsk 1998) 6

- high inflation, making long-term investment projects vulnerable;
- limited privatization and uncertainty about its results;
- over-taxation of profits;
- high credit rates and underdeveloped banking;
- failure of the amortization system, which resulted in inability of enterprises to purchase new technologies.<sup>221</sup>

Other influencing factors include an effective banking system, developed industrial infrastructure, communications and transport system.

In order to revive the investment process, in the beginning of the 1990's Belarusian government adopted a package of documents regulating foreign and domestic investments, later on directed by the Investment Code, passed in 2001.<sup>222</sup> But long before that the country had to consider the establishment of Free Zones as a tool to fight economic crisis and to attract foreign investments. In the following section, with the help of a case study on Free Economic Zone "Gomel-Raton," the experience of Free Zones in Belarus is looked at, specifically focusing on the reasons for low-performance. Such study helps to draft a Regulatory Free Zone Model in Chapter 6, which will be adapted to changeable conditions of a transitional economy. But first this research reviews the variety of Free Zones established within the country and its goals and objectives.

#### 4.2.1 Goals, Objectives and Variety of Free Zones

As already mentioned in the section on modelling a sustainable doing business regime in Chapter 2, every country establishing Free Zones has its own reasons, varied according to the country's needs. Analyzing the actual reasons for Free Zones establishment, one can note that the aims set up by host states can be quite distinct. Some nations try to solve regional economy problems, or unemployment or to improve socio-economic development. In other countries Free Zones are used to acquire and spread the leading experience of already developed regions in doing business and attracting high technologies. However, most often there is a combination of goals. In CIS, establishment of Free Zones usually aims to liberalize the business regime, enhance export oriented business activities and attract foreign investors.

Some of the researchers<sup>223</sup> suggest grouping the aims of Free Zones creation into three blocks. Economic goals, targeted at strengthening domestic economy, would

<sup>221</sup> B Gusakov, *Economic effectiveness of investment* (Minsk, Belarus 1998) 23

<sup>222</sup> 'Investment Code of Belarus' 62 *Belarus National Register of Legal Acts* 22.06.2001

<sup>223</sup> S Shuleiko, *Institutional Factors in the System of Foreign Investments of National Economy (Conceptual Analysis)* (Gomel, Belarus 2001) 49, 50

usually include attracting foreign and national investments, enhancing import-substitute manufacturing and export-oriented activities, thus increasing Gross Domestic Product. Social goals, would include targeting improvement of living conditions of the local population, reducing unemployment rate, creating new work places, and raising social payments. Technical-scientific goals would include attracting new technologies, innovative methods of doing business, and increasing competitiveness of local enterprises.

The above classification, being rather general, does not fully cover the set aims and goals specific to Free Zones in CIS. Byk outlines six aims particular to Free Zone establishment in Belarus, which are considered common to most target jurisdictions.<sup>224</sup> These include the following:

1. Activization of export-oriented activities, such as manufacturing goods for export and enhancing scientific and technical exchange.
2. Development of import substituting manufacturing. For transitional countries it is common to struggle in importing foreign goods due to the lack of international convertible currency (for Belarus, in the early transition period, such currency was the US dollar, but now it is also supplemented by the Euro).
3. Effective utilization of local resources. Many countries in transition have certain local resources, like well developed processing facilities (ready to use factories and plants), highly trained personnel and well-educated specialists or fully developed communications and transport network (such as ports or airports), which could be effectively incorporated into the work of the Free Zone.
4. Importing the innovative methods of doing business. By attracting foreign capital, the countries in transition also hope that investors would bring in the advanced business methods from the well developed countries, which would not only modernize existing technologies, but introduce know-how and some other forms of business which were not previously known by the host country. The example of that might be the establishment of a bank which besides traditional banking operations would introduce new services, like factoring.
5. Supporting economic development of local territories and gaining profit. Without hesitating we can conclude that countries establishing Free Zones in our target area hope to increase revenue and taxes. At first this may seem to be a paradox, as by lowering the taxation (what preferential regimes are all about) one would expect a decrease in overall collected taxes. However, in fact, the

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<sup>224</sup> n 21, p.25

introduction of well drafted preferential business regime produces an opposite result, as some tax exemptions for the residents are well substituted by an increased number of the taxpayers.

6. Reduction of unemployment and creation of new work places.

All the above points, even though being non-exhaustive, correctly depict the aims and objectives of Free Zones in transitional economies. Besides, these objectives to some extent also correlate with other researched jurisdictions setting up Free Zones.

The process of establishment of Free Zones in Belarus started in 1996 with the Presidential Decree #114 from 20 March 1996 "On Establishment of Free Economic Zones in Belarus."<sup>225</sup> In the Decree the President officially proclaimed the main aims of Free Zone establishment in Belarus to be as follows: fostering the favourable conditions for economic development of the country, attracting foreign investments, creating new work places, further enhancing the scientific and technical progress and developing trade with other countries.

This Decree was the first and very basic document about Free Zone establishment and its provisions were further developed in the "Concept of Free Zone Organization in Belarus."<sup>226</sup> The document further expands the aims of Free Zone to integrate the country into the world economic system (after the break up of the Soviet Union), utilizing the favourable geographic locations in the centre of Europe on the crossroads between East and West and achieving certain specific targets for the Belarusian economy, such as extensive development of manufacturing, improving qualification of workers and coping with insufficient amount of natural resources.

Before proceeding to the discussion on the preferential business regime offered by the Belarusian Free Zones, and the subsequent case study, this research provides a brief summary of the variety of Free Zones, already in operation within the country. Located throughout the country and occupying significant geographic territories, the Zones are not all equally developed.

Currently there are six Free Economic Zones established in Belarus: "Brest" (1997), "Minsk" and "Gomel-Raton" (both in 1998), "Vitebsk" (1999), "Grodno-invest" (2002), and Free Zone "Mogiliov" (2002). However, to date, only the first three of them were established long enough to start full scale operating.

The first officially established Free Economic Zone in Belarus—FEZ "Brest"—was created in 1996 in the Western part of Belarus, right near the Polish border.<sup>227</sup>

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<sup>225</sup> Decrees of the President of the Republic of Belarus and Decisions of Cabinet of Ministers of Belarus, #9 1996, art.225

<sup>226</sup> Belarus Cabinet of Ministers Decision from 23 October 1997 #1415

<sup>227</sup> *On Establishment of FEZ "Brest"* Presidential Decree #114, 20.03.1996

Belarusian researcher Druzik, describing FEZ “Brest,” compares it with one of the first and leading Free Zones of the post-war Europe—“Shannon.”<sup>228</sup> Like this Irish Free Zone, “Brest” also greatly benefits from its favourable location on a cross roads connecting Poland and the European Union with Russia via Belarus. The government has hoped that this unique location would instantly make the Zone a success, facilitating the attraction of foreign investors for the whole country.

However, Free Zone “Brest” being the first too early try of Free Economic Zone establishment in Belarus (established two years prior to the Law “On Free Economic Zones” was passed in 1998), suffered from vague and imperfect regulation of the preferential business regime. Initially there was a lot of confusion regarding the extent and operation of the regime, especially regarding the duty and tax-free provisions and guarantees of legislative stability. In time, however, the legal regulation of its preferential business regime was brought in line with the nation-wide policy.

Setting up the main goals of regional economic development, attracting foreign investments, new technologies and competitive manufacturing, Free Zone “Brest” targeted creating pharmaceutical, electronic, food, furniture and other industrial enterprises. Aside from the slow start, FEZ “Brest” has attracted over 100 residents, the majority of whom (74) were foreign investors. And even though the extent of preferences offered by the Zone to foreign investors is strictly limited by the state (and thus can be described as quite modest), the government is obviously counting on the favourable geographic location of the Zone to become one of the major decisive factors for foreign investors.

Free Economic Zone “Minsk” and Free Zone “Gomel-Raton” were both established at the same time, by Presidential Decree from 2 March 1998 #93. “Minsk” was created in the capital of the country on a number of isolated territories around the city. Being a Complex Zone by its type, Free Zone “Minsk”, similar to other Belarusian Free Economic Zones, is heavily focusing on export manufacturing, thus granting the specific preferences to companies aiming over 80% of the production for export.

Currently, together with FEZ “Brest”, “Minsk” can be considered the most successful operating Free Economic Zone of the country.<sup>229</sup> Up to date the Zone has accepted over 100 residents, many with foreign capital. Among the foreign investors the leading role is given to the UK (over 20% of total foreign capital).<sup>230</sup>

As Free Zone “Minsk” is situated far from the country’s borders, it could hardly benefit from the location factor to the same extent as “Brest”. However, the status of

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<sup>228</sup> n 33, pp.186-187

<sup>229</sup> I Baranouski, ‘Free Zones are Looking at the EU’ (2003) *Zviazda*, October 2, p.3

<sup>230</sup> More information at <<http://www.fezminsk.by/cgi-bin/fz.pl?R=adg>> accessed 28.08.2008



Minsk as a capital city and its size (three times more than the second biggest city in the country, Gomel) as well as the availability of developed industrial areas, infrastructure and highly skilled professionals and scientists constitutes the main advantages, not at hand in other Free Zones.

Belarusian government is willing to further experiment and widen the scope of Free Zones in Minsk and nearby regions. Not only the first Tourism and Recreation Zone is about to be established there, but the President recently ordered the officials to develop a unique “Belarusian Silicon Valley”—Science and high technology park like those in the UK, which would unite programmers, computer and software specialists. Targeted at computer and software production, as well as introduction of innovative technology, the Zone is hoped, according to President Assistant Valery Tsepkalo, to attract sufficient foreign resources without serious governmental investments. The State in this case would only provide for special preferential regime in terms of tax concessions to the investors, and the latter would be responsible for the factual product creation.<sup>231</sup>

The third Free Economic Zone, “Gomel-Raton” was created in the South-East of Belarus, on the border with Russia and Ukraine. Being set up in a well developed industrial region (Gomel has many factories) and benefiting from the favourable geographical location FEZ “Gomel-Raton” is rapidly developing. Successes and failures of this Zone as an example of all Belarusian Free Zones will be discussed in the case study in the concluding part of this Chapter in the SWOT analysis.

Free Economic Zone “Vitebsk” was created in 1999<sup>232</sup> in the North of the country, near the border with Russia. Set to target common to all Belarusian regions problem of scarce natural resources and utilize the availability of barely used manufacturing and technologic facilities and highly skilled personal, Free Zone “Vitebsk” claims to specialize on export manufacturing of textile and food products. One of the major current concerns for the administration, however, is to find the markets for exporting of goods produced and further development of the Zone, which still does not operate in full capacity and could benefit from an improved legal regulation of the regime.<sup>233</sup>

The last remaining two Belarusian Free Economic Zones, “Mogilev” and “Grodno-Invest” have been set up very recently, in 2002, and there are not many indicators to assess. Free Zone “Mogilev” managed to register just over a dozen

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<sup>231</sup> ‘Silicon Valley’ in Belarus would be established by investors’ (2004) *Interfax* 11.11.2004. available at <<http://www.charter97.org/bel/news/2004/11/11/dolina>> accessed 28.08.2008

<sup>232</sup> *On Establishment of FEZ “Vitebsk.”* 1999, Presidential Decree #458, 04.08.1999.

<sup>233</sup> E Gurko, ‘Main Features of Export Trade Development in Free Economic Zone “Vitebsk”’ (2002) First International conference “Transfer of Technologies in Free Economic Zones”, May 2002, Belarus, Gomel

residents, most of which are with foreign capital. This Complex Zone, focused on trading, attracting innovative technologies, custom-free manufacturing, is also clearly export oriented (98% of produced goods is being sold abroad).<sup>234</sup> Free Zone “Grodno-Invest,” being a Mixed Zone by the type, is situated near the border with Poland and specializes in manufacturing of high-tech products. The overwhelming majority of enterprises registered within the Zone is also with foreign investments. Benefiting mostly from its location, “Grodno-Invest” has a potential to further engage and enhance the trade between Belarus and members of the European Union.

Summarizing this short overview it is submitted that the situation in nearly all Belarusian Free Zones is rather similar:

- all of them have been recently set up, thus being relatively young and inexperienced;
- the Zones are targeting a complex combination of social and economic objectives, set up by the government;
- all of the Zones are export-oriented and encourage goods manufacturing;
- the Zones are heavily foreign-investor focused;
- preferential regime of doing business in all Zones (discussed in the section below) is mostly restrictive and limited;
- the residents of the Zones are over-regulated, thoroughly controlled and restricted by the national legislation and powerful administration.
- in addition to the preferential regime, the major general advantages of the Zones include:
  - location (bordering with the European Union and Russia);
  - infrastructure (well developed service and transport links);
  - availability of educated and skilled labour;

From the above discussion one can see that Belarusian government is actively trying to set up Free Zones, which, accordingly managed and regulated, could become a powerful tool in reviving the national economy. Having many common goals, objectives and other features the Zones have not yet become successful, mostly due to imperfect legal regulation of the preferential business regime, to be discussed below.

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<sup>234</sup> K Nadudik, V Kozlov, ‘FEZ “Mogilev” grows’ (2002) First International Conference “Transfer of Technologies in Free Economic Zones”, May 2002, Belarus, Gomel

#### 4.2.2 Legal Regulation of the Preferential Business Regime

Legal regulation of the preferential business regime in Belarusian Free Economic Zones is made through a number of legislative acts. The Zones are always established by an appropriate Decree of the President, often initiated by the Belarusian Government. The Decree is accompanied by the Decision of local authorities about the respectful Free Zone creation, plan of the territories and precise description of the borders of the Zone, as well as technical and economic grounds for its creation. The powers of Free Zone Administration are described in an appropriate Regulation for each of the Zones.

The list of the legal acts regulating Belarusian Free Zones in addition to already mentioned Presidential Decree, the Law "On Free Economic Zones" and the "Concept of Free Zone Organization in Belarus", includes the number of specific provisions addressed to the Zone. For example, Free Zone "Gomel-Raton" was created by the Presidential Decree "About Establishing Free Zones "Minsk" and "Gomel-Raton"<sup>235</sup> and everything about its creation and functioning is provided by the Decision of the Council of Ministers of Belarus "About FEZ "Gomel-Raton,""<sup>236</sup> as well as the laws establishing the preferential regime.

Any legal regulation of a Free Zone always starts with the definition. The official definition of Belarusian Free Economic Zone is provided in the Law "On Free Economic Zones": [Free Zone] is a part of the territory of the Republic of Belarus with exactly determined borders and a special legal treatment establishing more favourable than usual conditions of executing entrepreneurial and other economic activities.<sup>237</sup>

When comparing the above definition with the cumulative definition of a Free Zone, introduced in Chapter 1, one can see that even though the adopted Belarusian Law definition of a Free Zone is narrower than the cumulative one, it still contains the three major features: Free Zone is a part of the state's territory, having clearly determined borders and offering a conditional preferential doing business regime.

Another important feature of Free Zones is typology, i.e. types of the Zones established in the country. Chapter analysed different classifications and types, the most important of which being the classification, based on specialization and functions of a Free Zone.<sup>238</sup> Belarus legislation provides for a creation of a number of functional types of the Zones, such as Manufacture and Free Export Zones, High Technology and

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<sup>235</sup> Decree of the President of Belarus from 2 March 1998. Published in *Decrees of the President of the Republic of Belarus and Decisions of Cabinet of Ministers of Belarus* (Belarus, Minsk 1998), #7 1998, art.155

<sup>236</sup> Published in *7 Customs Law Review* (1998) 36, 47

<sup>237</sup> Art. 1

<sup>238</sup> Chapter 1.2.3

Innovation Zones, Complex Zones and even Tourism Recreation Zones. The government determines the exact type of the Zone according to local aims and objectives.

Considering specific features of Belarusian economic development and well established complex of big industrial enterprises retained from the Soviet Union era, Belarus Government seems to be more interested in creation of Complex Zones which combine preferential regimes for manufacturing and processing of goods aimed for export while attaining diverse social tasks, like regional development and combating unemployment.

Even though all six Free Zones established in Belarus can be considered Complex, there are expectations that other types of Free Zones may be established. For example, researchers from Mogiliov State Technological University suggest the synthesis of Free Zones with Technologic Parks as an important instrument of attracting foreign investments assumed in the nearest future.<sup>239</sup> Local authorities in Minsk are also preparing the establishment of a first Tourism and Recreation Zone near Nesvizh Lake, which would unite historical, cultural and ecological objects of Minsk and Grodno regions.<sup>240</sup>

Diverse specializations of Belarusian Free Zones does not mean that the residents are free to engage in any kind of activity they wish, as there are certain restrictions common to all Free Zones of the country. Article 7 of the law "On Free Economic Zones in Belarus" prohibits the following inside the Free Zones: any activities connected with provision of protection and defence of the state (including armament, ammunition and explosives); dealing with radioactive materials, drugs and narcotics; production of vodka and other alcoholic drinks (except wines and beer); production of tobacco, money and postal stamps; holding lotteries; preparation of TV and radio programs; treatment of patients and animals with dangerous diseases; and any activities dealing with foreign labour migration.

The government here is trying to prevent interference with the state security, manufacturing of high-taxed products (vodka and tobacco), which in Belarus are monopolized by the state. So far the residents in Free Zones are allowed to engage in any other kinds of business activities; when licensing is required (over 50 types of

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<sup>239</sup> V Kozlov, A Stefanin, 'Synthesizing technological parks and FEZ: strategy of economic development in Belarus' (2002) First International Conference "Transfer of Technologies in Free Economic Zones, May 2002, Belarus: Gomel.

<sup>240</sup> 'Tourism FEZ is to be established near Minsk' (2004) *Belarusian Telegraph Agency* 16 June Available at <<http://www.belta.by/engnews.nsf>> accessed 28.08.2008

activities, from banking, legal counselling, pharmaceutical to notary)<sup>241</sup>, the rules fully apply to enterprises in Free Economic Zones as well.

In addition to the governmental regulations, its say on the encouraged types of business activities within the Zone has its local administration, which is in charge of granting the residency. Registering an undertaking in Belarus is not a very simple procedure as it is.<sup>242</sup> Neither is it made easy within the Free Zone.

Theoretically, any foreign or local company can acquire residency in a Belarusian Free Zone, but in practice this right is subject to satisfying certain conditions: approval of the investment project by local authorities, amount and terms of investments and successfully satisfying the contest criteria on getting the residency in the Zone.

The general requirements for starting up a business in Belarus have been discussed in Chapter 2.4. For the specific requirements applicable to Free Zones it is submitted that even though the Belarusian government tried to simplify the registration procedure, it still remains quite complicated and painful, being similar to other CIS members. More on how the conditions of becoming a Free Zone resident may adversely affect the sustainability of the Zone will be further analyzed in the case study of FEZ "Gomel-Raton."

Next the general legal preferential doing regime business in Belarusian Free Zones is looked at: this comprises a combination of elements, such as regulations on taxation, customs, fiscal provisions, labour relations, property and land leasing rules.

According to the information, advertised by Free Zone Officials,<sup>243</sup> applicable preferential tax regime in Belarusian Free Zones allows residents to reduce the overall tax burden up to 40%. This is achieved due to a reduced rate of certain taxes (Value Added Tax and Profit Tax) and elimination of some other taxes (Real Estate Tax, deductions to the Republican Support Fund for Agricultural and Food Producers and Agricultural Science, as well as deductions to Road Maintenance Fund), and a reduction in some non-tax payments (Employment Promotion Fund, Land Rent).

Additional concessions apply on profit received from manufacturing activities or if it was re-invested nationally. Free Zone residents with more than 30% of foreign capital can also enjoy additional tax benefits (available nationwide for undertakings with foreign capital). Tax exemptions, however, do not cover trading activities of Free

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<sup>241</sup> 'On Licensing of Certain Activities' (2003) Decree of the President of Belarus #17, 14.07.2003.  
79 *National Registry of Legal Acts of the Republic of Belarus*, 1/4779

<sup>242</sup> Note the duration for company creation, discussed in Chapter 2.4

<sup>243</sup> <[http://www.gomelraton.com/russian\\_set/section\\_legislation/treatments.asp](http://www.gomelraton.com/russian_set/section_legislation/treatments.asp)> accessed 22.02.2004

Zone residents, such as retail trade or restaurant business, which suggests that the government would generally welcome export-oriented activities.

All Free Zones in Belarus have received a status of a Custom-free Zone. But unlike custom-free warehouses in Western Europe (for example, "Shannon," where goods can be stored free of customs for up to 3 years), Belarusian Free Zones are part of the national customs territory, so limited customs procedures do apply to all goods and products entering or leaving the Zone. Besides, if goods leave the territory of a Free Zone going into the inside market, all taxes, customs and duties are to be paid as normal.<sup>244</sup> Anything which concerns goods produced for export, can be exported free of quotas and limitations. Such provisions once again promote the export-oriented specialization of Belarusian Free Zones.

Application of fiscal provisions for Free Zone residents is mostly restricted nationwide. The country's official currency, the Belarusian Rouble, is somewhat not easily convertible; thus, other currencies are often used between the enterprises, namely the US Dollar, Euro and the Russian Rouble (non-cash transactions only). The government, being very protective, is trying to limit the circulation of foreign currencies and strictly regulates the currency exchange. Each Free Zone resident is allowed to open only one current and one special account in foreign currency. For ordinary Belarus residents it is illegal to open and keep bank accounts in foreign banks, unless an express permission is given by the National Bank. Opening of accounts in foreign banks for Free Zone residents (since they are also considered to be local residents) also requires a special license and is subject to permission.<sup>245</sup> This provision is viewed as a serious detriment by many foreign investors.

Another important restriction imposed by the government on fiscal transactions concerns transfer of funds from Belarus to Offshore Companies. According to national legislation, any resident, performing a transaction to a non-resident undertaking, registered in an Offshore Territory, is required to pay an "offshore duty", which equals 15% of the transferred funds.<sup>246</sup> This unpopular provision applies to all Free Zone residents except foreign subsidiaries; it severely limits the possibility of the investors to freely transfer their profits into their subsidiaries located in International Offshore Financial Centres.

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<sup>244</sup> 'On Free Economic Zones' (1998) Law of the Republic of Belarus #213-Z, 7.12.1998.

<sup>25</sup> *National Assembly of Belarus* 1999, p.428

<sup>245</sup> 'Regulation of Currency Transactions on FEZ Territories in Belarus' 05.05.1998; full text at: [http://www.gomelraton.com/russian\\_set/section\\_legislation/acts/fez\\_42.asp](http://www.gomelraton.com/russian_set/section_legislation/acts/fez_42.asp) accessed 22.02.2004

<sup>246</sup> 'On Offshore Duty' (2003). Presidential Decree #104, 12.03.2003. *Soviet Byelorussia*, 14.03.2003.

The list of such “offshore duty” territories is provided by Belarusian National Bank.<sup>247</sup> Initially, it contained 47 jurisdictions, including the British Overseas Territories and Crown Dependencies focused on in Chapter 3: Gibraltar, Isle of Man, British Virgin Islands, and Jersey, as well as Some European Countries implementing favourable tax regime, like Ireland (Dublin and Shannon), Luxembourg, Cyprus, Malta and certain Cantons of Switzerland. Recently, however, the National Bank reduced the number of such territories<sup>248</sup> and excluded Jersey, Isle of Man, Ireland, Cyprus, Malta, Luxembourg and all Cantons of Switzerland from the list.<sup>249</sup> This is a sign of both, liberalization of Belarusian regime and adherence of the excluded territories to the OECD regulatory principles on money laundering and tax evasion, discussed in Chapter five.

Labour regulations in respect to any staff employed in Free Economic Zones are to be on the same level as generally within the country. This criterion does include provisions on the minimum salary and all social benefits. For instance, directors of any legal entities, private or state, can be administratively and financially penalized for salary delays. The fact that such provision as timely payment of wages, which is absolutely common in the developed economies, in Belarus have to be regulated by special legislation, once again indicating the instability of the national economy.

Foreign workers employed in FEZ have the same minimum rights guaranteed to the nationals, as the labour law does not make any distinctions. Additional preferences are applicable here, such as simplified procedures for foreign specialists to enter the country and FEZ Administration to issue special passes allowing queue jumping at the border and faster clearance into the country.

Legal regulation of ownership, especially on immovables, is still being developed in Belarus. Property and land leasing regulations permits Free Zone residents to rent and buy properties within the Zone’s territory for offices and enterprises. Land, however, cannot be purchased for private ownership, but can be leased on a contract for up to 99 years.

Last, business administration within the Zones is not very much different than generally in the country. Unlike in many International Offshore Financial Centres, residents of Belarusian Free Zones are required to carry out proper accounting and file tax reporting on the same conditions as all other legal entities in the country. Plus, all

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<sup>247</sup> ‘Instruction on Submission by the Banks of Information on Certain Financial Operations: Attachment 1 to the Decision of the National Bank of the Republic of Belarus’ April 18, 2002 #75

<sup>248</sup> Decision of the National Bank of the Republic of Belarus on 28.01.2004 #3, included in the National Reestr of Legal Acts 11.02.2004

<sup>249</sup> The List of Offshore Territories, Recognized by the National Bank on 15.04.2004 Available at <<http://pravo2004.by.ru/new02/y2004/m01/d02k0953.shtm>> accessed 28.08.2008

residents are subject to more than regular inspections by the extensive number of governmental bodies, ranging from tax authorities to health and safety inspectors.

The picture of Belarusian preferential legal regime would not be complete without the discussion of the role of Free Zone Administration. As mentioned above, each FEZ in Belarus has an Administration created by the Council of Ministers. The Administration is a legal entity, chaired by a governmental official. In the best traditions of the Soviet laws, Free Zone Administration is granted many more rights and competencies than duties imposed,<sup>250</sup> which many investors see as a negative rather than positive addition to a Zone's preferential regime. The list below shows an extent of the Administration's powers:

- Take part and direct programs on economic and social development of the Zone;
- Propose legal acts, including laws on business organization and taxation within the Zone;
- Execute the State registration and liquidation of Free Zone residents;
- Evaluate the investment projects of local and foreign investors, organize competition process on the residency;
- Collect taxes and non-tax payments from the residents;
- Obtain statistical reporting data on residents' activities;
- Withdraw and provide land estates located within the borders of the Zone, lease it to residents and execute control over the use of such plots;
- Determine the lease rates (both land and buildings);
- Command the State property delivered, issue bonds and shares;
- Execute ecological control over residents' activities;
- Promote the Free Zone locally and abroad.

Among the very few official duties imposed on the Administration, the law provides for: compliance with legislative framework, providing assistance to different state bodies, promoting the development of the Zone and, probably, the most important declared duty—providing the residents with necessary assistance for performing their activities. Once again, the Administration is granted extensive powers, but very few responsibilities towards the residents, which adversely affects sustainability of Free Zones and their competitive advantage.

Concluding this section on legal regulation and preferential business regime of Free Zones in Belarus it is submitted that despite rather limited amount of preferences and over regulation by the state, the statistics show<sup>251</sup> the increased popularity of Free

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<sup>250</sup> 'On Free Economic Zones' the Law of the Republic of Belarus, Art. 12,

<sup>251</sup> 'Foreign Investors might be deprived from preferences' (2004) *Interfax*. Available at:



Zones, as more residents register annually. However, alarming is the number of FEZ residents, suffering an economic loss, which, according to different sources, could be as high as 25%.<sup>252</sup>

Considering the doing business regime offered by Belarusian FEZ being far from liberal or, indeed, preferential, unsurprising comes the fact that many residents try to abuse (or unjustifiably extend) it. The State Control Committee regularly inspecting the registered undertakings finds many violations, mostly related to unjustified use of the tax concessions and preferences by the residents inside the Zone and engaging into supply of tax free goods outside it. This has prompted the government to strictly link granting tax concessions and preferences to the actual export rate of the goods produced, preventing the inflow of such products into local markets, which distorts competition with national companies. The logical move in this situation would be to require the residents to pay full taxes, when they supply goods into the local market. But the obvious problem is a thorough control over this process.

Comparing the general features of legal regulation of Belarusian Free Zones with jurisdictions researched in Chapters 2 and 3, it is no surprise that Belarus and other CIS members lose out in international regulatory competition.

The Belarusian government may be working hard to develop and regulate the Zones. As per the Deputy Minister of Economics, Leonid Demidov, each year the state invests into Free Zones a sufficient amount of money which is mostly being spent on infrastructure development, improving the Zones' attractiveness, with the anticipation that every dollar invested internally will attract approximately 10 dollars of foreign capital.<sup>253</sup> However, the few positive elements introduced by the preferential business regime (such as reduced taxation or custom-free regime) may be well overtaken and diminished by the negative ones (such as overregulation of local economy, instability of the legal system and insufficient protection of private property).

Understanding that after decades of planned economy the transition to open market and sustainable legal regulation of doing business regime cannot happen instantly, our target jurisdictions need to enhance this transition process. And even though the mere fact of Free Zones' emergence indicates that such transition is already happening, more has to be done to make the regime transparent, efficient, and investor-friendly. There is no simple solution. But the proposed Regulatory Free Zone Model, developed in Chapter 6, is here to help.

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< <http://www.charter97.org/bel/news/2004/12/06/lgota> > accessed 28.08.2008

<sup>252</sup> L Demidov, 'Interview to BELTA' 26.04.2004. Available at: <[www.belta.by](http://www.belta.by)> accessed 28.08.2008

<sup>253</sup> *ibid*

The next sections focuses on a case study of Free Economic Zone “Gomel-Raton,” analyzing the Strengths, Weaknesses, Opportunities and Threats, helping to understand how to adjust the Model to the conditions of a transitional economy and what exactly should be done by the CIS countries to run sustainable Free Zones.

### **4.3 Case Study on Free Economic Zone “Gomel-Raton”: SWOT Analysis**

Free Economic Zone “Gomel-Raton” in this section is looked at as an overall example of not just Belarusian Free Zones but also Free Zones of other CIS states. Even though “Gomel-Raton” has some specific and distinguishing features, a lot in legal regulation and Zone modeling is common to a vast majority of Free Zones in the target region.

To better access the case study an analytical tool, commonly known as SWOT analysis, is applied. This is used in business law and management to analyze comparative advantages and disadvantages of companies and other legal entities.<sup>254</sup> This tool is particularly good in auditing an organization and its environment, allowing development of a plan that takes into consideration internal and external factors, maximizing the potential of its strengths and opportunities while minimizing the impact of its weaknesses and threats. SWOT analysis involves specifying the objective of the project (in present case, a sustainable running of a Free Zone) and identifying the internal and external factors that are favourable and unfavourable to achieve that objective.

During the SWOT analysis Free Zone “Gomel-Raton” is looked at from two perspectives: internal factors (such as Strengths and Weaknesses of the Zone) and external factors (Opportunities and Threats, affecting its sustainability). The analysis implies answering four questions:

1. What are the Strengths of the researched subject? This section outlines the strong elements of the Zone, which help to achieve its objectives.
2. What are the Weaknesses of the Zone, leading to uncompetitiveness and failure to succeed? Here the factors adversely affecting the sustainability of the Zone and its capability in reaching its set objectives are looked at.

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<sup>254</sup> More on SWOT see <<http://businessmajors.about.com/cs/casestudyhelp/a/SWOT.htm>> accessed 28.08.2008

3. What are the favorable Opportunities, which the Zone can utilize for future development? Mostly external conditions, likely to facilitate achievement of the objectives are included here.
4. What are potential Threats, which could harm the Zone and prevent it from reaching the target goal? The threats could either be internal, coming within the Zone itself, or, most likely, external, relevant to the conditions of the transitional economy in the target region.

There are numerous parameters on which the SWOT can be based. For the current case study it is appropriate to divide the analysis of FEZ “Gomel-Raton” into two sections, general and legal. General SWOT analysis of the Zone looks at the geographic location, political situation, general legislation, Free Zone’s territory and infrastructure, social and labor issues and ecology. This provides a general overview of weaknesses and strengths of “Gomel-Raton.”

The legal SWOT analysis focuses specifically on Free Zone’s Establishment, Administration, Registration as FEZ resident and legal regulation of the doing business regime, thus not only providing a lawyer’s insight to the regulational issues of Free Zones in the target region, but also giving valuable data to consider in drafting a Sustainable Regulatory Free Zone Model. This research concentrates more on the Legal SWOT results, rather than the general one, as this provides for the strong and weak aspects of Zone’s preferential business regime and helps us use the Strengths and Opportunities to reduce the Weaknesses and Threats for all Free Zones in countries with transitional economies.

As mentioned above, Free Economic Zone “Gomel-Raton,” created in Gomel, the second biggest town in the Republic of Belarus with a population slightly more than half a million inhabitants. It was also a second FEZ which came into existence in the country (after FEZ “Brest,” which as an experiment was started two years earlier):

The location of the Zone in Gomel, situated on the border with the Russian Federation and the Ukraine, was not an accidental choice. Gomel, traditionally a well-developed industrial region, still plays an important role in Belarus economy, producing combine harvesters, window glass, clothing, various agricultural products and having limited oil resources together with the refinery facilities. A well-developed infrastructure, including a major rail station and second largest airport in the country is also a significant advantage.

In the first section of the SWOT analysis, summarized in a table below, more general features of the Zone, representing its Strengths and Weaknesses and affecting Opportunities and Threats are outlined. For the assessment the following seven

categories, which are the most likely to affect sustainability of the Zone are analyzed. The outcome of the General SWOT analysis is as follows.

Geographic location of the Zone is certainly successfully chosen, as being a Border Zone, it can effectively attract investments from the neighboring countries, Ukraine and Russia. However, to strengthen its position, the Zone should not leave out potential investors from the West,<sup>255</sup> especially the neighboring European Union countries. Having another potential locational advantage, such as Opportunity of linking Russia with the European Union, Belarus does not utilize this fully, as many shipping companies avoid the country due to restrictive customs regulation and wide cases of commercial cargo confiscation. Absence of the seaport and sea access is definitely a Weakness, but is potentially compensated by effective use of the river routes.

Political and economic situation in the country always plays an important role for investors in making the relevant decisions, and yet, this is the criteria often the most difficult to access. From one side, Belarusian government is highly interested in attracting foreign investments<sup>256</sup> and stabilizing the economy, thus trying to portray a positive image.

From another side, due to the restrictiveness of the regime and economic over-regulation, the international perception of the country is often negative, which does not help in securing sustainability of the Zones. The will of the government to comply with the international standards of business is surely an Opportunity to explore, but instability of the regime remains a serious Threat.

Legal regulation of the preferential business regime is covered in more details in the legal section of the SWOT analysis, but a very brief mention here: traditionally a fairly restrictive jurisdiction, Belarus is doing well trying to thoroughly regulate all legal and other aspects of business life. However, the legislation is non-transparent and being complicated and confusing, cannot gain the trust of the investors. The legislator should try to utilize the Opportunity to modify the regime, but this could bring in the Threat and fear of uncertainty and unpredictable changes of preferential regime.<sup>257</sup>

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<sup>255</sup> V Lednik, 'Will There Be a Second Window Into Europe?' (2003) 15 *Russian Federation Today* 8

<sup>256</sup> S Shuleiko, *Institutional Factors in the System of Foreign Investments of National Economy (Conceptual Analysis)* (Gomel, Belarus 2001) 34, 36

<sup>257</sup> Abramchuk, S. *State Regulation of Free Economic Zones in the Republic of Belarus* (Publishing of S. Lavrov, Brest, 2001) 82

## General SWOT analysis of FEZ “Gomel-Raton”

	<b>Strengths</b>	<b>Weaknesses</b>	<b>Opportunities</b>	<b>Threats</b>
<b>Geo-graphic location</b>	<ul style="list-style-type: none"> <li>- located in the center of Europe, on crossroads between East and West</li> <li>- located in an industrially developed region</li> <li>- neighboring links with Russia and Ukraine</li> </ul>	<ul style="list-style-type: none"> <li>- no sea access, no ports</li> <li>- distant from western border, not in proximity with the EU</li> </ul>	<ul style="list-style-type: none"> <li>- direct transport route between Russia and Western Europe</li> <li>- major railroad junction</li> <li>- local airport</li> </ul>	<ul style="list-style-type: none"> <li>- far from the capital and country's centre</li> <li>- insufficient economic and political links with the EU</li> </ul>
<b>Political situation</b>	<ul style="list-style-type: none"> <li>- local government is interested in regional economic development and attraction investments</li> </ul>	<ul style="list-style-type: none"> <li>- negative international perception of Belarusian internal and external policies</li> </ul>	<ul style="list-style-type: none"> <li>- expansion of political will to further develop and better regulate Free Zones</li> </ul>	<ul style="list-style-type: none"> <li>- instability of the existing regime</li> <li>- escalation of the restrictive measures</li> </ul>
<b>Legislation</b>	<ul style="list-style-type: none"> <li>- FEZ activity is regulated by local and State legislation</li> <li>- FEZ residents enjoy preferential business regime and a number of tax preferences</li> </ul>	<ul style="list-style-type: none"> <li>- complicated and confusing legislation</li> <li>- no consistency and transparency</li> <li>- no investor's trust in the legislative safeguards</li> </ul>	<ul style="list-style-type: none"> <li>- the government can attempt to create/improve the favorable conditions for investors</li> <li>- more preferences to foreign investments</li> </ul>	<ul style="list-style-type: none"> <li>- recent communist past and fear of its return</li> <li>- insufficient amount of preferences for regulative competition</li> </ul>
<b>FEZ territory and infrastructure</b>	<ul style="list-style-type: none"> <li>- land spots available for organizing the manufacturing</li> <li>- well-developed infrastructure</li> <li>- easy access to: railroad, airport, river port</li> </ul>	<ul style="list-style-type: none"> <li>- physical limits of FEZ territory</li> <li>- poor condition of many transport routes and infrastructure</li> </ul>	<ul style="list-style-type: none"> <li>- possible expansion of FEZ territory within the Gomel region</li> <li>- relatively low cost of communication and transport</li> </ul>	<ul style="list-style-type: none"> <li>- financial burdens of FEZ expansion</li> <li>- costly infrastructure development, dependent on funding and investments</li> </ul>

	<b>Strengths</b>	<b>Weaknesses</b>	<b>Opportunities</b>	<b>Threats</b>
<b>Economic potential</b>	<ul style="list-style-type: none"> <li>- all major industries represented</li> <li>- manufacturing facilities at hand</li> <li>- high rated agricultural land</li> </ul>	<ul style="list-style-type: none"> <li>- insufficient natural resources</li> <li>- outdated technology, lack of innovation</li> <li>- high cost of production</li> <li>- low competitiveness of local products</li> </ul>	<ul style="list-style-type: none"> <li>- unique local resources for machinery and electromechanical industries</li> <li>- possible economic union with Russia</li> <li>- fast investment return</li> </ul>	<ul style="list-style-type: none"> <li>- low attractiveness of economy due to prolonged transition</li> <li>- lack of free market and over-regulation</li> <li>- scare for further stagnation and economic destabilization</li> </ul>
<b>Social and labor spheres</b>	<ul style="list-style-type: none"> <li>- availability of highly qualified, well-educated specialists</li> <li>- well-developed leisure and recreation facilities</li> <li>- strong social security and protection</li> </ul>	<ul style="list-style-type: none"> <li>- low income of workers</li> <li>- high migration of skilled labor abroad</li> <li>- insufficient medical and social care, low birth and high death rates</li> <li>- insufficient encouragement of small business development</li> </ul>	<ul style="list-style-type: none"> <li>- low cost of skilled labor, allowing fast and smooth operation start up</li> <li>- compact location of production complex</li> <li>- explore possibilities of FEZ integration into local economy</li> </ul>	<ul style="list-style-type: none"> <li>- weak link between market demand for vocational training and educational institutions</li> <li>- poor standards of vocational training</li> <li>- problems with recognition of professional qualifications and foreign labor employment</li> </ul>
<b>Ecology</b>	<ul style="list-style-type: none"> <li>- moderate climate</li> <li>- availability of forests and water reservoirs</li> </ul>	<ul style="list-style-type: none"> <li>- ecological constraints on manufacturing</li> <li>- emission control</li> <li>- radioactive pollution due to Chernobyl</li> </ul>	<ul style="list-style-type: none"> <li>- good incentives for tourism and recreation development</li> </ul>	<ul style="list-style-type: none"> <li>- ecological constraints on new manufacturing development</li> </ul>

FEZ territory and infrastructure is an overall positive feature, as the Zone is located in a well-developed region with good transport network. Potential Weakness is the current physical limits of the Zone, which can be easily dealt with by adding more territories and enterprises. The expansion certainly bears a Threat of extra governmental expenditures,<sup>258</sup> but these are compensated by the Opportunity to attract more investors and the availability of relatively low-cost labor and resources.

Other less vital elements include the economic potential, social and labor spheres and ecologic issues. Among the Strengths availability of highly qualified labor and reasonably good overall economic development of the country can be certainly outline. Lack of natural resources, over-protection of labor, migration of highly skilled workers abroad and ecologic problems concerning contamination of part of the land with radiation after the Chernobyl explosion come under Weaknesses. For existing but not fully used Opportunities one could outline possible economic union with Russia,<sup>259</sup> availability of low-cost labor and potential for tourism development within the country. Among the general Threats gross over-regulation of the economy, lack of open market and growing demand for “green” manufacturing are located.

Looking at the above general characteristics it is submitted, that “Gomel-Raton,” similar to other Belarusian Free Zones, is still growing and developing,<sup>260</sup> and factors like geographic location, political and economic situation of the country play a big role in success or failure of the Zones alike. The above discussed indicators give a vivid picture of the situation with Free Zones in the target region and the General SWOT analysis provides for an appropriate basis in developing a Sustainable Regulatory Free Zone Model for CIS.

To make this model complete, a Regulatory element is added—accounting for the legal regulation of its preferential business regime. This is best done by examining a specific Legal SWOT analysis of Free Zone “Gomel-Raton,” the main findings of which are summarized below. The legal aspect of the four elements of the preferential business regime, which influence sustainability of the Zone: Establishment, Administration, Registration as a resident and the actual Preferential doing business regime are considered.

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<sup>258</sup> O Rustamova, ‘How Do We Manage FEZ?’ (2001) 4 *Russian Economy: XXI century* 32

<sup>259</sup> A Shekhovtsev, M Shestakova, A Gromov, ‘Free Economic Zones: World Experience and Perspectives in Russia’ (2000) 10 *Economic Issues* 108

<sup>260</sup> Statistics online at <[www.gomelraton.com/news\\_arc.php](http://www.gomelraton.com/news_arc.php)> accessed 29.07.2007

## 1. Establishment of the Free Zone

As specified above, Free Zone “Gomel-Raton” was set up at the same time as Free Zone Minsk, in 1998, by the Decree of the President of Belarus.<sup>261</sup> Notably, the establishment of the Zone took place almost a year before the Law “On Free Economic Zones” itself was adopted.<sup>262</sup> While the Law supplied the general provisions about FEZ establishment, organization, regulation and functioning, the government has passed a number of special legal documents, regulating establishment and operation of each Belarusian Free Zones, including the one researched here. “Gomel-Raton” was created as a Complex Zone, incorporating Free Manufacturing, Export Production and Free Custom Zones, with the term of duration of 50 years.

Complex status of the Zone is important, as it gives investors the possibility to engage in various activities.<sup>263</sup> In practice, however, since Belarus mostly is interested in manufacturing goods for export and production of export substituting goods, these are the types of activities granted the most preferences. For instance, only manufacturers, which plan to provide at least 90% of the produced goods for export, will be considered for registration within the Zone.<sup>264</sup>

Another Strength of the Zone is a relatively long term of duration—50 years (compared with 30 years of Free Economic Zone “Minsk” or even shorter terms of Ukrainian Free Zones). This contributes to legal certainty and suggests that the Zone will not be terminated after few years of operation, which happened to most of the Russian Offshore territories. Moreover, by the decision of the government, the term of operation of “Gomel-Raton” could even be extended.<sup>265</sup>

Limited term of duration, however, could also represent a potential Threat, as still there are no guarantees that the Zone would not be terminated earlier. This fear is triggered by political and economic instability and high potential for change or even withdrawal of the preferential regime.

Among the obvious Weaknesses in the establishment is that early creation of the Zone resulted in the need to change and amend the already existing laws.<sup>266</sup> This

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<sup>261</sup> ‘About Establishing FEZ “Minsk and Gomel-Raton” (1998) Presidential Decree. 2.03.1998. *Legal Texts “Decrees of the President of the Republic of Belarus and Decisions of Cabinet of Ministers of Belarus”*, 7.1998. art.155.

<sup>262</sup> ‘On Free Economic Zones’ (1998). Law of the Republic of Belarus #213-Z, 7.12.1998. 25 *Publications of National Assembly of Belarus* 428

<sup>263</sup> M Proskura, *Special Economic Zones in Poland: a Unique Investment Opportunity* (Poland, Warsaw 2000) 44

<sup>264</sup> This requirement, however, is often waived

<sup>265</sup> A Lopatova, ‘Free Economic Zones: Positive and Negative Aspects of Development’ (2002) First International Conference “Transfer of Technologies in Free Economic Zones”, May (Gomel, Belarus)

<sup>266</sup> S Stuart, ‘Islands of Uncertainty’ (1996) November 22 *The Independent* 21



## Legal SWOT analysis of FEZ “Gomel-Raton”

	Strengths	Weaknesses	Opportunities	Threats
<b>FEZ establish-ment</b>	<ul style="list-style-type: none"> <li>- one of the first Zones established some experience</li> <li>- term of creation—50 years, can be prolonged</li> </ul>	<ul style="list-style-type: none"> <li>- slow start</li> <li>- early creation resulted in insufficient legal regulation</li> <li>- improvement went slow</li> </ul>	<ul style="list-style-type: none"> <li>- the Zone was established as a Complex Zone—combination of features</li> <li>- opportunity for further development and specialization</li> </ul>	<ul style="list-style-type: none"> <li>- the Zone can be terminated when 50 years is over or even before</li> <li>-change of political / economic situation, endangering stability of preferential regime</li> </ul>
<b>FEZ Administ-ration</b>	<ul style="list-style-type: none"> <li>-governmental body interested in successful FEZ functioning</li> <li>-broad competences in regulating FEZ activities and everyday life</li> </ul>	<ul style="list-style-type: none"> <li>- appointed by the State, Administration is short of professionals in the sphere of international economics and law</li> <li>- excessive powers lead to over-regulation of the regime</li> </ul>	<ul style="list-style-type: none"> <li>- having a lot of powers, Administration can somewhat shape the preferential business regime</li> <li>- Administration should include more specialists in Free Zones, plus representatives of the residents</li> </ul>	<ul style="list-style-type: none"> <li>-representing the State, FEZ Administration has a tool to intervene in activities of residents, which could be abused</li> <li>- as a key decision maker Administration is subject to corruption</li> </ul>
<b>Registrat-ion as FEZ resident</b>	<ul style="list-style-type: none"> <li>-Administration’s direct interest and necessary legal tools for registration of new residents</li> <li>- registration procedure ensures impossibility of establishing one-day and sham companies</li> </ul>	<ul style="list-style-type: none"> <li>-starting a business requires too many operations and takes too long</li> <li>- bureaucracy of the procedure and constantly changing requirements for registration</li> </ul>	<ul style="list-style-type: none"> <li>- introduction of “one window” registration policy</li> <li>- significant reduction of required operations and for the registration</li> <li>- making FEZ Administration responsible for contacts with all involved agencies</li> </ul>	<ul style="list-style-type: none"> <li>-possibility of money laundering, fraudulent companies and criminal activities with poor governmental control over incorporation</li> <li>- when registering many new residents the limit of available territory could be reached</li> </ul>

	<b>Strengths</b>	<b>Weaknesses</b>	<b>Opportunities</b>	<b>Threats</b>
<b>Preferential business regime</b>	<ul style="list-style-type: none"> <li>-overall tax payment in the Zone is 30% less than generally in the country</li> <li>- regime of Free Custom Zone is in force</li> <li>- the state guarantees protection against confiscation, nationalization and other forms of expropriation of property</li> <li>- investors are free to use or transfer profits abroad</li> </ul>	<ul style="list-style-type: none"> <li>- guaranteed by law immunity from changes of the preferential business regime (first 5 years of residency) is not enforced</li> <li>- Custom-Free regime applies only to goods produced for export and mostly applicable just to foreign companies;</li> <li>-mechanism of state protection is discredited by numerous cases of unfair property confiscation</li> <li>-all transactions to recognized offshore territories are subject to 15% tax</li> </ul>	<ul style="list-style-type: none"> <li>-potential to reduce the tax burden on Free Zone residents</li> <li>- Customs Office should be created within the Zone's territory to ease the declaration and paperwork procedure</li> <li>-guarantees to foreign investors have to be easily enforceable</li> </ul>	<ul style="list-style-type: none"> <li>- in conditions of transitional economy, the government might introduce new taxes and charges, applicable to Free Zone residents</li> <li>- high corruption of tax officials, resulting in goods confiscation even for minor discrepancies in accompanying documents;</li> <li>-possibility of withdrawal of the preferential regime prior to the end of declared duration</li> </ul>

produces a negative impact on legal certainty and stability of the regime, which affected overall sustainability of the Zone.

The above mentioned Complex structure of the Zone is an Opportunity for further development, as the government here can be flexible in attracting those types of activities the region needs the most. Flexibility of the approach will also secure sustainability in the process of stabilization of the transitional economy and adaptation to constantly changing market conditions.

## **2. Administration of the Free Zone**

The Administration of “Gomel-Raton” is a legal body with extensive competencies, set up by the state to manage and control the Zone. The Administration directly or indirectly influences all aspects of residential activities within the Zone and its impact on sustainability of the Zone is hard to underestimate. The powers, granted to Free Zone’s Administration are, indeed, very wide, ranging from: registration and liquidation of residents to carrying out tax and other fiscal collections, and even suggesting the changes for legal regulation of the Zone.<sup>267</sup> This is both a positive and negative feature, as on one hand the Administration should be trying to ensure successful operation of the Zone and stability of its regime and on another, it has a lot of potential for corruption and bureaucracy.

Among the Strengths one can also list the state status of the Administration. As a body set up and run by the State, the Administration of the Zone possesses of the full set of powers and competencies, and is capable of effective and efficient decision-making. This is exactly the institution which has to make sure the residents are welcome and at home in “Gomel-Raton.”<sup>268</sup> However, such a status could also mean a Threat, as while representing the state and exercising the extensive powers, FEZ Administration may not use those appropriately and intensively intervene with residential activities. Another possible Threat is that the Administration is subject to corruption and may use its powers inappropriately.

Among the Weaknesses it is noted that even though being appointed by the state, the Administration, often comprised of quite old-fashioned and conservative ex-governmental officials, lacks well-educated and experienced professionals, competent in the fields of international economics, investment management and law. Unprofessional officials slow down the development of the Zone<sup>269</sup> and contribute to the negative image, thus decreasing the Zone’s sustainability. In addition, even though possessing

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<sup>267</sup> ‘On Establishing the Administration of Free Economic Zone “Gomel-Raton” (1998) Decision of the Council of Ministers of Belarus #744, 15.05.1998

<sup>268</sup> *ibid.* n 21, p.55

<sup>269</sup> O Chmir, *Special (Free) Economic Zones and Territories of Prioritized Development (Scientific and Methodical Aspects)* (Shidnii vydavnychiy dim, Ukraine, 2001) 102, 103

the extensive competences, the Administration of the Free Zone is still subject to strict governmental control and cannot show too much initiative.

As an Opportunity, the state should consider instead of giving more controlling powers to the Administration, better providing it with a real tool in shaping preferential business regime and fostering the residents.

### **3. Registration as a Free Zone resident**

Regarding the investments into a particular jurisdiction, potential investors frequently choose a Free zone upon the ease of regulation.<sup>270</sup> Hardly any investor is willing to risk his money investing into a Free Zone if to start an actual business there it would take months. Normally Free Zones are known as leaders in facilitation of company formation, offering fast and efficient incorporation (in some International Offshore Financial Centres in just a day). Certainly, even though Free Zones in Belarus could never offer such an extreme speed in company formation, in CIS efficiency of registration has always been an issue for the Free Zones.

Not surprisingly, incorporation for FEZ residents in Belarus is synchronized with the nationwide regulations, which requires an extensive number of procedures and remains overly complicated, appearing as a serious Weakness. According to the "Doing Business Report", yearly prepared by the World Bank,<sup>271</sup> to start a business in Belarus, one needs to perform 16 operations which takes 69 days. Even though this figure has significantly improved with years, such a lengthy registration period within a Free Zone remains a serious disadvantage, imposing a negative image on the preferential regime, since time costs investors money and not everyone is ready to wait for so long.

As already mentioned above, to become a resident in "Gomel-Raton," one has to pass through a special competition and selection process, as the possibility of establishment within the Zone is granted on a competitive basis (which itself is rather strange having in mind the country's striving for foreign investments). To participate in the competition, an investor has to submit an investment project, which has to meet certain criteria, namely to provide for a minimum reserve capital of 10 000GBP, to secure the export of at least 90% of the goods produced, and to promise to bring in relatively new and modern technologies and equipment. Just to participate in the contest, one has to submit an extensive list of documents (which is another Weakness), pay a fee of about 200 GBP, and to wait for up to 30 days for the decision to be made. In "Gomel-Raton" certain industries are given the priority in registration as Free Zone residents, such as: machine building and metal processing, electronics, information

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<sup>270</sup> A Bogatyriov, *Investment Law* ( Russian Law, Moscow, 1992) 94, 95

<sup>271</sup> For more details look Chapter 2.4 on Modelling a sustainable doing business regime

technologies, construction, agriculture, ecology and light industries. But before the actual registration process can be started, the contest committee must approve the investment project and grant the residency right.

Assessing the Strengths of registration requirements, it is admitted that the powerful Administration of the Zone has a direct interest in facilitating the registration process to attract new residents, so it should be attempting to minimize the bureaucratic delay and cut the number of the procedures.

One of the helpful Opportunities here could be an introduction of so-called “one window registration,”<sup>272</sup> when the potential investor submits all the documents to a single agency (preferably run by the Administration and providing its services free of charge), and allows it to take care of all hassle with registration and all other legal procedures. The agency would then establish necessary contacts with all other interested institutions and bodies regarding the registration procedure, licensing, notary services, etc. Such procedure organized under the Administration’s umbrella would not just free the investors from all hassles of registration, but also eliminate corruption, such as bribery.

When easing up the registration and minimizing the requirements, one should not forget about the potential Threat of abusing the regime; if the government less strictly control the registration, this might give way to “one-day” bogus companies.<sup>273</sup> The risk of money laundering, tax evasion, criminal activities is always high in Free Zones; thus, one of the purposes of lengthy and complicated registration of residents is a thorough document check by the host jurisdiction to insure compliance with international standards, set by FATF and the OECD.<sup>274</sup> Plus, another possible Threat is over-population among the residents, as if the registration becomes overly easy, an excessive amount of companies would want to gain residency in a Free Zone which could lead to exhaustion of the territory.

Here it is not suggested for the host state to lose control over the registration. However, for a Free Zone to remain competitive and sustainable, the authorities should have to make the registration process as much hassle-free, fast and inexpensive as possible, which would incorporate reduction of bureaucracy and eliminate unnecessary paperwork.

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<sup>272</sup> S Shuleiko, *Institutional Factors in the System of Foreign Investments of National Economy (Conceptual Analysis)* (Gomel, Belarus, 2001) 114, 118.

<sup>273</sup> M Pieth, G Aiolfi, ‘The Private Sector Becomes Active: The Wolsberg Process’ (University of Basel, Switzerland 2002) Available at <<http://www.wolfsberg-principles.com/pdf/wolfsbergprocess.pdf>> accessed 28.08.2008

<sup>274</sup> More on this in Chapter 5

#### **4. Preferential regime of doing business**

Last, but, undoubtedly, the most important element of the Legal SWOT analysis of FEZ “Gomel-Raton” is the preferential regime of doing business, which includes taxation, customs regulations and guarantees to investors. The importance of this element is hard to underestimate, as often the actual preferences and concessions given in a Free Zone play the decisive role in making the investors undertake the risk of investing into a transitional economy.

Lower taxation of Free Zone residents is one of the major Strengths of the preferential business regime. The law provides for a number of incentives, such as lower Value Added Tax (10% instead of 20), income tax of 15%, and an exemption from real estate tax. Overall profit is also exempt from taxation for the first 5 years after the registration, and further locally re-invested profit is tax free. Administration of “Gomel-Raton” claims that by registering in the Zone companies could save up to 30% on payable taxes.<sup>275</sup>

In addition to the above, among the Strengths one could mention the application of Custom-Free regime for goods exported abroad, as enterprises with foreign capital do not need to obtain any permissions or licenses to export the goods outside the Zone. The regime also allows exemption from the VAT and all customs duties of appropriate export-manufacturing equipment imported into the Zone.

The residents with foreign capital are free to transfer the profits abroad. The Weak side of this provision is the existing rule limiting the transfer of funds into recognized Offshore Territories: each transfer of profits (or any other funds) to a company located there is subject to 15% offshore tax, levied by the government.

To give foreign investors additional means of protection, the national Investment Code introduced a provision, which provides for non-application of all new legal acts, having a negative impact on foreign enterprises, for the first 5 years after the registration.<sup>276</sup> This seemingly strong feature of the regime is designed to immunize Free Zone residents from rapid legislative changes, which are unavoidable in a transitional economy. However, instead of being a Strength, this provision has ended up as a Weakness of the regime. Theoretically, all new foreign investors should be immune from changes in any tax or other provisions, which adversely affect business conditions: including, but not limited to, extensions in licensing, additional statistical reports, new limitations on foreign currency circulation, etc. But this rule does not work in

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<sup>275</sup> <<http://www.gomelraton.com/investl.php>> accessed 30.07.2007

<sup>276</sup> Belarus Investment Code, Art. 79

practice<sup>277</sup> and is not being enforced by the courts (with silent approval by the government). The official, but unhelpful, explanation is that since the current legislation does not allow for any discrimination between foreign and domestic investors, the new changes, applying to national investors, should also apply to foreigners.

Among other Weaknesses one can outline the failure of the state protection mechanism against nationalization, confiscation, forced purchase and other forms of expropriation of Free Zone residents' property, guaranteed by the current legislation.<sup>278</sup> This is another theoretically strong provision having a very weak judicial enforcement, as shown by numerous cases of confiscation of goods and transport vehicles at borders for minor unimportant discrepancies in accompanying documents.<sup>279</sup> Such weak enforcement of the guarantees does not foster sustainability and success of the Free Zones, nor does it help to gain investors' trust.

Some of the valuable Opportunities the government should utilize include further liberalization and reduction of the tax burden. One can clearly see that the limits for tax exemptions in "Gomel-Raton," similar to other Zones in transitional economies, have not been yet reached, as these Zones still lose out in comparison with the Free Zones established in the developed countries. In addition to that, effective judicial enforcement of the guarantees is a must, as the current situation with the immunity rights is clearly unacceptable. As a helpful solution, the Administration might negotiate establishment of a special tax and customs office within the Zone, which would help to ease declaration of goods, reducing the paperwork and time.

Concerning Threats, it is noted that, for a preferential business regime in a country with a transitional economy, these are plentiful, ranging from the increase of tax burden on the residents to total elimination of the preferences and termination of the Zone. Truly speaking, Threats of the similar scale are applicable to virtually any Free Zone in any jurisdictions, thus there is nothing extraordinary here: the investors always have to account for the potential risks. What only matters is the relative probability that the risks would come into being: for a transitional economy the latter is considerably higher.

In summary, this section looked at the experience of Free Economic Zone "Gomel-Raton" and analyzed its Strengths, Weaknesses, Opportunities and Threats in general and legal SWOT analysis. This example, which is relevant to most of the Free

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<sup>277</sup> A Lopatova, 'Free Economic Zones: Positive and Negative Aspects of Development' (2002) First International Conference "Transfer of Technologies in Free Economic Zones", May (Gomel, Belarus)9

<sup>278</sup> Belarus Investment Code, Art. 10-11

<sup>279</sup> Anon. 'Foreign Investors Might Be Deprived From Preferences' (2006) 6 December *Interfax*. Available at <<http://www.charter97.org/bel/news/2004/12/06/lgota>> accessed 28.08.2008

Zones in the target jurisdictions has provided the valuable data and ideas which are to be implemented in the proposed Regulatory Free Zone Model.

Overall, Chapter 4 has looked at the developments of Free Zones in CIS, with specific examples of successes and failures from Russia, Ukraine and Belarus. Many points from the analysis above will be revisited in Chapter 6 while drafting the Model. But before that, this research needs to consider the impact of international regulations restricting Free Zones and issues of compliance with those. This is the topic of the following Chapter.



## **Chapter 5. Complying With International Regulations Restricting Free Zones**

### **5.1 Harmful Tax Competitions: the OECD measures**

### **5.2 Combating Money Laundering: FATF**

### **5.3 Other Restrictive Provisions**

#### **5.3.1 Bank Secrecy**

#### **5.3.2. Transparency of the Regime**

#### **5.3.3. Tax Evasion and Avoidance**

Concluding the research required to develop a Sustainable Regulatory Free Zone Model for CIS, this Chapter focuses on compliance with international regulations restricting Free Zones. As the number of jurisdictions providing for the preferential doing business regime and engaging in regulatory competition has been increasing rapidly within the past century, so has been the concern of high tax countries, fearing to lose a significant part of tax revenue due to businesses shifting away to Free Zones.

Globalization of the world economy and development of international financial instruments (such as electronic banking) has undoubtedly increased capital mobility, which allows businesses in high tax countries to ease their national tax burden and relocate their capital in low tax countries and Tax Havens. Notably, the number of Free Zones over the recent years has more than doubled.<sup>280</sup>

In this race for the better share of the world capital, while providing for the most advantageous business conditions, some countries have reached the bottom line,<sup>281</sup> and introduced measures having a detrimental effect on international business and financial systems, such as harmful tax practices, tax avoidance, excessive bank secrecy and insufficient governmental control over the regime. Such measures, being very appealing to foreign investors, are based on unfair regulatory competition between the countries, and do not just put high tax jurisdictions in a disadvantaged position, but also discredit in general the reputation of Free Zones. Uncontrolled tax evasion has given birth to international financial crimes, like money laundering, which has made it possible for the criminal groups to legalize illicitly earned profits through different financial instruments, one of them often being Free Zones and Tax Havens.

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<sup>280</sup> B Spitz, *2000 International Tax Havens Guide* (Harcourt Professional Publishing, USA 1999) 235

<sup>281</sup> J Trachtman, 'International Regulatory Competition, Externalization, and Jurisdiction' (1993) 47 *Harvard International Law Journal* 464

In response to that evolving threat, the international community developed a number of measures and rules, restricting the operation of Free Zones in various ways. These rules are accordingly accounted for in the Regulatory Free Zone Model, because the Free Zone should not be an outcast in the international community.

This chapter focuses more specifically on rules initiated by the Organization for Economic Cooperation and Development (OECD) against harmful tax competition; anti-money laundering provisions introduced by Financial Action Task Force (FATF); issues of bank secrecy, transparency of the regime and anti-avoidance, influencing Free Zones in the target region.

## **5.1 Harmful Tax Competitions: the OECD Measures**

The Organization for Economic Cooperation and Development (OECD) unites 30 member countries sharing a commitment to democratic government and market economy. Together with over 100 other non-member states and non-governmental organizations, the OECD has a global reach covering economic and social issues from macroeconomics and trade to education and science. In accordance with its objectives, the Organization develops and refines economic and social policies, compares experiences, seeks answers to common problems and works to co-ordinate domestic and international policies, helping members and non-members deal with an increasingly globalized world.<sup>282</sup>

But what is more important for present research is that the OECD through its bodies (Council, Secretariat and Committees) can adopt legally binding agreements (i.e. Council Decisions) and non-binding instruments on different issues (such as reports on harmful tax practices). Uniting the countries which produce two thirds of the world's goods and services, the OECD, initially designed to administer aid under the Marshall Plan, in recent years has moved beyond the focus on its member states to offer analytical expertise and accumulated experience to developing and emerging market economies.

This section focuses on the OECD's recommendations on eliminating harmful tax practices, as this is one of the aims, which becomes apparent, distilled from general OECD policies stipulated in Article 1 of Convention on the Organisation for Economic Co-operation and Development 1960.<sup>283</sup>

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<sup>282</sup> More detailed information at <<http://www.oecd.org/home/>> accessed 28.08.2008

<sup>283</sup> Full text at <[http://www.oecd.org/document/7/0,2340,en\\_2649\\_34483\\_1915847\\_1\\_1\\_1\\_00.html](http://www.oecd.org/document/7/0,2340,en_2649_34483_1915847_1_1_1_00.html)> accessed 28.08.2008

The problem of harmful tax practices started to interest OECD only recently, from 1996, when the Ministers called upon the Organization to develop some measures to counter the distorting effects of harmful tax competition on investments and financing decisions and the consequences for national tax basis. This request prompted the Committee on Fiscal Affairs to launch the project on harmful tax competitions, focusing specifically on geographically mobile activities (such as investment into Tax Havens), both within the member and non-member states.

In 1998, after thoroughly researching and analyzing the issue, the OECD produced a report on "Harmful Tax Competitions: an Emerging Global Issue." The report, in addition to drawing international attention to harmful preferential tax regimes, has also indicated the specific features of such regimes<sup>284</sup> and certain recommendations on how to avoid the harmful tax practices. These recommendations and guidelines should be thoroughly accounted for by any jurisdiction, member or not, which wants to legitimately run Free Zones. Indeed, even the non-OECD countries (which cannot be legally bound to follow its rulings), can still be "softly, but persistently" forced to follow the recommendations, facing economic and political pressure from the stronger members.

As said by Seiichi Kondo, former Deputy Secretary-General, by countering the harmful practices, the OECD "*works to ensure fair competition in the global financial services market. [Such practices] include lack of transparency in accounting standards and unwillingness to exchange information with other countries, [thus creating] the risk of abuses of the free market system.*"<sup>285</sup> Here, the lack of transparency and non-exchange of information are declared to be key factors contributing to harmful tax practices, thus it is important to analyse this criteria as well.

But first of all, one has to clarify the OECD's position towards Free Zones and preferential tax regimes. The Organization does not outlaw Free Zones, as the mere existence of zero or low taxation within the jurisdiction does not automatically constitute the harmful tax practice. Indeed, harmful tax practices represent a complex combination of features, such as distortion of investment flow, precluding access to economic data, undermining the fairness of tax structures or causing undesired shift of tax burden to less mobile tax bases.<sup>286</sup> Thus, it is the criteria and extent of the provisions which matters.

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<sup>284</sup> 'Harmful Tax Competitions: An Emerging Global Issue' (1998) OECD Report. Available at <<http://www.oecd.org/dataoecd/33/0/1904176.pdf>> accessed 28.08.2008

<sup>285</sup> S Kondo, *Ending Tax Haven Abuse* (2002) OECD publications April 18<sup>th</sup>. Available at: <<http://www.oecd.org/dataoecd/60/15/2082521.pdf>> accessed 21.05.2004

<sup>286</sup> *n* 286, Art. 30-31

The Report also clearly recognises the distinction between legitimately acceptable tax avoidance and illegal tax evasion<sup>287</sup> and underlines that each country is free to establish its own taxation regime as long as it does not constitute a harmful tax practice. Besides, as Congon notes,<sup>288</sup> there may be many mitigating factors, like poor geographical location or lack of natural resources which could justify a jurisdiction's desire to introduce a preferential business regime, based on zero taxation, in attempt to attract investments.

The key issue for this research, so the Model can be construct, is determination of the features of a preferential business regime which might be considered harmful and illegal by the OECD. There is no clear definition, but from studying the Report, four factors can be used to identify potentially harmful preferential regimes.

Firstly, the jurisdiction in question would be imposing zero or low tax on a respectful income. However, as stipulated above, zero taxation alone does not constitute a harmful regime.<sup>289</sup>

Such regime, secondly, should be "ring-fenced": restricted to non-residents and quite isolated from the domestic economy. The countries imposing significantly reduced tax rates on income acquired from operations abroad, leaving domestic taxes relatively high, fit into this criterion. Ring-fenceness leads to the host country receiving double revenue, from domestic taxes and from attracted foreign businesses (which normally pay a fixed yearly charge). At the same time the home jurisdictions of such foreign investors, while bearing the social burden, do not receive the required taxes.

Thirdly, the regime would impose a significant degree of secrecy (including banking). Such uncooperativeness can make it difficult for other countries to obtain tax information. And bank secrecy can easily give way to another recently developed type of crime—money laundering.<sup>290</sup> Sometimes experts also include under this category the no accounting rules and no requirements to perform a regular audit. However, it is submitted that to be treated as harmful tax competition, this criteria should be accompanied by other serious violations from the list.

Fourthly, the regime would not be transparent, thus making the information exchange rather complicated. For example, the tax rate being determined on a case by case basis may give way to corruption of local authorities.<sup>291</sup> Legal transparency of the

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<sup>287</sup> More on this in Chapter 5.3.3

<sup>288</sup> T Congdon, *Towards a Low-tax Welfare State* (Politeia, Italy 2002) 34

<sup>289</sup> More information on determining this criteria can be found in 'OECD Guidance in Applying the 1998 Report to Preferential Tax Regimes (Consolidated Application Note)' (1998) Available at: <http://www.oecd.org/dataoecd/60/32/30901132.pdf> accessed 28.08.2008

<sup>290</sup> See Chapter 5.2

<sup>291</sup> n 286, Art.46, 60-67

doing business regime should normally involve clear and precise legal regulation of how, when and to whom the preferences are being granted.

Depending on the degree of the violation, one or a combination of the above factors may mean the doing business regime is found harmful. It is also worth noting some other side factors which could outlaw the tax regime: an artificial definition of a tax base, non-observance of international transfer pricing rules, significant amount of tax treaties, different ways of 'tinkering' with taxes.

Analyzing the above, it is concluded, that due to the extensive number of qualifying conditions and their variable nature, it is hardly possible to suggest a clear and precise definition of a harmful tax competition regime in line with the OECD. Serious violation of just one rule could be harmful, when minor problems with few criteria could still leave the regime legitimate.

As suggested by William Witherell, OECD Director of Financial, Fiscal and Enterprise Affairs,<sup>292</sup> on 20<sup>th</sup> Cambridge International Symposium on Economic Crime (10 September, 2002), the OECD should develop some minimum standards of violations and more precise guidelines, to indicate when a regime will or will not be found harmful. In making such a decision, besides the four conditions discussed above, competent bodies should also take into account the actual economic effect of the measures and consider the reasons and motivations which allowed the host country to introduce the regime in the first place.

Thus, the report "Harmful Tax Competition: An Emerging Global Issue" had basically launched the work of the OECD against harmful tax practices. Together with the recommendations in the Report, the OECD enacted non-binding Guidelines for Dealing with Harmful Preferential Tax Regimes, where it suggested to the countries to refrain from adopting new harmful rules, and suggested to review existing measures and their effect and remove all harmful elements of preferential tax regimes. The Organization, however, has continued its fight and introduced 3 succeeding Progress Reports<sup>293</sup> for within the next five years.

One of those reports, "Towards Global Tax Co-operation," presented in 2000, included the progress of reviewing the regimes in thirteen member countries. The review revealed more or less serious aspects of harmful regimes in banking, insurance, fund management and service activities in almost every country.

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<sup>292</sup> W Witherell, 'International Approaches to Combating Financial Abuse and Promoting Stable Financial Markets' (2002) Vol.5 No 4 *Journal of Money Laundering Control*, Spring, 14

<sup>293</sup> Full text available at <[http://www.oecd.org/topic/0,2686,en\\_2649\\_33745\\_1\\_1\\_1\\_37427,00.html](http://www.oecd.org/topic/0,2686,en_2649_33745_1_1_1_37427,00.html)> accessed 01.10.2007

The second part of the report, relevant to our discussion, was dedicated specifically to the tax regime in Free Zones, and the results were not reassuring either: analysing 35 Tax Haven jurisdictions, the OECD found a huge amount of violations and resistance. This forced the Organization to prepare the list of un-cooperative Tax Havens.

This list appeared to be a very effective mechanism of forcing Free Zones to overlook their regimes and introduce the necessary changes. For instance, it was the threat of being blacklisted which made the International Offshore Financial Centres analyzed in Chapter 3 (Gibraltar, Isle of Man, BVI and Jersey) to comply with the Guidelines, introducing provisions on effective exchange of information and transparency and making the tax regimes harm-free.<sup>294</sup>

In the process of complying, some of the Free Zones inevitably had to sacrifice certain elements of their attractive regimes. Gibraltar, for instance, had to give away the ability for investors to negotiate the applicable tax rate with the government. The Isle of Man reshaped the legislation on Exempt Companies and reconsidered the number of double taxation treaties.<sup>295</sup>

The extent of the OECD initiatives is not solemnly accepted by all the member countries. Luxembourg and Switzerland do not share “the Organization’s implicit belief that bank secrecy is necessarily a source of harmful tax competition”<sup>296</sup> and abstained from the report, proclaiming it to be “partial and erroneous.” It is suggested that bank secrecy in excessive form is perfectly able to constitute the harmful tax practices and could easily give way to money laundering on its own, but in most cases it would be just one of the required combination of the criteria.

To enable successful operation of Free Zones, CIS need to cooperate with the OECD and comply with its initiatives and recommendations regarding harmful tax competitions, paying special attention to the four factors discussed. Adherence to the above principles would not only allow sustainable operation of the Zones, but would also avoid being black listed, preserving their international good reputation.

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<sup>294</sup> Commitment letters and list of committed jurisdictions and non-cooperative tax havens is available at: <http://www.oecd.org/dataoecd/61/12/2067924.pdf> accessed 1.10.2007

<sup>295</sup> *n* 153, Binders 1-3, IOM 23

<sup>296</sup> *ibid*, Annex II

## 5.2 Combating Money Laundering: FATF

Another important set of rules, which CIS countries running Free Zones should account for are international regulations against money laundering—one of the most serious financial offences, dramatically increased in recent years. The main idea behind money laundering is that criminals try to legalize illicit profits by using various financial instruments, such as Free Zones and International Offshore Financial Centres.

According to the United Nations estimates, at least 500 billion US dollars are being “laundered” yearly and the law-enforcement agencies manage to find and withdraw only about a quarter of a percent.<sup>297</sup> That is why the international community (led, once again, by the OECD) had to have a unified approach to tackle money laundering on local and global levels.

One of the first definitions of money laundering was provided in the Strasbourg Convention “On Laundering, Search, Seizure and Confiscation of the Proceeds from Crime” of 1990. According to Article 6, money laundering is defined as the conversion or transfer of property, when such property is proceeds, for the purpose of concealing or disguising the illicit origin of the property or ... the concealment or disguise of the true nature, source, location, disposition, movement, rights with respect to, or ownership of, property, when such property is proceeds.<sup>298</sup>

The OECD provides a more succinct definition:<sup>299</sup> money laundering is the process of legalizing illegally generated profit. This involves three stages:

1. eliminating any connections between illegal income and its beneficiary
2. wiping out any traces of illegal activity
3. and receiving the funds back for owner’s disposal, when it is not possible to track the source and way of its acquisition.

One of the most popular ways of money laundering is investing illegally gained profits into a legal business. This is where Free Zones are being used. As most of the high-tax countries have either enforced anti money laundering legislation or do not offer very attractive conditions for doing business in the first instance, the criminals target International Offshore Financial Centres and Free Economic Zones, which risk becoming potential havens for illegal capital. A combination of tax preferences, secrecy and non-transparency of the regime makes Free Zones the first choice for the suspicious activities. Thus, no surprise that countries offering preferential doing business regimes had attracted the attention of Financial Action Task Force on Money Laundering.

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<sup>297</sup> ‘UN Global Program Against Money Laundering’ (1999). NY:UNDPI/2010. July 1999.

<sup>298</sup> full text available online at <<http://conventions.coe.int/Treaty/EN/Treaties/Html/141.htm>> accessed 1.10.2007

<sup>299</sup> <[http://www1.oecd.org/fatf/MLaundering\\_en.htm](http://www1.oecd.org/fatf/MLaundering_en.htm)> accessed 1.10.2007

The Financial Action Task Force on Money Laundering (FAFT) was created by G-7 Summit in Paris in 1989 to develop a co-coordinated international response to rising threats of money laundering and financial crimes. FATF, an inter-governmental body, currently consisting of 34 member countries and numerous observing bodies and organizations,<sup>300</sup> including the major countries of the EU and Russian Federation, is targeted to monitor the progress of implementing necessary anti-money laundering measures on national and global levels.

Among its very first tasks, FATF developed 40+9 Recommendations, which set out the universally applied measures for national governments to implement in order to ensure effectiveness of anti-money laundering programmes. These recommendations are of direct interest to this research, as they constitute the criteria to be accounted for in legal regulation of Free Zones in CIS and by the suggested Regulatory Model.

Prior to analyzing the Recommendations, it is noted that even though many of the researched jurisdictions managing Free Zones are not themselves members of the Force, they do have to follow the Recommendations by virtue of either being part of the European Union, Crown Dependencies or British Overseas Territories (the UK is a FATF member), or just wanting to not being outcast on the international financial arena and to safeguard their positive image. The majority of the International Offshore Financial Centres (Gibraltar, Cyprus, Guernsey, Isle of Man, Malta, Jersey and others) are also members of Offshore Group of Banking Supervisors, which is an observing member of FAFT. One of the conditions of being a OGBS member is a clear commitment to 40+9 Recommendations, thus all OGBS members had endorsed them.<sup>301</sup>

FATF Recommendations represent a list of guidelines<sup>302</sup> for countries to follow in order not to allow money laundering. These recommendations, even though being initially designed for International Offshore Financial Centres, should also be incorporated by the newly established Free Zones in CIS, as, naturally, money laundering is not limited just to traditional Tax Havens. Due to the space constraints, this section does not analyze all 40+9 Recommendations, but focuses on the groups of those most relevant to our Free Zone Model.

Firstly, all countries should introduce criminal and civil liability for money laundering (which has been successfully done by an overwhelming majority of the researched Free Zones). Usually this involves an adoption of a legislative act, criminalizing money laundering and like activities. For example, the Isle of Man's

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<sup>300</sup> Full list at < [http://www.fatf-gafi.org/pages/0,2987,en\\_32250379\\_32235720\\_1\\_1\\_1\\_1\\_1\\_1,00.html](http://www.fatf-gafi.org/pages/0,2987,en_32250379_32235720_1_1_1_1_1_1,00.html) accessed 1.10.2007

<sup>301</sup> n 282, p.257

<sup>302</sup> Full text at <: [http://www.fatf-gafi.org/document/28/0,3343,en\\_32250379\\_32236930\\_33658140\\_1\\_1\\_1\\_1,00.html#40recs](http://www.fatf-gafi.org/document/28/0,3343,en_32250379_32236930_33658140_1_1_1_1,00.html#40recs) accessed 1.10.2007



government adopted Criminal Justice (Money Laundering Offences) Act in 1998 which introduced four new money laundering offences: assisting another to retain the benefit of criminal conduct; acquisition, possession or use of the proceeds of criminal conduct, concealing or transferring the proceeds of criminal conduct and tipping off.<sup>303</sup> It is suggested that criminal liability for money laundering is much more effective than civil, as the latter normally results in financial penalties, the risk of which is effectively nullified by the potential gains if money laundering activities go undiscovered.

Secondly, anonymous accounts should be prohibited. This outlines the "customer due diligence" principle, applicable to the banking sphere. The principle requires proper identification and verification of the identity of beneficial owners by the banks ("know your client") and also includes prohibition of numbered accounts. Some of the Free Zones and low tax jurisdictions (Switzerland, Luxembourg) do rely on bank secrecy and the restrictive measures can seriously undermine the advantages of such countries. But they do not have much choice.

Switzerland, for instance, adopted the Money Laundering Act in 1997, which obliged all physical and legal persons (including those working in numerous Free Trade Zones of the country) to ascertain the identity of customers and beneficial owners, to clarify the transactions and to establish and keep copies of all the documents.<sup>304</sup> However, the fact that the bank (and the country's officials) know the identity of their clients, does not necessarily mean they are going to share this information with tax authorities of the client's home country. And so raise an issue of non-exchange of information and non-transparency of the regime. In CIS bank secrecy might be somewhat less of a problem, but there are obvious issues with transparency.

Thirdly, all financial and business transactions (like cross-border currency transfers), both domestic and international, should be recorded and suspicious transactions verified and if necessary, reported to the controlling agencies. This includes gathering sufficient information about a respondent institution to fully understand the nature of the business.<sup>305</sup> This provision has been recently endorsed by the European Union, which now obliges anyone crossing the borders and carrying more than 10 000 euro to declare this to the authorities.<sup>306</sup>

There are some other, more specific, Recommendations which are omitted here. The overall idea, though, is clear: CIS countries establishing Free Zone should do their best to incorporate the above guidelines into legal norms regulating the Zones.

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<sup>303</sup> Sections 17 A-D

<sup>304</sup> n 282, p.251

<sup>305</sup> 'The 40 Recommendations' (2003) Available at <[http://www.fatf-gafi.org/document/28/0,2340,en\\_32250379\\_32236930\\_33658140\\_1\\_1\\_1\\_1,00.html](http://www.fatf-gafi.org/document/28/0,2340,en_32250379_32236930_33658140_1_1_1_1,00.html)> accessed 02.09.2008, Recommendation 7, 10

<sup>306</sup> 'Regulation 1889/05/EEC' (2005) L 309 *Official Journal* 9

Researchers admit that there is a tendency for some of the Free Zones to deliberately attract specific customers, such as international banks, by offering minimal supervisory standards.<sup>307</sup> Inexperienced transitional countries, setting up Free Zones, might also be tempted to follow that dangerous path. That is why adherence to national and international legislation combating money laundering should be supplemented by a conscious attitude of both the country officials running the Zone, and the private individuals, such as banks and companies, doing business in it.

On a final note, after analysing the framework of relevant provisions, one could conclude, that anti-money laundering legislation and international recommendations inevitably force Free Zones to limit their preferences, introducing a more restrictive regime, and that should be avoided when possible. Not denying all the downsides of the restrictions, it is stipulated that accusation in money laundering can damage the sustainability of the Zone much more. And simple research shows that most of the Zones manage to find the way how not to break the rules and retain their clients.<sup>308</sup>

## **5.3 Other Restrictive Provisions**

Having looked at how incompliance with the rules combating harmful tax competitions and money laundering can adversely affect sustainability of Free Zones, this section analyzes other restrictive provisions which can potentially limit the Zones' operation, namely bank secrecy, transparency of the preferential regime and tax evasion.

### **5.3.1 Bank Secrecy**

Bank secrecy is widely recognized as an important tool protecting the confidentiality of financial affairs between a banker and a client. Any successful preferential business regime offers such protection to some extent. However, the legitimate bank secrecy (confidentiality and 'the know your customer' principles) should be distinguished from the illegitimate (or excessive) one which gives rise to harmful practices.

To the internal 'know your customer' rule there can be no exceptions, as every bank is under the absolute obligation to know whom they are dealing with. It is sharing that information externally, with the authorities in the clients' domestic countries or international controlling agencies, as well as recording and reporting suspicious transactions that becomes problematic.

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<sup>307</sup> R Alba, 'Fraud Control in Offshore Banking Centers' (1999) 20 *Amicus Curiae* .11

<sup>308</sup> R Mathavious, 'Regulation in the British Virgin Islands' (2001) in N Courtis, (edt) *Financial Regulation in Offshore Centres* (Central Banking Publications, London 2001) 27

The main concern of the international community is that the banks in some jurisdictions are unable or unwilling to scrutinize transactions and monitor suspicious activities, which leads to money laundering and tax evasion. Especially when it comes to Free Zones, where the traditional veil of bank secrecy is often particularly difficult to pierce and the risk of related crimes is high. Among such illegitimate banking practices one could mention opening and running numbered accounts, not obtaining or hiding the clients' identity, allowing suspicious financial transactions and insufficient control over the cash inflow.

One might argue that the issue of bank secrecy is more relevant for International Offshore Financial Centres and not for traditional Free Zones like the ones being established in CIS. To some extent this might be true, as banking secrecy is not the most serious problem of Free Zone regulation in our target region. However, there is always a risk that transitional economies can oversee compliance with international standards and permit suspicious banking activities, even unwillingly. Thus, not to get blacklisted, the preferential regime in our Free Zones should be in compliance with the above regulations. The most important issue here is how this could be best achieved without damaging attractiveness and sustainability of the Zone.

Julian Francis, the governor of the Central Bank of the Bahamas, has identified the following common allegations against Free Zones:

1. The tax regimes, under which they operate, deprive onshore (domestic) jurisdictions of tax revenues properly due to them.
2. The secrecy, under which the Zones operate, attracts and facilitates disreputable business and money laundering.
3. Poor oversight and regulation by the host state allows such Zones to prosper with mediocre standards, posing considerable risks to investors and even the global financial system.
4. The Zones (or indeed, the host jurisdictions themselves) do not or cannot adequately cooperate with other countries in regulatory and economic matters, which gives rise to unfair regulatory competition.<sup>309</sup>

Looking at this list, after harmful tax competition and money laundering, it is bank secrecy and transparency of the regime which are often considered to be the most serious allegations against the Free Zones. And if at earlier times due to limited relocating ability of the financial instruments the bank secrecy did not give way to much of the criminal activity, during the last century due to globalization and technological

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<sup>309</sup> J Francis, 'The Bahamas Perspective' (2001) in N Courtis, (ed) *Financial Regulation in Offshore Centres* (Central Banking Publications, London 2001) 12

advancement of financial operations, the boost of electronic commerce and internalization of business the criminals started to actively use banks for financial crimes, which brought bank secrecy under attack by the international community.

As mentioned above, bank secrecy can be defined in several ways and looked at from different perspectives. The UK case law, for instance, describes bank secrecy as *[an implied term of the contract between a banker and his customer that the banker will not divulge to third persons ... either the state of the customer's account, or any of his transactions with the bank, or any information relating to the customer acquired through the keeping of his account...]*.<sup>310</sup> From one side, being wholly legitimate, this is the duty of the bank to keep its customers' affairs confidential. From another side, this duty also enables the bank not to disclose certain information about the customer and its business to the third parties, including the tax officials from other countries. In most jurisdictions running Free Zones, bank secrecy is provided for in national law and banks are being held liable for disclosing confidential information. This only contributes to the difficulty in establishing a successful exchange of information between the countries in banking, financial and tax spheres.

To be fair, bank secrecy has historically been part of the banker-customer relationship, first as a moral duty, based on customary law,<sup>311</sup> then as a contractual principle. Campbell suggests that bank secrecy originates as early as 4,000 years ago in Babylon, since tangential references to it were found in the Codes of Hamurabi (about 1800 B.C.), thus potentially being even older than the first alleged Free Zones. Being later developed in customary and statutory law, the concept of banking secrecy has been almost universally acknowledged.<sup>312</sup> However, its application and regulation in law by many countries running Free Zones is far from being uniform. Researchers, bankers and legislators are still arguing how exactly to define bank secrecy, which information should remain confidential and under which circumstances the veil of secrecy should be revealed.<sup>313</sup>

Unsurprising, each jurisdiction running a Free Zone has adopted its own provisions on bank secrecy with which all undertakings have to comply. The banks collect business and personal information about creditworthiness of their clients anyway, as this is not only required by law, but also guarantees bank's protection against the fraud. Such information contains various data: from economic issues (business, accounts, property assets) to private life (hobbies, interests, etc), not to

<sup>310</sup> *Tournier v. National Provincial and Union Bank of England* [1924] 1 K.B. 461

<sup>311</sup> M Hapgood, *Paget's Law of Banking* (12<sup>th</sup> ed Butterworths, London, 2002) 127

<sup>312</sup> D Campbell, *International Banking Secrecy* (Sweet and Maxwell, London, 1992) VII

<sup>313</sup> On general discussion of these issues see E Moschouri-Tokmakidou, 'The Institution of Banking Secrecy in English and Greek Law' (2003) PhD Thesis, the University of Manchester

mention all the transactions going through the accounts, thus disclosing it to the third parties could potentially have a serious impact on clients' privacy. However, internationally accepted banking standards and principles of co-operation do not only require Free Zones to keep record and accordingly verify all financial transactions, but also impose certain constraints, obliging banks to disclose the information to foreign tax authorities in case of suspected crimes.

Every Free Zone deals with banking secrecy in its own way, trying to secure the appealing preferences and not to conflict with universally applicable principles. British Overseas Territories and Crown Dependencies, for instance, had all utilized the UK's approach to banking secrecy where no person who receives or possesses the confidential information shall disclose it without the consent of the related person.<sup>314</sup> However, it is still subject to some restrictions, such as the "due diligence," "know your client" and the disclosure rules.

The Isle of Man, for example, while recognising the contractual duty of a banker to keep the affairs of his customer confidential and the customers' entitlement to non-disclosure, still allows a few (limited) exceptions to these principles<sup>315</sup> in the circumstances where the disclosure is required to assist in criminal proceedings. Jersey requires all banks to keep copies of their current audited accounts available for inspection by any person and to submit annual audited accounts.<sup>316</sup> BVI, which would hardly ever respond to 'tax fishing expedition' enquiries from other jurisdictions,<sup>317</sup> provides for the disclosure of information to the regulatory authorities and law enforcement agencies in other countries to assist the investigation of illegal or criminal activities.

The question remains how is it possible for a sustainable Free Zone to provide for the preference of bank secrecy and confidentiality without being black-listed and blamed for unfair practices by the international community? The answer to that is that one needs to maintain the adequate internal and external control in banking sphere and allow the necessary exchange of information.

According to John Aspden, Chief Executive for Financial Supervision Commission for Isle of Man,<sup>318</sup> in the fight against secrecy, one of the keystone principles to adhere is "know your customer" rule, which obliges every financial institution (trust, bank or other) to properly identify their customers by gaining and

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<sup>314</sup> Banking Act 1987, S.82-87; Data Protection Act 1998, S.15

<sup>315</sup> Set out in the Financial Supervision Act 1988

<sup>316</sup> Banking Business Law 1991, Article 25

<sup>317</sup> G Clarke, *Offshore Tax Planning* (12<sup>th</sup> edition Tolley, London 2005) 227, 228

<sup>318</sup> J Aspden, 'Financial Regulation in the Isle of Man' (2001) in N Courtis, (edt) *Financial Regulation in Offshore Centres* (Central Banking Publications, London 2001) 61

verifying information about the actual and beneficial account holders. Nowadays, in the age of internet and e-commerce, providing financial services on-line became widespread and popular, so is the rising number of the fraudulent transactions. As verification of the physical identity of customers is particularly difficult in electronic banking, emerging Free Zones have to refrain from on-line account opening, making all registration to be carried off-line, so the documents could be properly examined.

Jersey, even though having no specific legislation governing banking secrecy, was widely enforcing a duty of confidentiality, as local agents were bound to reveal beneficial ownership only under a court order, plus it was still possible to open a numbered bank account there.<sup>319</sup> However, after the regulation of its financial services (as well as of some other UK Crown Dependencies) have been reviewed by the Edwards Report in 1998,<sup>320</sup> to avoid being accused in non-disclosure of beneficial owners, use of nominee directors, governmental corruption resulting in ability of big companies to negotiate the tax rate and insufficient international co-operation, Jersey was forced to very carefully follow the suggested proposals for radical legislative changes in financial regulations, especially in tax policy, use of tax treaties, tax evasion, disclosure of information and banking secrecy.

Most of the on-shore Free Zones set up by the researched jurisdictions, for instance, Cyprus or Switzerland, facing the pressure from the OECD and the EU, had also to undertake the appropriate measures complying with banking secrecy and transparency. Cyprus, which used to offer significant bank secrecy guarantees, after joining the EU in 2004 was forced to introduce legislation in line with the OECD initiatives on disclosure of informational and international co-operation, and banking activities. Thus, its Central Bank (being a member of the Offshore Group of Banking Supervisors since 1982), is only granting banking business licenses to institutions which *[enjoy a good reputation internationally, have an established track record of growth and profitability and are subject to adequate banking supervision in their countries of incorporation.]*<sup>321</sup>

Switzerland, notably “one of the oldest-established financial refuges”<sup>322</sup> is also best renowned for its banking system. Preserving bank secrecy for hundreds of years, Switzerland is still very uneasy towards the EU and the OECD efforts to reduce its bank confidentiality. Unlike many existing Free Zones, bank secrecy in Switzerland is

<sup>319</sup> C Powell, ‘Jersey as a Financial Centre’ (2001) in N Courtis, (ed) *Financial Regulation in Offshore Centres* (Central Banking Publications, London 2001) 66

<sup>320</sup> Available online at <<http://www.archive.official-documents.co.uk/document/cm41/4109/4109.htm>> accessed 1.10.2007

<sup>321</sup> S Stavrinakis, ‘Financial Regulation in Cyprus’ (2001) in N Courtis, (ed) *Financial Regulation in Offshore Centres* (Central Banking Publications, London 2001) 33

<sup>322</sup> C Daggart, *Tax Havens and Their Users* (Economist Intelligence Unit, London 2002) 239

protected not only by criminal, but also by administrative and civil law. For revealing the information on clients' affairs, an employer may end up in prison for six months and the licence may be revoked by the Swiss National Bank.<sup>323</sup> No surprise, that with such legislation the information is not likely to be passed on easily, especially to foreign authorities. In fact, the secrecy veil can only be lifted for the government authorities where an evidence of a client's involvement in crime exists. Thus if that is merely the matter of tax assessment or tax evasion, the information is not to be disclosed, because tax evasion has not been criminalized. Tax fraud, on a contrary, has, but it is being defined very narrowly and is thus restricted.

The situation in Switzerland is subject to change, though, as the country has to eventually comply with international regulations. Until recently it was possible to open a numbered account in a Swiss banks, so the information about an account holders was known to only a few members of staff, and the transactions through foreign banks were made "from the name of one of our clients." But from 2004 Swiss banks adhered to the rules of inter-bank data processing system S.W.I.F.T, which provides for submitting full information about transfer sender and recipients.

International community is doing more and more to introduce uniform standards and provide advice on sustainable regulation of bank secrecy. In the year 2000 the OECD issued a report "*Improving Access to Bank Information for Tax Purposes*,"<sup>324</sup> which besides suggesting a definition and identifying the key features of bank secrecy, provided for the possible ways of granting access to bank information and recommendations on how to improve the situation. Particularly, the Report recommends to foster the facilities for effective tax information exchange between the member states.

Same year the Wolfsberg Group—an association of twelve global banks, which aims to develop financial services industry standards for "Know Your Customer," Anti-Money Laundering and Counter Terrorist Financing policies—publish so-called "Wolfsberg Anti-Money Laundering Principles."<sup>325</sup> These principles are seen as key guidelines to be followed by international financial and banking organizations, not to mention any jurisdictions setting up and running Free Zones.

Concluding this section, it is stressed that the issue of bank secrecy, even though not necessarily being a number one problem for Free Zones established in, occupies an important place on the list of allegations against Free Zones. Evidently, the scope of bank secrecy is extended to all information about the customers, financial situation,

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<sup>323</sup> *ibid*, p.240

<sup>324</sup> Full text available online at <<http://www.oecd.org/dataoecd/3/7/2497487.pdf>> accessed 1.10.2007

<sup>325</sup> Full text and relevant information available online at <[www.wolfsberg-principles.com](http://www.wolfsberg-principles.com)> accessed 1.10.200

business or private life, as well as information on bank deposits and all other transactions between bank and customers.<sup>326</sup> However, the necessity and extent to such information disclosure remains unclear.

To stay on the safe side, Free Zones in CIS should develop and effectively apply all the discussed principles, especially “know your client” and “customer due diligence.” In particular, “know your client” principle should include the requirements for banks to properly identify account openers, identity, source of wealth and beneficial owners and to eliminate non-client, numbered, anonymous or hidden accounts.

“Due Diligence” principle, on the other hand, mostly refers to collecting and recording the information about the reason of account opening, planned activities and source of wealth. This should prevent Free Zones from accepting the residents from high-risk countries (i.e. blacklisted Offshore jurisdictions or countries accused of money laundering) and ensure provision of additional diligence and advanced scrutiny towards notorious public figures (namely, the dictators) which might stand behind the incorporated residents. The banks are also obliged to pay special attention to unusual or suspicious activities, such as cash or pass-through transactions.

As rightfully noted by Pieth and Aiolfi,<sup>327</sup> adoption of the above mentioned international principles does not revolutionize the ideas of banking secrecy (as they were built on well established concepts of identification and diligence) but does prevent Free Zones from engaging in risky or harmful activities. Regrettably, the practical adherence to these principles by many Free Zones remains to be insufficient.

### **5.3.2. Transparency of the Regime**

Next is an issue of transparency of the preferential regime. Being important for the status and image of a Free Zone, this has a lot in common with bank secrecy, only being somewhat wider. Indeed, transparency of the regime includes not only reasonable restriction of bank secrecy, but also appropriate disclosure and effective exchange of relevant information by the Free Zone officials with other jurisdictions and enforcement bodies.<sup>328</sup>

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<sup>326</sup> E Moschouri-Tokmakidou, ‘The Institution of Banking Secrecy in English and Greek Law’ (2003) PhD Thesis, the University of Manchester, 95

<sup>327</sup> M Pieth, G Aiolfi, ‘The Private Sector Becomes Active: The Wolsberg Process’ (2002) University of Basel, Switzerland. Available at <<http://www.wolfsberg-principles.com/pdf/wolfsbergprocess.pdf>> accessed 28.08.2008

<sup>328</sup> R M Anotine, *Confidentiality in Offshore Financial Law* (Oxford University Press, Oxford 2002) 326



It is understandable why Free Zones might offer some degree of confidentiality to their clients: not only do most of the investors not wish to disclose their business transactions due to the protection of commercial and intellectual secrets, but, naturally, in a business world wide publicity does not really go alongside with serious transactions. So many jurisdictions hosting Free Zones have recognized and legally secured confidentiality of the investors. However, many CIS Free Zones do not provide for the necessary information exchange and are unwilling to co-operate with other countries. This prompts the international community to declare the regime non-transparent and harmful. Which raises a very controversial issue: how to make the preferential regime more transparent without unnecessarily invading privacy and scaring off the investors. The answer to this is not simple: a jurisdiction has to carefully balance.

Stibbard notes,<sup>329</sup> that at the time of Edwards Report<sup>330</sup> in the above researched Crown Dependencies the requirements to disclose financial information, even internally, remained very limited. For instance, in Jersey and Isle of Man, only public companies were required to file the accounts. In Guernsey, no companies other than regulated institutions were required to keep accounts at all. Double taxation treaties, widely used by many Free Zones<sup>331</sup> often create obstacles in information exchange with foreign countries, not to mention a posed threat of money laundering.

Jersey, referred by Mitchell as [*an international Tax Haven with a reputation for facilitating flight of capital and global financial instability by providing secrecy and artificially low taxes*]<sup>332</sup> has had a history of facilitating secrecy, tax avoidance, evasion and lax of public accountability;<sup>333</sup> the island is still very uneasy toward changing it. None of the existing double-tax treaties<sup>334</sup> provides for information exchange, plus alleged money laundering activities non-cooperation with international regulators do not contribute to Jersey's good reputation.

Even though, radical proposals for changes suggested in the Edwards Report faced considerable opposition from Jersey and other Offshore jurisdictions, the government managed to enact legislation on exchange of information with foreign states in respect of major criminal offences (in spheres of drug trafficking, terrorism, fraud,

<sup>329</sup> P Stibbard, 'Offshore Financial Centres Under Attack' (1991) in *Tolley's Tax: The Challenge of Free Economic Zones in Central and Eastern Europe (International Perspectives)* (United Nations, NY 1991) 8

<sup>330</sup> Discussed in the previous section

<sup>331</sup> n 153, Binders 1-3, IOM 30-31

<sup>332</sup> A Mitchell, P Sikka et al, *No Accounting for Tax Havens* (Association for Accountancy and Business Affairs, Essex 2002) 20, 23

<sup>333</sup> S Stuart, 'Islands of Uncertainty' (1996) November 22 *The Independent* 21

<sup>334</sup> There are three of them: with the UK, Guernsey and France

insider dealing, banking, insurance and collective investment schemes is at place),<sup>335</sup> but there is still no formal legal obligation for exchange of tax information.

For Free Zones in CIS the only solution is to ensure the regime's transparency, having to balance between providing for the most attractive and competitive conditions for foreign investors and possibility of being blacklisted as non-cooperative countries. Most of the Zones would try to avoid it and the compromises will have to be found.

To a contrary, a positive example is found in Cyprus. In this new EU Member State, the exchange of information is accordingly provided for in tax legislation, including double taxation agreements (Cyprus has concluded over thirty) and mutual legal assistance treaties. All the treaties are based on the OECD Model Convention and thus generally provide for the exchange of tax information between Cyprus tax authorities and partner countries.<sup>336</sup>

The experience of Cyprus should be considered by the target jurisdictions, as following the OECD Model Conventions and providing for the effective exchange of information plays a dual role: in addition to ensuring transparency of the regime, it also allows the government to enforce compliance with their own tax law. Globalized economy opened up a lot of opportunities for companies to avoid taxation and it is the transparency criterion which helps ensuring equal application of law to similarly situated taxpayers.<sup>337</sup>

Concluding on transparency, there is a number of other important elements, which should be considered by a jurisdiction setting up a Free Zone. These include the provisions on disclosure of information on companies' beneficial owners and trusts, absence of shadow directors, guaranteed access to bank information in tax investigations and, where appropriate, enforcement of the requirements to keep full accounts and audit and license certain financial activities. Among other influencing factors there are constantly changing principles on international tax avoidance, piercing of corporate veil, expanded interpretation of money laundering (to include tax offences), increased invasion of privacy through routine reporting requirements and relaxation of the rule against non-enforcement of foreign fiscal law.

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<sup>335</sup> n 282 pp.461-62

<sup>336</sup> C Daggart, *Tax Havens and Their Users* (Economist Intelligence Unit, London 2002) 197

<sup>337</sup> 'The OECD's Project on harmful tax practices: The 2001 Progress Report' (2001) Available at <<http://www.oecd.org/dataoecd/60/28/2664438.pdf>> accessed 28.08.2008

### 5.3.3. Tax Evasion and Avoidance

Introducing unfair provisions for the minimization of the tax burden, which deprives the high tax jurisdictions from the legitimate revenue and allows the nationals to escape from taxation by relocating in jurisdictions setting up and running Free Zones is another common allegation against Free Zones by the international community. And even though, as Lord Clyde has put it in *Ayrshire Pullman Motor Services and Ritchie v. IRC*<sup>338</sup>: [no man ... is under the smallest obligation, moral or other, so to arrange his legal relations to his business or property as to enable the Inland Revenue to put the largest possible shovel into his stores], the possibility to reduce the tax burden by any available means is necessarily balanced by the liability for tax evasion.

It is important to fully understand the difference between tax avoidance and tax evasion. Avoidance can be referred to as utilization of the tax regime to one's own advantage (reducing the amount of payable tax) by lawful means (such as applying various tax deductions, playing around with incorporation, or, indeed, establishing a subsidiary in a Tax Haven). Tax evasion is a criminal escape from taxes by the means, which are unlawful.<sup>339</sup> The border line between the two definitions seems to be the lawfulness of the activity in question, however, when it comes to combating tax avoidance, the immediate problem Free Zones face is the absence of clear universally accepted definition. Uncertainty about what exactly constitute unlawful means makes the line between legal evasion and illegal avoidance rather blurred.

In the United Kingdom and in jurisdictions following the UK's common law approach, the distinction between illegal tax avoidance and legal tax mitigation is clarified judicially. As stipulated by the case law, tax avoidance is a course of action designed to conflict with or defeat the evident intention of the Parliament<sup>340</sup> (thus being undoubtedly illegal) and tax mitigation is a conduct which reduces tax liabilities without "tax avoidance" (thus not being contrary to the intention of Parliament).

This rather precise distinction is, in fact, dubious, as plenty of debates exist in interpreting what is the actual intention of the Parliament. On the face of it may look like until the activity is stopped by the Parliament, it is a mitigation and should remain legal. Thus, only after the Parliament had outlawed the activity in question it becomes illegal tax avoidance.

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<sup>338</sup> 14 TC 754, (1929)

<sup>339</sup> On terminology distinction between avoidance and evasion see: *Fisher v Brierly* (1860) 1 de G F&J 643; *Bullivant v AG* [1901] AC 196; *Bullen v Wisconsin*, 240 U.S. 625, 630 (1916) and *Craven v White* (1988) 62 TC 1 at 197

<sup>340</sup> *IRC v Willoughby*, 70 TC 57

This approach has its downsides. Firstly, not every country is prepared to follow the approach of the modern democratic society that any not expressly forbidden activity is lawful. Some countries, especially in CIS, tend to be much more restrictive. Secondly, how would the Parliament know which activity to outlaw? Researchers suggest that the relevant factors helping to decide whether the conduct is avoidance or mitigation (evasion) could include the following:

- whether there is a specific tax regime applicable;
- whether transactions have economic consequences;
- extent of confidentiality of the regime; tax linked fees.

Opposers of the above approach put up an argument about extent of criminalization: when tax avoidance is commonly followed, it is always stopped by the appropriate legislation within a few years. Would it make any common practice in the community, which has an effect of tax avoidance, but have not been stopped by the Parliament for whatever reason, automatically lawful? The answer to this is unclear. So is the fact that international community would unilaterally accepted this approach.

Noting the debates surrounding this issue, we would just assume that in the absence of the proper definition, the major and determining difference between avoidance and evasion is the legality of the activity in a taken jurisdiction, when evasion is criminal activity *per se* and tax avoidance is legal as long as the government does not attempt to prevent it.

With tax evasion the situation is clear: as long as the activity is prohibited by law, Free Zone residents would be precluded from engaging in it. With tax avoidance, the situation is much more complex: even though the activity may be perfectly legal, many high-tax countries still try to stop their own citizens from engaging in it, as it leads to serious revenue loss for the domestic jurisdictions. Thus, instead of outlining all anti-evasion rules (which are monitored by FATF, the OECD and a number of other international organizations) in this section, we will focus on more general anti-avoidance provisions, which if imposed by jurisdictions running Free Zones, may adversely affect attraction of foreign capital. In doing this, we will consider the experience of certain countries.

As mentioned above, a general anti-avoidance rule—are either a legislation, introduced by high-tax jurisdictions to override the purported tax advantages of an evasion, or a general presumption in law against such an abuse.<sup>341</sup> In many civil law jurisdictions the doctrine of law abuse is accordingly utilized to frustrate the transactions that may appear lawful while abusing intent of the law. Example could be

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<sup>341</sup> n 153, Binders 1-3, Issue 66, Gar/13

Article 42 of German Tax Procedures Code, which prohibits a perfectly legal tax transaction, which is abuses the tax structure. In most cases the law would not give a definition of such an abusive measure, leaving it up to the national courts to decide on that matter.

Other jurisdictions, like Ireland, as a part of their tax legislation adopted General Anti-Avoidance Rules (GAARs). These rules also do not provide a definition of a 'tax avoidance transaction'; allowing tax officials to define and nullify it. Even though such an approach may prove being appropriate, there is a risk that by introducing a general rule against tax avoidance without specifically defining it, a country may rule out many non-harmful transactions, thus disadvantaging the investors. That is why when introducing a preferential business regime, a sustainable Free Zone should think very carefully when introducing both, general rules, having an anti-avoidance impact and specific anti-avoidance tools which might prevent the companies from investing into Free Zones.

Interestingly, it is noted that not every jurisdiction introduces General Anti-Avoidance Rules in their legislation. Two major players at the Free Zone field, the UK and US, have chosen not to proceed with formal GAARs. However, it does not mean these countries do not address anti-avoidance; instead, they instituted so-called *Ramsay doctrine*,<sup>342</sup> under which the judges when determining if the suspicious transaction should come within anti-avoidance rules, would not look at its purpose, but rather at the end-result.

Apart from GAARs, which despite being called 'general' are in many cases rather specific, some countries impose other anti-avoidance rules. Regulating corporate residence is one of those. As some countries use various definitions of residence (incorporation, location of management and control (seat), or, very commonly, both), national companies, establishing subsidiaries or just doing business in the Free Zones abroad, could still be considered domestic for tax purposes and thus be liable for the full range of taxes. Many common law jurisdictions, in addition, provide similar rules for trust residence to prevent sheltering assets and income offshore. Various forms of taxation imposed on certain categories of residents can also serve as a general anti-avoidance tool. For example, withholding taxes which are deducted at source (taxes on income, paid to non-residents, mostly in a passive form, such as dividends, royalties, etc.), allows taxing the income gained in the country by non-residents. A similar purpose is served by estate taxes on local assets such as inheritance taxes.

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<sup>342</sup> *WT Ramsay Ltd v Inland Revenue Commissioners* [1981] STC 174

In addition to general anti-avoidance rules, the countries can also enforce various specific tools and legislation, which would make utilizing the preferential business regime in other states difficult. An example could be provisions, regulating Controlled Foreign Companies, which are being implemented by most of the OECD Member States.<sup>343</sup> CFC rules introduce an effect of attributing the profits of companies, located in low-tax jurisdictions to residents of high-tax countries, who control such companies, where full tax is payable. In the UK, a company is considered to be CFC if it is controlled by a UK resident and the tax on its profits is less than 75% of the tax, which would otherwise be payable in the country.

This restriction, about which Free Zones cannot do much, does impact considerably companies' investing strategy. What Free Zones should be able to utilize is the exception from this rule, provided by many jurisdictions, when a CFC is engaged in an activity, particularly valuable for the domestic State. In these cases the company would be exempt from the above rule. Alternatively, a Free Zone could happen to be located in a "white listed" jurisdiction which would too guarantee the exception, or the activities in question could be permitted if a Controlled Foreign Company manages to demonstrate that tax avoidance is not the main reason for its existence.

Another regulatory mechanism many high-tax country residents use is double taxation treaties, eliminating double taxation between domestic and foreign jurisdiction. To avoid taxation, the companies try to route the income through that jurisdiction to ensure that beneficial owners (who are not residents in either treaty-party jurisdiction) would get the best tax advantages. To prevent such treaty shopping a specific anti-avoidance rule can be incorporated in the treaty itself or included in the domestic jurisdiction. In addition to that, domestic jurisdictions can engage in transfer pricing, making sure that cross-border transactions between affiliated persons take place at a market price, eliminating artificial transfer of profits out of the jurisdiction.

Special rules on Offshore Funds comes under this category too. These provisions aim to tax individuals and companies on the income and capital gains on investments in low-tax jurisdictions which are not distributed to them but are accumulated on their accounts. In countries with an Anglo-Saxon legal system there can also be a tax levied on beneficiaries of foreign trusts.

An exit tax on individuals and companies is another way to ensure protection of a high-tax domestic jurisdiction's interests. Such tax is imposed on emigrating assets when an individual ceases to be a resident in a particular country, and, for instance, is moving offshore or to the jurisdiction with a more favourable regime. Such a restriction

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<sup>343</sup> *n* 153, Binders 1-3, Issue 66, Gar/21

is imposed, for instance, in Belarus, where any company transferring funds offshore needs to pay a special duty.

However, not every country is allowed to financially penalize those who are trying to take advantage of preferential business regimes elsewhere. This matter has been very successfully regulated by the European Union, where the European Court of Justice protected the right of a company to choose a less restrictive jurisdiction for incorporation in another Member State.<sup>344</sup> Thus, in the famous *Centros* case the ECJ held that a Member State cannot prevent establishment of a Danish company in UK even though the only reason for such establishment was avoiding payment of a minimum share capital under the domestic jurisdiction.

Concluding the section on tax avoidance, it is submitted that that for the Free Zones in CIS it is extremely difficult to legitimately fight the anti-avoidance and anti-evasion restrictions imposed by high tax countries on their own nationals. The optimal solution here is for high tax countries to ensure that these provisions are not excessively restrictive and apply only to illegal transactions<sup>345</sup> and for Free Zones to keep good faith and reputation by remaining as transparent and co-operative as possible.

Summarising the findings for this Chapter, it analyzed various international regulations restricting Free Zones and considered how the legal regulation of the preferential business regime of Free Zones in CIS can be best adapted to ensure compliance. Particular attention was paid to the rules against harmful tax competitions and money laundering imposed by the OECD and FATF and to the problems of banking secrecy, transparency of the regime and tax evasion and its effect on sustainable operation of the Free Zones.

Another issue which could have been legitimately raised and discussed in this Chapter is the impact the European Union's legislation on the development of Free Zones in the target jurisdictions. Considering that some of the CIS countries can possibly join the Union in near future, its attitude towards Free Zones may be somewhat relevant to the present research. Especially, since in the process of establishment of the common market among its Member States,<sup>346</sup> the EU actively attempt to harmonize the taxation, establishment and custom duties,<sup>347</sup> which affect operation of Free Zones. However, due to the space constraints, that extremely interesting issue, which itself makes a good topic for a Doctorate Thesis is left aside.

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<sup>344</sup> *Centros Ltd. V Erhvervs-og Selskabsstyrelsen*, C-212/97, [1999] ECR I-1459

<sup>345</sup> J Plummer, 'A General Anti-Avoidance Rule for the United Kingdom' (1999) August/September *Business Law Review* 213

<sup>346</sup> Rudden and Wyatt, *EU Treaties and Legislation* (8<sup>th</sup> ed Oxford University Press, Oxford 2002) Art 14 EC Treaty

<sup>347</sup> C Radaelli, 'Policy Narratives in the European Union: The Case of Harmful Tax Competition' (1998) Working Papers RSC No 98/34. (EUI, Florence) 6

## Chapter 6. A Proposed Regulatory Free Zone Model in CIS

### 6.1 Birth of a Free Zone: Creation, Status and Administration

### 6.2 Legal Regulation of Preferential Business Regime as a Key Factor of Free Zone's Sustainability

#### 6.2.1 Administrative Preferences

#### 6.2.2 Preferential Tax Regime

#### 6.2.3 Other Financial Preferences

#### 6.2.4 Compliance With International Standards

### 6.3 Termination of a Free Zone

This final Chapter summarizes all the findings of this research and suggests a Regulatory Free Zone Model which can be used in CIS countries setting up their own Zones.

As outlined in Chapters 1, 2, and 3 of this Thesis, a huge number types and models of Free Zones has been established worldwide. These models, being quite diverse, operate in absolute variety of political and economic conditions and are subject to wide range of regulatory norms. And even though the legal regulation of a Free Enterprise Zone differs significantly from an Offshore Financial Centre or a Science City, in this research some common positive and negative regulatory factors were analyzed, which, influencing Free Zone's attractiveness and sustainability, with proper modifications can be adopted by Zones in the target jurisdictions.

Chapter 4 provided an insight into political and economic systems of the target recipients, countries of CIS, and researched a range of preferential business regimes in already established Free Zones there. It was concluded that the legal regulation of business in each transitional country differs considerably and the norms freely accepted in the Russian Federation may not be allowed in Belarus or Ukraine and *vice versa*. However, all transitional economies in Eastern Europe share some common features of the regulatory playing field,<sup>348</sup> which dictate the trends for Free Zones' development.

Constructing a Sustainable Regulatory Model, it is not aimed to design a specific Free Zone for a specific country. Nor will it be possible to create a uniform solution, a Regulatory Model, which could entirely be adopted in all or some of the countries with

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<sup>348</sup> R Dragneva, 'CIS Model Legislation and Its Contributions to Company Law Reform and Harmonization' (2007) in R Dragneva, et al. *Investor Protection in the Commonwealth of Independent States* (Martinus Nijhoff Publishers, Boston) 1



# The Structure of the Proposed Regulatory Free Zone Model for CIS

## 1. Setting up a Free Zone

- aims
- type
- size
- location
- status
- administration

## 2. Legal regulation throughout its duration

- Administrative preferences
  - establishment and registration of residents
  - licensing
  - rent/purchase of premises
  - employment regulations
  - environmental protection
- Preferential tax regime
  - referential tax regime
    - income tax
    - profit tax
    - VAT
    - capital gains tax
    - non-essential taxes and payments
  - exemptions from taxes, duties and charges
  - tax-free export regime for goods
- Other financial preferences
  - accounting
  - banking
  - transfer of funds and profits
  - minimum authorised capital
  - local authority rates
- Compliance with international standards
  - harmful tax practices (OECD)
  - money laundering (FATF)
  - banking system
  - transparency of the preferential business regime
  - European Union

## 3. Termination of a Free Zone

- Duration of preferential business regime
- Regime's maximum guaranteed application
- Assurance mechanisms

developing economies, as this is hardly possible.<sup>349</sup> What this research aims and targets to do is to develop a sustainable Regulatory Free Zone Model for general application, a template, which with some necessary modifications can be of use for the Eastern European Countries in transition those which wish to establish and effectively run Free Zones. In developing the Model, drawing upon the findings and conclusions of the present research, it will consider how to set up, operate and terminate such a Free Zone, paying special attention to legal regulation of its preferential business regime as a key factor of Free Zone's sustainability.

## **6.1 Birth of a Free Zone: Creation, Status and Administration**

Any legal Model of a Free Zone should start with the definition, as it is the definition which outlines the key features of the defined object. The essence of a Free Zone as a model of business organization and variety of its definitions were accordingly discussed in Chapter 1. As an outcome, a Cumulative Definition of a Free Zone relevant to the target jurisdictions, CIS countries was suggested. This definition outline Free Zone is a part of the territory of one (or several) state(s) with clearly defined geographical boundaries and special preferential regime of doing business, which, drawing upon free market economy and legislative stability during the FEZ functioning term, guarantees the realization of certain goals and aims set up by the host country.

This definition, serving as a starting point for this Model, highlights the general and specific features, relevant to Free Zones in the designated region. However, as a starting point, before actually trying to implement the Model on practice, any potential jurisdiction wishing to set up and run a Free Zone should have a clear answer for the following questions:

- Is there an objective need to set up such a Free Zone? What is the country hoping to achieve by establishing it?
- Is having a Free Zone really makes the best way to fulfill the stated objectives? Would running a preferential business regime actually advance the overall economy?
- How feasible is the successful operation of a chosen Free Zone type in relation to socio-economic and political situation in the host jurisdiction? What are the possible Opportunities, Strengths, Weaknesses and Threats the country might experience in this process?

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<sup>349</sup> On theorising of the general principles of regulatory regimes see D Milman, 'Regulation of Business Organizations: Into the Millennium' (1999) in D Milman, *Regulating Enterprise: Law and Business Organizations in the UK*. (OUP, Oxford 1999) 3,6

Making the right “to be or not to be” decision in relation to setting up a Free Zone is not an easy process: it requires an extensive assessment of all the above issues on the highest governmental level.<sup>350</sup> Providing further guidance to the named target jurisdictions on that matter is, however, beyond the scope of this research. But only after the government makes a positive decision regarding establishment of the Free Zone, one can start considering how the Model, outlined below, can be best utilized in legal regulation of its preferential business regime.

In the first section of the Model the process of setting up a Free Zone will be focused on, considering the following: when would it be the most appropriate to do? What type of a Free Zone to choose? Where to locate it? Who should run the set up process and how? Which body and on which terms should regulate and govern such a Zone?

As pointed out by Kursad Tuzmen, Turkey’s ex-trade minister, “[a Free Zone] is a basic medicine for a developing country’s economy and could be a solution if not to every economic problem but to many of them.”<sup>351</sup> Thus, the general suitability of Free Zone as a Model of business environment in times of economic crisis in the countries for CIS can hardly be disputed. In any case, as pointed out in Chapter 4, the overwhelming majority of the target jurisdictions are quite keen to establish and run such Zones to advance their economic situation, attract local and foreign investors and further develop the designated regions.

One has to beware that in spite of being commonly recognized as a popular tool to boost economic prosperity of the country, in certain situations a Free Zone can lower the welfare of a host state. The essential feature of any Free Zone is its preferential doing business regime, which involves either eliminating or significantly reducing the level of taxation, offering various financial and other preferences to residents. The potential threat here is that re-location of domestic companies inside the Zone could actually deprive the state from fiscal gains, as the more tax exemptions it offers to Free Zone residents, the less would it collect for the budget.

One agrees with Grubel, who warns that in setting up a Free Zone, the costs of its establishment can actually exceed the gains from the increased trade and capital inflow.<sup>352</sup> That is another point to bear in mind, as apart from potentially losing out in tax gains, the host state will also have to invest a significant amount of funds into Free

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<sup>350</sup> See S Butler, *Enterprise Zones: a Solution to Urban Crisis?* (The Heritage, Washington 1979)

<sup>351</sup> C Fingar, ‘EU Entry Poses Threat to Free Zones’ (2005) 07 June *FDI Magazine*. Available at <[http://www.fdimagazine.com/news/fullstory.php/aid/1266/EU\\_entry\\_poses\\_threat\\_to\\_free\\_zones.html](http://www.fdimagazine.com/news/fullstory.php/aid/1266/EU_entry_poses_threat_to_free_zones.html)> accessed 28.08.2008

<sup>352</sup> H Grubel, ‘Free Trade Zones and Their Relation to GATT’ (1984) in R H Snape (ed), *Issues in World Trade Policy* (Macmillan Press, USA 1984) 140

Zone development, providing for everything: modifying the location, improving transport links, infrastructure and building construction, marketing and advertising the Zone locally and abroad.

That is why, in absolutely all cases, a thorough economic cost-benefit analysis should be performed to determine whether the costs of establishing and maintaining a Free Zone would actually be lower than the potential increase of government's revenue from the increase of business and economic development of the region, to ensure that offering a low tax regime in Zone-to-be would not be a detriment to the state.

Drawing upon the experience of the researched jurisdictions, where in absolute majority cases an accordingly regulated Free Zone was beneficial for the country's economy and wellbeing,<sup>353</sup> this research does not speculate about Free Zones' necessity for the transitional economies (assuming an affirmative answer to this) and focuses more on how to start up a Free Zone, in particular, when, who and how is to create it.

The idea to set up a Free Zone can either come from the state or from the private sector. Depending on a Free Zone type and the situation in a host country, commonly it is the government, which decides to set up the Zone to tackle certain economic problems. Examples of this are plentiful among the researched jurisdictions: anything from the UK Enterprise Zones, which were established by the UK government under the Urban Development Program, to absolutely all Free Zones in CIS and Eastern European Countries in transition, where the Zones are exclusively established and run by the state.

In some, less numerous cases, a Free Zone can be initiated by a private party or a non-governmental institution, like the famous Silicon Valley in the USA, which was started by Stanford University. However, for the purposes of the present Model, as it is specifically relates to CIS, it is assumed that a Free Zone will be established, controlled and run by the government, as this is normally the case in the target jurisdictions. And even though, when provided by law, a Free Zone could be initiated by a private institution, in such ad hoc cases the government would and certainly should still be in full control over the granted preferential regime.<sup>354</sup>

As an initial step in giving birth to a Free Zone, the host country should think of its type, size and location. Decision-making for these key features<sup>355</sup> largely depends on goals and objectives the Zone is set to achieve. As outlined in Chapter 4, there might be

<sup>353</sup> See R L Bolin, 'Why Export Processing Zones are Necessary' (2004) The Flagstaff Institute. Available at <<http://www.wepza.org>> accessed 28.08.2008

<sup>354</sup> B Lambert, 'Building Innovative Communities: Lessons from Japan's Science City Projects' (2002) European Institute of Japanese Studies. Working Paper 107, November 2000. Available online: <<http://web.hhs.se/eijswp/107.pdf>> accessed 28.08.2008

<sup>355</sup> On a more general discussion of Free Zone methodology see V Ignatov, V Butov, *Free Economic Zones (Methodical and Organizational Approach)* (Os'-89, Moscow 1997)

a variety of reasons why the government would consider setting up a Free Zone, ranging from merely money making purposes to attaining complicated social and economic objectives.

The relevant purposes of Free Zone establishment are the main (but not the only<sup>356</sup>) determining factor, influencing the decision of the State on the actual type of Free Zone to create. Thus, if the government wants to encourage manufacturing and export procession, the Export Procession Zone is an appropriate type to set up; if the aim is to attract tourists and develop infrastructure, than the country might look into a Tourism and Recreational Zone; if the goal is to increase capital inflow and develop financial sector, Offshore Financial Centre is a possibility; and if the major priority is developing science and innovation, than the Technopolice or a Science City is the one to establish.

Evidently, the aims and goals of Free Zone's in CIS, researched in Chapter 4, are to be accounted for the present Model. There was formulated three general fields of applicable purposes, namely economic social and technical-scientific, goals most of the host states would like to achieve by setting up Free Zones. Being more specific to the designated region, the research has outlined six general aims of FEZ establishment common to most of the target jurisdictions, as follows:

- activization of export-oriented activities,
- development of substituting manufacturing based on new technologies,
- effective use and development of local resources,
- implementation of innovative methods of doing business,
- supporting economic development of local territories
- and reduction of unemployment.

These aims, being region-specific, are very general and each country has their own particular needs and problems, they want Free Zones to tackle.<sup>357</sup> For instance, Ukraine, by creating Tourist Recreation Zones was mainly aiming to develop resort infrastructure and attract tourists, and Russia, by establishing Offshore Zones was mostly hoping to increase capital inflow and local business development. In any case, by establishing a Free Zone, the target jurisdictions aim advancing economic prosperity of the region, reduction of unemployment, revival of the depressed territories, increase of export production, attracting foreign investments and capital, new hi-tech technologies to modernize the industry and improve qualification of the labour force.

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<sup>356</sup> See O Chmir, *Special (Free) Economic Zones and Territories of Prioritized Development (Scientific and Methodical Aspects)* (Shidnii vydavnychiy dim, Ukraine 2001) 36, 39.

<sup>357</sup> V Byk, *Free Economic Zone "Gomel-Raton"—Strategy of Sustainable Development* (Gomel, Belarus 2003) 9

With the relevant goals and objectives in mind, it is for the government of the host state to decide which actual type of Free Zone to establish. Choosing the right type is a difficult task due to a huge variety in Free Zone typologies. As noted analyzing the examples from Russia, Ukraine and especially the case study of Belarus, the most common Free Zone types for CIS are Free Trade Zone, Free Economic Zone and Export Production Zone. A limited number of other types of Zones is being established as well, such as the rather exotic Technology and Science Parks (which are now entering a phase of rapid development)<sup>358</sup> or tax havens and offshores (which are currently in the phase of elimination due to increased control over taxation).<sup>359</sup> In any case, the majority of the researched jurisdictions would rather choose to establish some more traditional, and common to the region, types of Zones, such as suggested above.

As the Model does not focus on any specific class of the Zones, it has to ensure general applicability, being relevantly non-dependent on the actual type of the Free Zone, chosen by the host state. Here it is submitted that in addition to general goals and objectives targeted by the Zone, the decision about an actual type will also depend on the political and economic situation in the country, availability and variety of resources, potential location of the Zone and the offered preferential business regime.

After deciding on the actual type of Free Zone to be established, the next step is to choose the location. Picking a suitable location is of crucial importance, as bad placement adversely affects the sustainability of the Zone. Often deciding on a type of Free Zone, the government already have a location in mind. Thus, a Duty Free Zone is the most appropriately placed near the borders; a Free Port is to be located in a port city; and a Tourism and Leisure Zone would be situated in a recreation area or seaside. However, in many cases the choice of location may not be that obvious and the host state has to make the best judgment.

There is a number of factors affecting the host state's decision. This includes, but is not limited to, land available for construction (ideally in public ownership, so the government would not have to reclaim it), well developed infrastructure (premises for business and offices, manufacturing sites, utilities, roads and transportation, etc.), available and easily accessible labor and services.

Without properly accounting for the above factors, the cost of setting up and running the Zone might not be sustainable as it will not be covered by the benefits from

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<sup>358</sup> B Paton, 'Technoparks in Ukraine: Results, Problems, Future Perspectives' (2004) October 4. Available at <<http://www.investments.com.ua>> accessed 28.08.2008

<sup>359</sup> A Shekhovtsev, M Shestakova, A Gromov, 'Free Economic Zones: World Experience and Perspectives in Russia' (2000) 10 *Economic Issues* 108

the Zone's activities.<sup>360</sup> The importance of the locational factor is illustrated by the experience of the UK Enterprise Zones (which were established within the small highly populated and industrially developed territories). It was suggested that in CIS, most of the Free Zones are to be located in well populated areas, as this reduces the expenditure on communications and infrastructure and provide for the better qualified and easily accessible labor.

Another relevant factor is the Free Zone's size. It will ultimately depend on location, territory and typology of the Zone; however one should be very careful with sizing. The present research and analysis shows that the large size of the Zone could be a disadvantage, as such Free Zones are difficult to run and control. For example, the Free Zone in Russian Kaliningrad, where the government after proclaiming the whole region (which is geographically separate from Russia) a Free Zone, failed to properly control it, which led to severe violations of customs regime of alcohol and tobacco import and export and adversely affected the region's economy.

It is important that the Free Zone occupies only a strictly geographically limited territory or separate (but defined) geographical region, such as a city, a district of the city, or even a neighborhood. Unless justified by specific circumstances, the host State should avoid establishing extensively large Free Zones. There are a few successful examples of Zones, occupying a huge territory (like Zone "Manaus" in Brazilian Amazonia); however, the number of such Free Zones is very limited.<sup>361</sup> Success of an unusually large-scale Zone is subject to availability of land, types of activities involved and capability of officials to accordingly control the regime.

Another extreme decision the government should refrain from is placing the whole country under the regime of a Free Zone. Even though it could be appropriate in cases of small island jurisdictions (which mainly introduce Tax Havens and International Offshore Financial Centres as types of Free Zones), it is hard to imagine a whole territory of an Eastern European Country with economies in transition to be under such a regime. Some commentators might disagree, referring to the European Union, which is perceived by many as one huge Free Zone due to established internal market with free movement of goods, services, establishment and capital.<sup>362</sup> However, it is submitted that the extent of the regime offered by the European Union is not identical to a preferential business regime normally provided by a typical Free Zone. Plus, one

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<sup>360</sup> B Gusakov, *Economic effectiveness of investments* (Minsk, Belarus 1998) 56, 58

<sup>361</sup> C Fingar, 'Free Zone Express' (2008) 09 June *FDI Magazine* Available at : [http://www.fdimagazine.com/news/fullstory.php/aid/2458/Free\\_zone\\_express.html](http://www.fdimagazine.com/news/fullstory.php/aid/2458/Free_zone_express.html) accessed 28.08.2008

<sup>362</sup> See G Hertig, 'Regulatory Competition for EU Financial Services' (2001) in D Esty, D Geradin, *Regulatory Competition and Economic Integration* (OUP, Oxford 2001) 218, 240

could hardly consider the EU to fit into a cumulative definition of a Free Zone suggested in Chapter 1. Thus, its example cannot really speak in favor of oversizing.

Last in establishing location, one should avoid fragmentation. Undoubtedly, a selected single geographical territory for a Free Zone would be more sustainable than several fragmented sites with significant distances between them, as this will create uncertainty in application of the regime and problems with its control and regulation.

Both location and size will directly depend on<sup>363</sup> the conceptual approach used by the host State in the establishment of a Free Zone. Under territorial approach, the Zone (and its preferential regime) will cover the whole defined territory and all the residents in it; under functional—only certain indicated activities within the region or separate enterprises; and under mixed approach, the regime would apply to all businesses of certain type in a geographically limited territory.<sup>364</sup> For CIS a variety of approaches could apply, depending on the individual situation.

Even though each approach has its own advantages, for countries in transition we consider the mixed one to be the most appropriate, as it allows applying both principles, strictly defined territory and wide range of chosen activities. Since economies in transition tend to establish Free Zones in already developed and well populated (but possibly depressed or undermined) economic regions, which is difficult to completely isolate from the rest of the country's territory, it is best to enable the host State to selectively grant preferences to certain chosen industries, enterprises or activities within its territory.

To illustrate the above it is suggested to look at a classical Export Procession Zone.<sup>365</sup> In such Zone all export producing manufacturers and enterprises within the geographically defined region are covered by the regime, but other establishments, such as banks, supermarkets, local service providers, etc., even though being located inside the Zone's territory, are excluded. Such selective approach from one side instead of total separation of a Free Zone from the rest of the region at least allows its partial integration into economic and social spheres, and from another side it makes it possible for the Zone to best attain specific aims and goals, set out by the host country, without losing out too much from under-collection of taxes and other revenues.

Another successfully implemented variation of a mixed approach was described in case-study on Belarusian Free Economic Zone 'Gomel-Raton' in Chapter 4. Legal regulation of that export-oriented Free Zone permitted not only resident export-oriented

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<sup>363</sup> n 33, pp.25-27

<sup>364</sup> More on this in Chapter 1

<sup>365</sup> C Baissac, 'Look again at EPZ impact' (2004) 20 October *FDI Magazine*. Available at : [http://www.fdimagazine.com/news/fullstory.php/aid/854/Look\\_again\\_at\\_EPZ\\_impact.html](http://www.fdimagazine.com/news/fullstory.php/aid/854/Look_again_at_EPZ_impact.html)> accessed 28.08.2008



manufacturers to benefit from the preferential regime, but also some other market players, such as banks or transport organizations, who received certain preferences and concessions while servicing the above mentioned residents.<sup>366</sup> However, the law should still clearly indicate the fields to which the preferential regime does not apply, such as supermarket trade, retail or restaurant businesses within the Zone, securing the selectiveness of the applicable regime.

Finally, when making a decision regarding the size and location of the Free Zone, the government should bear in mind the possibility of future expansion, allowing for an increased number of residents. For that purpose, both extra land and infrastructure should be available or easily obtainable. Obviously, plans for the Free Zone development should be pragmatic and progressive, which entails a limited use of state funds where possible. Since to organize a successful Free Zone the government has to sponsor the infrastructure and related developments, instead of acquiring a large scale property or territory, constructing new buildings, building sole use roads, etc., it is better to reasonably limit the territory of the Zone, with some potential for future expansion if required. One should support the suggestion that instead of targeting excessive regional development, the Free Zone should be better placed in or around an already developed urban sector, attracting the best qualified labour and utilizing already existing infrastructure.

Another factor to account for in this section is Free Zone Administration. The decision of the host State on how the Zone to be run is of crucial importance, as potential investors pay due attention to not just powers and competences granted to the body or institution running the Zone, but to duties and obligations of the latter towards the Free Zone's residents. As indicated above, for the designated region, it is most likely to be the state which sets up and run a Free Zone. But to actually administer it, the government will have to appoint or create some kind of an institution or department responsible for dealing with residents and various aspects of the preferential business regime, which we call Free Zone Administration.

In analysing the existing models of Free Zones, various types of Free Zone Administration were outlined, ranging from almost absolute freedom-granting local authorities in some International Offshore Financial Centres<sup>367</sup> to overly-restrictive and

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<sup>366</sup> S Abramchuk, *State Regulation of Free Economic Zones in the Republic of Belarus* (Publishing of S. Lavrov, Brest 2001) 18

<sup>367</sup> C Powell, 'Jersey as a Financial Centre' (2001) in N Courtis, (edt) *Financial Regulation in Offshore Centres* (Central Banking Publications, London 2001) 67

all-controlling FEZ Administration in CIS and (post) communist countries.<sup>368</sup> To make the Zone sustainable, the host State needs to find the best balance between the duties imposed on the Administration and its competences.<sup>369</sup>

In the designated region, as outlined in Chapter 4 and re-instated by the SWOT analysis of Belarusian Free Economic Zone “Gomel-Raton”, it is the government which normally appoints the administration and determines its legal status. To effectively run a Free Zone, the state inevitably delegates a certain amount of powers and competences to its administration, so it can represent the governmental interests controlling the application of the preferential regime. As a rule, Free Zone Administration is allocated an extensive combination of competences, including:

- overall management of the Zone;
- development of its territory and infrastructure;
- shaping the preferential business regime (i.e. preparation of necessary legislation and suggesting or even deciding on the actual preferences and exemptions);
- selection, registration and liquidation of residents;
- collection of taxes, non-tax payment and statistical data;
- exercising ecological and other control.

This list of competences is very general, as often the powers of the Administration reach much further.

The role of the Free Zone Administration is hard to underestimate, as it would (and should) be exercising powers in areas of vital importance for the residents. Often the residency in a Free Zone in CIS is granted on a competitive basis, when the future residents are required to submit their investment projects for the consideration by the special Committee, and only the best (or most suitable) projects will be selected. Being in charge of the actual registration of residents, the Administration is the one to deal with all the supportive documents and data, thus being able to shape the time-scale for registration, and eliminating (or, indeed, creating) bureaucratic obstacles. Site selection and provision of office, not to mention determining the lease rate, are usually also subject to the Administration's discretion; same as the granting of tax exemptions and

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<sup>368</sup> See J de Kort, 'The Investment Climate in the Commonwealth of Independent States' (2007) in R Dragneva, et al, *Investor Protection in the Commonwealth of Independent States* (Martinus Nijhoff Publishers, Boston 2007) 193, 208

<sup>369</sup> On the division of powers see H Malajny, 'The Principle of Division of State Power and its Current Constitutional Stigmata' (2000) in P Torremans, et al, *Legal Convergence in the Enlarged Europe of the New Millennium* (Kluwer Law International, UK 2000) 161, 190

preferences, especially if the law would allow discretion in respect of who gets the preferences, to what extent and for what duration of time.<sup>370</sup>

Having such a wide nature of competences, for a sustainable Free Zone it is of crucial importance to ensure that the Administration is accordingly accountable, both to the government and to the residents of the Zone. And although the capability of the state to properly control the Administration is beyond doubts, in many CIS countries it is the accountability of the Zone's Administration toward its residents what seems to be problematic as being not legislatively provided for.<sup>371</sup>

To ensure attractiveness of the Zone and its regime, the state should guarantee that the Administration is not only granted the necessary competences and powers over the residents, but it is also actually exercises certain duties and responsibilities to the latter. When legally determining the status of Free Zone Administration, the government should provide for:

- open, clear and fair residents selection criteria;
- demand only those documents and papers provided by law;
- strict compliance of the Administration with the maximum time for making a decision about registration of residents (universally accepted terms vary between 2-4 weeks);
- clear provisions on licensing and activities allowed or restricted in the Zone;
- elimination of subjective discretion of the Administration in terms of the extent of granted preferential regime, allocation of the State property and establishment of lease and other rates;
- clear limits of controlling and supervising powers of the Administration;
- available and easily accessible mechanism of complaints if the Administration exceeds its competences.

Another way to improve the system of checks and balances and to guarantee a successful co-operation of the Administration with all the elements involved in a Free Zone operation is an enhanced involvement of residents in the development and even operational management of the Free Zone. This can be achieved by either allowing the latter to participate directly or via the representatives in the meetings of the Administration and the government regarding the functioning of the Zone or simply

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<sup>370</sup> A Pikhno, 'Special (free) Economic Zones of Ukraine: myths and reality, parts I, II and III' (2004) Available at <<http://www.investments.com.ua/media>> accessed 28.08.2008

<sup>371</sup> A Lopatova, 'Free Economic Zones: Positive and Negative Aspects of Development' (2002) First International Conference "Transfer of Technologies in Free Economic Zones", May 2002 (Gomel, Belarus)

encourage residents' feedback, which should be utilized by the authorities in shaping up the future of the Zone. The main control over the preferential regime would then still remain in the government's hands, but the concerned residents would be able to contribute to the sustainability of the preferential regime.

Summarizing the findings for the first phase of the Model outlining the Birth of a Free Zone, it is stipulated that after the State makes a key decision on the needs and reasons for establishment of the Free Zone (based on a cost-benefits analysis), of vital importance is not only to appropriately choose its type, location and size, but also to outline who is going to run and regulate the Zone-to-be and on which terms.

When deciding on the site selection and locational preferences, the host State should ensure that the land is available and suitable for the purpose. Easy transport access, developed infrastructure and availability of highly skilled labour are a must. In sizing the Zone, one should avoid fragmentation, to maintain a clear identity for the Zone, but also to refrain from over-sizing. In typology, specialization and sectoral focus of the Zone the government should be able to decide which types of investment projects to welcome, choosing the investments according to plan and priority. Plus, effectiveness of the undertaking and its further development can be secured by thorough control over the preferential regime. In terms of Free Zone's management, one coherent Zone Administration, a managing body, established and regulated by the government, with clearly identified competences, duties and obligations, is preferable to ensure maximum benefits in the attraction of inward investments and to gain marketing advantage.

## **6.2 Legal Regulation of Preferential Business Regime as a Key Factor of Free Zone's Sustainability**

After the host State makes a responsible decision regarding the necessity, type, location and Administration of a future Free Zone, the key feature to consider next is the actual preferential doing business regime, which the Zone is to offer to its residents. As stipulated above, the extent and attractiveness of the preferences is one of the major decisive factors for the potential investors in choosing the Free Zone. The government, finding itself on a road to regulatory competition,<sup>372</sup> needs to ensure that the regime is comparatively attractive, which, however, should not undermine the State's control over the Zone and should provide for the attainment of the regional goals and objectives.

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<sup>372</sup> On a critical discussion of both, race-toward-the-bottom and regulatory competition theories see D Esty, D Geradin, 'Regulatory Co-Opetition' (2001) in D Esty, D Geradin, *Regulatory Competition and Economic Integration* (OUP, Oxford 2001) 30, 48

Sustainable preferential doing business regime proposed in this section, having a very complex structure and forming a central part of our Model, requires detailed coverage. Constructing it this research draws upon successful examples of legal regulation of various Free Zone Models as discussed earlier. Even though the Model itself has general application and the actual preferential regime between the respectful target jurisdictions is subject to change, here one need to address its actual elements and focus on the legal regulation of the following:

- administrative preferences, which include the rules on establishment, registration, licensing, rent or purchase of premises, employment and environmental protection;
- tax concessions, which relates to applicable taxes and fiscal payments;
- financial preferences, which include (but not limited to) favorable rules on accounting, banking, transfer of funds and profits;
- and compliance with international standards, which covers incentives by OECD, FATF, the European Union and other influential members of the international community, regulating Free Zones.

### **6.2.1 Administrative Preferences**

Granted to Free Zone residents administrative preferences represent a wide range of favorable doing business provisions, which should be introduced by the government ensuring successful and sustainable operation of the Zone. One of the most common challenges investors in CIS face is over-regulation of companies,<sup>373</sup> when the state makes it complicated and costly not only to get established, but to successfully run a business. To overcome this, the target jurisdictions should not merely offer an attractive preferential doing business regime in a selected Free Zone, but will also have to provide for the whole range of other influential factors, such as political and economic stability, rule of law, observance and guarantee of property and ownership rights, lower level of corruption and crime, etc.

Indisputably, the above factors impact directly on a Free Zones' sustainability. However, due to the nature and extent of our research, it does not offer a universally applicable solution on how to improve investment climate in CIS. Instead this section suggests a number of the key administrative and regulatory preferences, which make the

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<sup>373</sup> R Dragneva, 'CIS Model Legislation and Its Contributions to Company Law Reform and Harmonization' (2007) in R Dragneva, et al *Investor Protection in the Commonwealth of Independent States* (Martinus Nijhoff Publishers, Boston 2007) 1, 3

Free Zone of the named jurisdictions more competitive and attractive for the investors, as well as sustainable and profitable for the host country.

The experience of any potential investor in a Free Zone starts with going through the process of establishment and registration. Ease of becoming a resident in the Zone often plays an important part in choosing where to locate. Earlier in this research, when analyzing the statistics of doing business in Eastern and Western Europe,<sup>374</sup> the difference in ease of starting up a business between the developed and developing countries was noted: the number of the required procedures and number of days it takes in economies in transition (with Belarus as an example) can be ten times higher than in the developed economies, like the USA or Singapore.

Situation with registration in a CIS Free Zone is even more complicated by the competitive nature of the residency, which is subject to the additional criteria imposed on all potential investors by the host country. Those wishing to set up a company in a Free Zone are required to submit the investment project for the contest and evaluation to the Administration with the latter granting the right of residency only to the best or the most suitable investors.

Recognizing that such a selection process, even though it imposes additional requirements on an already complicated and prolonged incorporation in the Free Zone, cannot be fully eliminated as it is necessary to secure the Zone's sustainability, it is stipulated that the Zone's Administration should ensure this process remains as transparent, efficient and impartial as possible, and create the absolute minimum of obstacles for the potential investors.<sup>375</sup>

Leaving aside the element of competition, relaxing applicable registration rules for the new residents is still within the powers of the host State. There is more than one way of achieving this objective and throughout this research many successful examples in different jurisdictions have been looked at. Thus, to make Free Zones more sustainable, in the area of establishment and registration of residents, the host country may consider implementing or amending the following:

First, the Administration of a Free Zone should provide for an effective and simple incorporation procedure. As earlier discussed, attractiveness of the regime depends on how fast and easy the future residents can get established within the Zone; most of the transitional countries are far behind on the scale of effectiveness in incorporation. Throughout this research various jurisdictions were analyzed and some effective practices noted. For instance, in Ireland, to start a business the investors should

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<sup>374</sup> See Chapter 2.4

<sup>375</sup> S Abramchuk, *State Regulation of Free Economic Zones in the Republic of Belarus* (Publishing of S. Lavrov, Brest 2001) 23

only perform 3 procedures: to file an application with a registrar, to make a company seal and to register for taxes and employment. This takes around 12 days and cost approximately 1,500 Euro.<sup>376</sup> One does not suggest that all Free Zones should copy this example (due to the diverse national systems and requirements) or follow the lead of International Offshore Financial Centres (such as Gibraltar), where the whole incorporation procedure takes just 3 days (due to high potential for abuse);<sup>377</sup> but waiting for over 120 days to register a company is too excessive for most investors.<sup>378</sup>

The next suggestion, the principle of a “single window,” might be of further help here. By ‘single window’ it is mean to introduce the one institution or agency within the Zone (it should be run by the Administration) empowered to collect and process all required documents from the residents-to-be and on their behalf further communicate with all governmental bodies involved in incorporation.

Considering an extensive number of documents required to register a company (ranging from articles of association to various specific statements and notes regarding property, members, income, etc.), which are usually submitted to different agencies, each enjoying varied decision-making time, a ‘single window’ would not only relieve the investors from hassle and time wasted while submitting all the documents, but also provide for the fast and prompt response from the Administration, thus reducing the overall time it takes to set up an enterprise.

An excellent example of such mechanism is provided in company law of the United Kingdom, where a company can be registered in just one day once all the paperwork has been prepared and submitted to Companies House (which can even be done electronically). Such registration takes hours and cost no more than 50GBP. The House, in addition to registration, is also further involved in regulating the operation of the companies, by collecting statistical data and reports or taking notes on changes in the documentation, share capital, etc. Plus, the in-house specialists can offer help in preparation of the articles of association and other documents, required for the registration.<sup>379</sup> Something of a similar type (but maybe of a lesser scale) should be introduced in any Sustainable Free Zone.

Third, in addition to the principle of a ‘single window’ it is always desirable to provide for the maximum response time (i.e. the principle of Speedier Administration) for any institution dealing not only with establishment and registration of investors, but

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<sup>376</sup> For other details and statistical data see Chapter 2.4

<sup>377</sup> D Milman, ‘Regulation of Business Organisations: Into the Millennium’ (1999) in D Milman, *Regulating Enterprise: Law and Business Organizations in the UK* (OUP, Oxford 1999) 4

<sup>378</sup> I Baranouski, ‘Free Zones are Looking at the EU’ (2003) October 2 *Zviastda* 3

<sup>379</sup> More on Companies House in the UK is available at <<http://www.companieshouse.gov.uk>> accessed 02.12.2007

also with other aspects of residents' life in a Free Zone, such as licensing, permission planning, banking, providers of utilities, etc.

An example of such provision was given in the Urban Development Program in the UK, where residents of the Enterprise Zones were guaranteed a response from the Administration in 14 days.<sup>380</sup> Being properly adhered to, the principle of Speedier Administration improves efficiency of Free Zone's governance and serves as an additional guarantee to the residents.<sup>381</sup>

Once the permission to get established in a Free Zone is granted and the incorporation process is underway, the next issue the new residents face is acquiring from the Administration the permissions for intended business activities as specified in the investment project (i.e. export manufacturing, financial services, etc.), which will most likely result in licensing.

Regulating the activities within the Zone is normally both a competence and an obligation required by the state from the Administration, which has to review the investment projects and issue the required licenses. Traditionally, in line with incorporation, licensing in CIS countries is a very stressful and long procedure, as the government imposes a high number of qualifying requirements to receive an operational license. As established by the US researchers,<sup>382</sup> excessive state interference only deepens the economic crisis, thus the Free Zone Administration should thrive to ease that burden.

According to the World Bank,<sup>383</sup> licensing process in some transitional countries, like Belarus and Russia, may take well over a year and involve as many as 25 procedures. These standards are clearly incompatible with a Sustainable Free Zone, and the way to deal with licensing more efficiently should be found.

Unfortunately, obtaining a license is a basic requirement, as it effectively serves as a control mechanism for the government (and Free Zone Administration) over the residential activities; in most of the researched Free Zones (with exception of Tax Havens) licensing is widely implemented. What has to be done by CIS Free Zones is to simplify and cut down the number of the required procedures, which can be achieved in a number of ways.

Introducing special simplified licensing regime could be a solution. As illustrated by the UK Enterprise Zones, the government could provide a list of business

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<sup>380</sup> More on this in Chapter 2.1.1

<sup>381</sup> A Pikhno, 'Special (free) Economic Zones of Ukraine: myths and reality, parts I, II and III' (2004) Available at <<http://www.investments.com.ua/media>> accessed 28.08.2008

<sup>382</sup> S Butler, *Enterprise Zones: a Solution to Urban Crisis* (The Heritage Foundation, Washington 1979)

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<sup>383</sup> The statistics in Chapter 2.4



activities within the Zone for which the operational license is deemed to be automatically granted. This should include priority activities for the Zone (in accordance with its specialization and public needs) or agreed upon activities at the time of investment project approval. This is not detrimental for the State, as when approving the investment project the Administration review the proposed activities and the automatic grant of licenses seems to be a rather sensitive measure.

Alternatively, the application for licenses should be maximally speeded up. The discussed above principle of a “single window” might be of further help, because submitting all documents to one agency significantly reduces the number of steps to be undertaken by the investors and proper administrative control over this activity and strict enforcement of the maximum response time ensures effective decision-making and reduces the waiting time.

Next, administrative preference to be considered by a sustainable Free Zone is to secure some preferences in the fields of rent and property purchase. Any company, established in the Zone, will inevitably either purchase or rent facilities or construct on their own premises. The right to ownership of land and property is one of the areas where the investors face difficulties in CIS Free Zones.

As earlier discussed, when the country is planning to set up a Free Zone, it needs to consider the ownership of the land in the region. To minimize acquisition and nationalization, it was advised that such ownership should be public. Which is the case anyway in most of the European countries in transition. Considering the usually temporary nature of Free Zones, investors could hardly count on being given the possibility to purchase land into private ownership.<sup>384</sup>

But when one invests into the enterprise, the Administration needs to guarantee that the land and property would not be nationalized. There are various mechanisms of achieving this, ranging from a lease agreement for identified (or unidentified) period to contractually tying up the possession of the land with the ownership of the property on it (i.e. as long as the investor owns the manufacturing facilities the designated plot of land remains at his disposal).

Another issue is insufficient protection of private property. As discussed drawing upon the experience of Belarus (where violations of property rights and confiscations are still common), due to legislative instability of CIS Free Zone residents bear a risk of nationalization of their assets by the State. This is a recognized

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<sup>384</sup> A Lopatova, ‘Free Economic Zones: Positive and Negative Aspects of Development’ (2002) First International Conference “Transfer of Technologies in Free Economic Zones”, May 2002 (Gomel, Belarus)

problem,<sup>385</sup> applicable not only to ownership of land and constructions, but also to other investor's assets.

Unfortunately, it is difficult to suggest anything more effective for the Free Zone's Administration to implement apart from not just providing for the proper legislative guarantee of this right (which is provided by law in all transitional countries anyway), but ensuring strict practical adherence to this principle. Indeed, looking at the experience of many CIS states,<sup>386</sup> when it comes to legislative guarantees, it is the enforcement of the rights which turns out to be problematic, rather than its legislative introduction. Which basically means all the Administration has to do is to re-enforce in practice what has been explicitly provided by law.

Another alternative (which would be less attractive for the investors) is to administratively discourage private ownership of the premises but rather to effectively offer those for lease. From the governmental point of view this might be an optimal solution, as it permits the state to remain in maximum control over the enterprises located in Free Zones. All that the Administration has to ensure is to maintain a fair and affordable level of rent (not to scare off the residents), plus to provide for possible capital allowances to encourage either state or private property developers.

Another preference, which comes under the Administrative heading, is regulation of employment relations. An enterprise in a Free Zone will inevitably employ local or foreign labor, and the host State needs to provide preferential conditions for it.

Here, the case is not about the mere availability of labor. This is an obvious criterion which the government has to consider when deciding the possible location of a Free Zone anyway. As stipulated above, the adequate work force in accordance with the specialization of the Zone should be readily available. It is the competitive legal regulation of labor relations<sup>387</sup> that matters.

First of all, the host State needs to ensure that the investors can easily bring in and employ foreign specialists where necessary. Often, business projects in Free Zones involve introduction of innovative technologies and processes, when domestic workers might not be qualified and experienced enough to successfully run the enterprise.

Chapter 2 discussed the negative experience of China, where the Administration was not only solely responsible for providing staff and workers they thought were

<sup>385</sup> R Haywood, 'Free Zones in the Modern World' (2004) *Flagstaff Institute* Available at: <<http://www.wepza.org>> accessed 28.08.2008

<sup>386</sup> See O Chmir, *Special (Free) Economic Zones and Territories of Prioritized Development (Scientific and Methodical Aspects)*. (Shidnii vydavnychiy dim, Ukraine 2001)

<sup>387</sup> See B Bercusson, 'Regulatory Competition in the EU System: Labour' (2001) in D Esty, D Geradin, *Regulatory Competition and Economic Integration* (OUP, Oxford 2001) 241, 262

needed for SEZ, but also demanded that the investors employ Chinese nationals for the key managerial and other positions, to ensure transfer of technology and skills. Even though one can see the benefits of this requirement for the State, such limitations play an adverse effect on foreign investors, significantly limiting their freedom of operation. Any Sustainable Free Zone should refrain from restricting investors in such a way. Even though the government would encourage the employers to hire as much locally available labor as possible, they should not create obstacles for bringing in qualified foreign specialists. More over, Free Zone's Administration should seek better legal regulation of this procedure, introducing simplified applications for visas and work permits.

Another provision which a Free Zone should avoid is introduction of an upper limit for wages paid to foreign employees. It is understandable that the country will have to enforce certain social guarantees for the domestic workers, such as minimum wages, working time regulation, vacations, ect., but to demand a maximum cap in pay to foreign and national workers, especially in managerial positions, is too excessive.

Summarizing the above suggestions, the importance of the Administrative Preferences is emphasized. It comprises a significant part of a sustainable doing business regime and to note that the accordingly regulated preferential conditions for establishment and registration of residents, licensing, purchase of property and labor relations have a great impact on the overall image of the Zone.

Regulating this important sphere, the government have to be flexible and creative. On one hand, there is a need for a strong Free Zone Administration, capable of successfully regulating various aspects of the regime. On the other hand, over-competent authorities can easily abuse their powers and create further obstacles for the residents. The key aspect of sustainability is to find an appropriate balance between the powers of governmental control and preferences granted to residents. But having in mind the specific features of CIS one can affirmatively conclude that such a balance cannot be positively established without reducing the overall level of the State regulation of doing business regime.

### **6.2.2 Preferential Tax Regime**

Most analysts agree that capital does not move freely from one country to another and settle in a Free Zone purely because of lower tax.<sup>388</sup> Undoubtedly, there is a long list of reasons why investors might want to get established in a particular

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<sup>388</sup> C Radaelli, 'Policy Narratives in the European Union: The Case of Harmful Tax Competition' (1998) Working Papers RSC No 98/34 (EUI, Florence) 11

jurisdiction.<sup>389</sup> It is, however, the extent of the preferential tax regime offered by the Free Zone which usually serves as one of the major decisive factors for businesses in choosing whether to get established and invest there.

Throughout this research a wide range of preferential tax regimes offered by both high and low-tax countries was looked at, ranging from virtually tax-free International Offshore Financial Centres to highly regulated Special Economic Zones in China. The possible successful elements of such regimes were outlined and analyzed with proper modification to be incorporated into the Proposed Regulatory Free Zone Model for CIS.

The major problem with CIS is not just traditionally high tax level imposed by the government, but general economic instability, lack of resources, over-regulation of business and naturally unfavorable investment climate—all the factors, the combination of which could somewhat explain the increased tax burden imposed by the State, are still serving as a serious draw back for investors. This section of the Model looks at the favorable tax regime for the Free Zones to implement.

Before making the suggestions regarding the legal provision for the applicable taxes in CIS Free Zones, it is stressed that the overall nationwide amount of tax imposed by the target jurisdictions remains considerably high. Earlier in this research, the statistical information on tax payments provided in the Doing Business report prepared by the World Bank was analyzed and compared and a significant difference in tax burden ranking between the Eastern European countries in transition and developed countries of Western Europe was highlighted. Thus, most of the CIS (such as Ukraine and Belarus) received a very high ranking on paying taxes (180 and 181 respectfully), which in addition to an increased number of tax paying procedures, indicates a high level of state tax imposed on residents. In comparison, the low ranking of the Western European Countries, such as Ireland, UK or Switzerland (all ranked between 6 and 19), indicated the nationwide low-tax regime in these jurisdictions; in addition to even more attractive preferences offered by the Free Zones, it makes the above countries look especially appealing for investors.

The present discussion highlighted internationally supported<sup>390</sup> argument that in order to be positively viewed by investors, CIS should not only provide for the low tax

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<sup>389</sup> As outlined when discussing modelling of a sustainable doing business regime in Chapter 2.4

<sup>390</sup> See for example J de Kort, 'The Investment Climate in the Commonwealth of Independent States' (2007) and R Dragneva, 'CIS Model Legislation and Its Contributions to Company Law Reform and Harmonization' (2007) in R Dragneva, et al *Investor Protection in the Commonwealth of Independent States* (Martinus Nijhoff Publishers, Boston 2007); T Congdon, *Towards a Low-tax Welfare State* (Politeia, Italy 2002); D Shaviro, 'Some Observations Concerning Multijurisdictional Tax Competition' (2001) in D Esty, D Geradin, *Regulatory Competition and Economic Integration*. (OUP, Oxford 2001) 49, 68

regime inside the Free Zones, but also liberalize the nation-wide taxation. This move requires certain political will and economic background, but for CIS it is not unrealistic.

A positive example here is provided by Russia, which in recent tax reform introduced a universally applicable low income tax rate of just 10%. Such move, which should also be considered by other jurisdictions in our target group, have not only provided Russia with appealing tax ranking by the World Bank, but has also served as an additional incentive for domestic and foreign investors.<sup>391</sup> One could question the relevance of Russian approach to our discussion, as this illustrates the regulation of nationwide taxation and is not specifically related to Free Zones. However, certain parallels to Free Zones can be drawn here: when the country-wide tax is reasonable, it is politically easier for the state to introduce even more preferable conditions in its Free Zones.

In any case, the key principle is that when it comes to designing a preferential tax regime for Free Zones, the CIS governments needs to exercise flexibility and reason by offering such a combination of attractive provisions, which would not just be attractive compared with the high national tax rate, but also secure Free Zone's victory in regulatory competition battle against the neighboring Western European low tax countries.<sup>392</sup>

So how does one design a sustainable preferential tax regime for the target jurisdictions? Even though no universally applicable formula exists, there is a number of rules to be observed and a variety of suggestions to be implemented.

The first standard rule is that CIS government establishing a Free Zone has to guarantee significant exemptions from any custom duties, taxes and charges on import of raw materials, capital, equipment and other investment resources which the residents are going to bring from abroad to effectively commence the project.

The extent of the above depends on an actual type of a Free Zone established, which is influenced by the aims and objectives of the host jurisdiction. One of the most likely types of Free Zones established in CIS would be Manufacture and Trade Zones (such as Export Processing or Free Trade Zones),<sup>393</sup> which are being multi-functional export-oriented Zones providing for a low-tax regime on goods produced for export, and the host state will have to provide for the accordingly balanced necessary exemptions.

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<sup>391</sup> O Rustamova, 'How do we manage FEZ?' (2001) 4 *Russian Economy: XXI century* 32

<sup>392</sup> D Shaviro, 'Some Observations Concerning Multijurisdictional Tax Competition' (2001) in D Esty, D Geradin, *Regulatory Competition and Economic Integration*. (OUP, Oxford 2001) 64, 67

<sup>393</sup> See the full typological range of Free Zones in Chapter 2

Foreign investors established in such a Zone would inevitably be importing means of production, equipment and materials to organize export oriented or export-substitution manufacturing.<sup>394</sup> Thus, it is wise to provide for a preferential or tax-free regime for import of such items into the Zone. As an example of successful application of this preference we looked at Special Economic Zones in China which allowed tax free import of all necessary raw materials and machinery, as long as the projects were leading to export manufacturing.

To secure effectiveness of this provision and to avoid its abuse by the residents, the Administration needs to clearly stipulate and adhere to the rules of its application, specifying which categories of residents can benefit, for which projects the preferences are offered, and under which terms, conditions and duration the exemptions are guaranteed.<sup>395</sup>

The second standard rule, closely linked to the first one and also being more relevant to export-oriented Free Zones in CIS, is to provide for tax-free export regime for all goods and products, made inside the Zone. Once the goods are produced under the beneficial tax regime, the investors should have absolute freedom to export them. Certainly, the host State needs to ensure that the goods are being exported abroad, not ending up on the domestic market (with the exception of import substitution); otherwise, to be fair to domestic companies the goods should be exempt from the preferential tax regime.

To improve the rule's efficiency, the Administration could legally provide for the minimum required amount of goods to be exported. This has been attempted by Free Economic Zones in Belarus, where companies subjected to the preferential regime were required to export at least 90% of manufactured products, thus only 10% could be sold on the internal market. The major problem with this, however, is a prompt enforcement<sup>396</sup> and the strict adherence to import/export ratio (which has not been done effectively in Belarus, leading to numerous violations and abuses of the preferential regime).

The abovementioned two rules are mostly relevant to export-oriented Free Zones. Many CIS Countries, however, are not likely to limit themselves to just this typology and will introduce other types of Free Zones, as discussed in Chapter 4. Thus, the present Model is not limited to just export-oriented Free Zones and will suggest

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<sup>394</sup> C Baissac, 'Maximising the Developmental Impact of EPZs' (2004) vol.XXVIII, #1, June *Journal of the Flagstaff Institute* 53, 76

<sup>395</sup> O Rustamova, 'How do we manage FEZ?' (2001) 4 *Russian Economy: XXI century* 32

<sup>396</sup> S Abramchuk, *State Regulation of Free Economic Zones in the Republic of Belarus* (Publishing of S. Lavrov, Brest 2001) 37, 40

other possible tax concessions of a wider application, which make preferential regime attractive and sustainable.

The main general rule here is to provide for tax exemptions and preferences tailored to needs of the host state and the type of the Zone. These would effectively form a key part of the preferential tax regime. The range and extent of the norms will depend not just on the actual Zone's type and specialization, but also on political willingness of the host country to bend the existing tax rules and undertake the risk of some under-collection of dues from Free Zone residents in return for economic revival in a taken region.<sup>397</sup> Throughout this research many forms of the applicable preferences were looked at and the following is suggested to be implemented for Free Zones in CIS:

#### 1. Income tax.

The preferential rate of income tax is one of the key features inducing investors to get established in a particular Free Zone.<sup>398</sup> Depending on model and type, Free Zones offer a variation of rates: from only marginally reduced income tax for all residents (Chinese SEZ) to virtually tax-free Exempt Companies in most of the offshore jurisdictions (Gibraltar or Isle of Man). So what is the best approach for the target jurisdictions, allowing them to succeed in international regulatory competition and still maintain revenue collection from Free Zone residents?

It is suggested the CIS Free Zones should not follow the Tax Havens' approach and totally abolish income tax: transplanting this Free Zone Model into the target jurisdictions without proper modification is not appropriate.<sup>399</sup>

What the transitional countries should consider is sufficiently reducing the existing income tax rate for residents. Surely, an average income tax of 30% traditionally applied in CIS countries can be painlessly lowered to a compromising 10%-15%. This would, allowing the host jurisdiction to collect necessary amount of revenue to cover the expenses of running the Zone, provide an appealing incentive to foreign and domestic investors avoiding high tax to relocate into Free Zone.

#### 2. Tax on profits

The same strategy should apply to any taxes on profits, as long as the profit is gained from the exempt activities. Effective application of this rule was

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<sup>397</sup> V Ignatov, V Butov, *Free Economic Zones (Methodical and Organizational Approach)* (Os'-89, Moscow 1997) 18, 20

<sup>398</sup> G Clarke, *Offshore Tax Planning* (12<sup>th</sup> edition Tolley, London 2005) 103, 105

<sup>399</sup> See D Ushakov, *Offshore Zones in Russia's Tax Payers' Practice* (Jurist, Moscow 2002) 33, 35

illustrated in Gibraltar, where qualified companies are highly taxed for all local activities, but non-residential business is basically exempt from profit tax.

### 3. Value Added Tax (VAT)

VAT is another flexible mechanism encouraging target activities within the Zone.<sup>400</sup> the goods produced for export or import substitutions should benefit from a reduced (or zero) tax rate. Certain services provided inside the Zone could be totally exempt from VAT (as attempted in Free Tourism Zones of Ukraine).<sup>401</sup>

### 4. Capital gains / capital acquisitions and other related taxes

The present research and analysis of Tax Havens, showing a positive relationship between the size of capital taxes and overall investment inflow, revealed a clear tendency of more flexible and progressive small island jurisdictions undercutting large traditional high-tax countries in international competition for capital.<sup>402</sup> What CIS countries can learn from this is that despite the certain risks of undercollection of overall dues when lowering the tax base,<sup>403</sup> if regulated accordingly, the Free Zones will ultimately benefit from capital mobility and increased number of residents. Additionally, this category of tax exemptions is very flexible and be could well expanded to include tax on dividends, tax on asset value, or even the stamp duty.

### 5. Elimination of other non-essential taxes and payments.

The extensive list of these in CIS<sup>404</sup> can include anything from Road Maintenance Tax to “offshore duty,” levied on any transfers (including profits and dividends) directed to accounts in recognized Tax Havens. The key point is to ensure sustainability and attractiveness of the Zone the Administration needs to provide as many tax concessions and preferences as possible. This inevitably includes abolishing most of minor and non-essential taxes, leaving just a few key ones with a preferential rate.

Considering the above, it is stressed that tax exemptions are not the only feature of the preferential business regime. This research has looked at other useful financial

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<sup>400</sup> See M Stewart, ‘Global Trajectories on Tax Reform: The Discourse of Tax Reform in Developing and Transition Countries’ (2003) 44 *Harvard International Law Journal* 139, 151

<sup>401</sup> A Pikhno, ‘Special (Free) Economic Zones of Ukraine: Myths and Reality, parts I, II and III’ (2004) Available at <<http://www.investments.com.ua/media>> accessed 28.08.2008

<sup>402</sup> S Stuart, ‘Islands of uncertainty’ (1996) November 22 *The Independent* 21

<sup>403</sup> Taken from: J Alworth, D Masciandaro, ‘Public Policy: Offshore Centres and Tax Competition: The Harmful Problem’ (2004) in D Masciandaro, *Global Financial Crime: Terrorism, Money Laundering and Offshore Centres* (Banco de Espana, Spain 2004) 196, 197

<sup>404</sup> J de Kort, ‘The Investment Climate in the Commonwealth of Independent States’ (2007) in R Dragneva, et al *Investor Protection in the Commonwealth of Independent States* (Martinus Nijhoff Publishers, Boston 2007) 203, 205



and non-financial preferences: anything from local authority rates' exemption in the UK Enterprise Zones to simplified amortisation for high-tech companies at Tsukuba Science City in Japan. And all these (in addition to other financial preferences discussed in the next section) can be successfully utilized by CIS Free Zones in addition to the above tax exemptions.

Drafting the preferential tax regime the host state should clearly indicate the territory or types of businesses to which the exemptions would apply. One needs to foresee and avoid mistakes of some jurisdictions (referring to the experience of Russian FEZ in Kaliningrad), which allowed unlimited and uncontrolled application of the preferential regime on the whole territory. Thus, the preferences should either be given on an outlined and strictly limited geographical basis or remain confined to certain types of undertakings within the region. The second approach was effectively utilized in another Russian FEZ, "Nakhodka", which only offered preferential tax regime to undertakings with at least 30% of foreign capital (thus fulfilling the region's ultimate goal to boost foreign investments).

Free Zone Administration shall also remember the operational time-scale of the preferential tax regime. Referred sometimes to as "tax holidays," concessions should be applicable for a certain (preferably long) period of time. The duration of the preferential tax regime does not necessarily correlate with the actual life time of the Free Zone, but the less changeable the regime is the better.<sup>405</sup> In the present research the effectiveness of short-term "tax holidays" (less than 10 years in the UK Enterprise Zones, up to 15 years in China) with long-term preferential business regime (over 30 years in Ukraine) was analyzed and compared and it was concluded that the duration of preferences in CIS should be of a longer period, as short-lived exemptions prove being ineffective.

Finally, it is submitted that the structure and extent of the preferential tax regime should closely relate to Free Zone's actual type and aims when all or some of the discussed concessions to be implemented. However, finding a right balance between granting wide scale tax preferences and running the Zone sustainably remains up to the host state.

### **6.2.3 Other Financial Preferences**

Having made some suggestions on preferential tax regime in CIS Free Zones in the above section, next one has to discuss other possible financial preferences, since preferential doing business regime is not confined just to taxes: there are other applicable provisions and references of fiscal nature, which give financial advantages to

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<sup>405</sup> S Stuart, 'Islands of uncertainty' (1996) November 22 *The Independent* 21

Free Zone residents. The list includes, but is not limited to a simplified accounting and reporting procedures, easier and cheaper banking operations, free transfer of funds and profits abroad, exemption from minimum share capital, reduction on utility rates and simplified amortization. Drawing upon the successful examples from the researched jurisdictions, some recommendations for Free Zones in CIS are provided below.

## 1. Accounting

In the target jurisdictions the State traditionally is keen to keep track on companies' accounts and require undertakings to report all types of activities. Such "accountability" in excessive form damages the investors, as they have to input sufficient time and resources (employ accountants and bookkeepers) to comply with the national regulations. Accounting issues could also be classified under administrative preferences, however it has been decided to include them in the current section as relaxing accounting rules will ease the financial burden on the investors.<sup>406</sup>

Throughout this research various Free Zone models have been considered, providing for a rather diverse range of accounting regulations: from very liberal British Virgin Islands, which do not require exempt companies to file any accounts or annual returns to established European Free Zones, which apply standard accounting procedures to all residents. Evidently, the target jurisdictions would not agree to totally relax the control over residents' financial operations; this not advisable in the conditions of transitional economy anyway. But introducing simplified accounting procedures is important, since it allows the state to keep track of taxation and finances of the residents, still serving as a very good incentive to investors.

A compromising solution here could be the legislative provision for less frequent preparation and submission of accounts (which in many CIS countries is done at least monthly). Considering already reduced tax burden applied in Free Zones, this goal is easily achievable. How this provision could be utilized on practice was illustrated by Offshore International Finance Centre in the Isle of Man, where investment businesses are required to submit financial reports only twice per year.<sup>407</sup>

## 2. Banking

A simple, effective and convenient banking system is another preference which can serve investors both as an administrative and financial incentive. The major issue in CIS is that banks there traditionally operate not only as financial service providers, but also as one of the key instruments of governmental control over financial operations of

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<sup>406</sup> S Shuleiko, *Institutional Factors in the System of Foreign Investments of National Economy (Conceptual Analysis)* (Gomel, Belarus 2001) 44

<sup>407</sup> M Hampton, *Offshore Finance Centres in Small Island Economies: Can the Jersey Model be Replicated by Other Havens?* (3<sup>rd</sup> ed MacMillan Press, USA 2000) 23, 24

the undertakings.<sup>408</sup> Indeed, it is within the banks' obligation to report to the authorities all kinds of data on clients and their transactions, ranging from purposeful use of funds to accounting for taxable income.

The problem is further escalated by a long and overly complicated accounts opening procedure (any undertaking in a Free Zone cannot function without a bank account), bureaucracy, and abuse of already extensive and discretionary power to approve transfers or allocation of funds, which altogether can further slow down a successful start up and operation of the investment projects.<sup>409</sup>

It is important for CIS Free Zones to liberalize banking regulations in order to improve attractiveness of the Zone, but the Administration has to exercise certain caution. On one hand, the government needs to secure protection of its own interests having ensured the residents adhere to aims and objectives of the target activities. Also, the country needs to comply with the wide range of international regulations restricting Free Zones' operation.<sup>410</sup> On another hand, banking regime in a Free Zone should remain utmost favourable to ensure smooth and efficient operation of the residents.

Leaving aside the necessity to comply with international financial standards, which is discussed in the next section of the Model, some suggestions for simplification of the banking regime, which would leaving the Zone sustainable also appeal to potential investors are proposed here. Drawing upon the experience of Free Zone Models researched, for CIS the following is suggested:

- Opening account procedures should be smooth and efficient. The Administration should impose on the banks only the requirement to review the most vital documents, such as those checking identity, due diligence and clients' legitimacy. This is a reasonable requirement as all residents established in a Free Zone have already undergone through a scrutiny by the Administration at the time of investment project approval.
- Efficiency of banking operations and related services provided for the residents should take priority over the attempts to challenge every move of the investors. This, however, should not prevent the banks from checking the legitimacy of funds and collecting information on purpose and reason for the account or anticipated activity.<sup>411</sup>

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<sup>408</sup> On banking supervision see A Arora, 'Banking Companies' (2001) in D Milman, *Regulating Enterprise: Law and Business Organizations in the UK*. (OUP, Oxford 1999) 117, 144

<sup>409</sup> T Danko, Z Okrut, *Free Economic Zones in International Business* (Infra-M, Moscow 1998) 18

<sup>410</sup> Some of them, like Wolfsberg Anti-Money Laundering Principles, have been discussed in Chapter 5

<sup>411</sup> W Witherell, 'International Approaches to Combating Financial Abuse and Promoting Stable Financial Markets' (2002) Vol.5 No 4, *Spring Journal of Money Laundering Control* 14

- International banking principles, such as banking secrecy and confidentiality of banking operations should not only be enacted, but strictly enforced.<sup>412</sup> Certainly, by having details of a client's personal and financial circumstances, the banks are in the best position to determine the appropriateness of any account activity or transaction on behalf of the Zone's Administration. But knowing and reporting this when necessary should not constitute a barrier to providing a fast and reliable service.<sup>413</sup>

### 3. Transfer of funds and profits abroad

The point made above is that the residents should be absolutely free to transfer any legitimate profits to any legitimate account abroad. This means that the legal regime in a Free Zone should refrain from not just excessively taxing such profits, but also from imposing any additional requirements to enable the transfer. In this research plentiful examples of this have been uncovered, anything ranging from restrictions applied to national undertakings in respect of holding the bank account abroad to introduction of the unfair additional tax on profit transfers to any Tax Havens.

Another factor affecting Free Zone sustainability in CIS, which is being especially relevant to foreign investors, is exchange control and difficulties in exchange operations. Remembering that most of the target jurisdictions being in the process of transition have rather unstable and not easily convertible national currencies, investors often face a problem of currency exchange when transferring the profits. The Administration and resident banks should be able to effectively deal with this. One of the solutions could be withdrawal of any exchange control or limitations within the Zone.<sup>414</sup>

### 4. Minimum authorised capital

The issues with minimum authorised capital being part of the registration requirements for Free Zone residents have been briefly discussed as one of the administrative preferences. However, it is also of financial importance, as the lower minimum authorised capital requirement makes starting up a business in a Free Zone cheaper and easier. Of course, it is hardly possible to underestimate the importance of the minimum authorised capital, which serves as a guarantee protecting the creditors in case of a company's insolvency. However, the analysis of different Free Zone models showed that authorised capital does not have to be high, as there are other ways of creditor protection.

<sup>412</sup> See D Champbell, *International Banking Secrecy* (Sweet and Maxwell, London, 1992)

<sup>413</sup> R Alba, 'Fraud Control in Offshore Banking Centers' (1999) 20 *Amicus Curiae* 11, 14

<sup>414</sup> V Byk, *Free Economic Zone "Gomel-Raton"—Strategy of Sustainable Development* (Gomel, Belarus 2003) 47, 48

A good example of how the authorised capital and other aspects of the doing business regime serve as an incentive for investors to relocate is provided by the European Union rules on freedom of establishment, where the European Court of Justice stipulated<sup>415</sup> that the EU companies are free to get established in other Member States purely for the reason of taking advantage of the most preferential doing business regime.

Thus, the Free Zone Administration should negotiate a reduced minimum authorised capital for its residents with the government, which will have a positive effect on attractiveness of the regime. A specific amount is not suggested here, as this is best to be decided by the target jurisdictions. However, this research came across a few successful models, where the minimum authorised capital varied from notoriously small £100 (as in International Offshore Financial Centre in Gibraltar) to a moderate £25 000 (for International Business Companies in British Virgin Islands).

#### 5. Local authority rates

Another financial preference is exemption from local authority rates, which has already been discussed under the above section on preferential tax regime. Without being repetitive, it is noted that local authority rates are not just comprised of taxes, but of any other payments of fiscal nature, including those for services rendered to residents. Indisputably, the residents cannot expect all local authority rates to be waived, but if the Administration manages to negotiate some subsidies and concessions (as seen in case of the UK Enterprise Zones), this will increase the general attractiveness of the Zone. The key idea, as always, is to find the right balance.

Summarising this section, it is submitted that the above list of possible financial preferences is not exhaustive and other concessions could apply to make the regime in CIS Free Zones more attractive. The range and extent of those depends on the actual type, aims and objectives of the host state, as well as the political and economic reason for amending existing legal rules.

### 6.2.4 Compliance With International Standards

To provide for a successful operation of a CIS Free Zone, the host State should not just carefully structure its preferential business regime to suit the needs and interests of the investors and regulate it accordingly to enable the Administration to properly oversee and control it, but has to ensure the compliance of Free Zone regulations with international standards on preferential doing business regimes, which often are restricting Free Zones.

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<sup>415</sup> *Centros Ltd. V Erhvervs-og Selskabsstyrelsen*, C-212/97, [1999] ECR I-1459

As pointed out above, a Free Zone does not exist in a vacuum as an enclave, a Tax Haven within the host state, dealing with just domestic and foreign investors. Rather it is a part of the world economic system, fitting neatly into the framework of regulations set up by various international organizations and occupying its niche among other preferential regimes. Thus, for the target jurisdictions not to become an outcast in globalized business system they should ensure that the Free Zone regime is compliant with internationally recognized principles regulating and restricting it.

Chapter 5 provided a general overview of such regulations, aimed at Free Zones. These are mostly supplied by the Organization for Economic Co-operation and Development (OECD), various United Nations Programmes, Financial Action Task Force (FATF) and the European Union (EU). Keeping these regulations in mind, in the following section of our Model offers a conclusive summary suggesting what should CIS countries running Free Zones implement in order not to violate the specific rules restricting Free Zones. These inspired by the international community rules related to harmful tax competition, money laundering, transparency of the preferential regime and regulation of the banking system within a Zone—all the provisions to be accommodated in legal regulation of a sustainable preferential doing business regime.

#### 1. Harmful tax practices

Vigorous tax competition between the jurisdictions can easily come down to one country having an unfair advantage over the others, resulting in abuse of the free market system and introduction of harmful tax practices,<sup>416</sup> combated by the OECD. The risk is especially high in the Free Zones, which can offer low-tax ring-fenced and non-transparent regime.

To fight this, the OECD has introduced a number of reports and non-binding (but strongly encouraged to follow) recommendations and has carried out quite effective black-listing and public shaming of all non-cooperative jurisdictions. Understandably, the last thing the CIS Free Zones want is to appear on such a list and face pressure and sanctions by the international community for harmful tax practices.<sup>417</sup> To ensure compliance, Free Zones in the target jurisdictions should consider the following:

- Avoid any obvious harmful tax practices. This recommendation is easy to follow, as even though harmful tax practices have no clear definition, their

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<sup>416</sup> See W Bratton, J McCahery, 'Fiscal Federalism, Jurisdictional Competition, and Tax Coordination: Translating Theory to Policy in the European Union' (2001) in D Esty, D Geradin, *Regulatory Competition and Economic Integration* (OUP, Oxford 2001) 157, 189

<sup>417</sup> I Raitt, 'Political Support is Needed at Home and Abroad' (2004) *FDI Magazine*. Available at: [http://www.fdimagazine.com/news/fullstory.php/aid/809/Political\\_support\\_is\\_needed\\_at\\_home\\_and\\_abroad.html](http://www.fdimagazine.com/news/fullstory.php/aid/809/Political_support_is_needed_at_home_and_abroad.html) accessed 28.08.2008

possible elements have been indicated by the OECD and include zero tax, ring-fencing and secrecy of the regime.

- Zero tax is mostly not an issue for the target jurisdictions.<sup>418</sup> as stipulated above, CIS Free Zones are likely to offer a reduced tax rate, but would hardly ever totally exempt the residents from it.
- Ring-fencing regime is indicated by the requirement for residents to focus only on foreign activities, restricting their operation on the internal market under the threat of dis-application of the preferential regime to such activities. For CIS it is difficult to observe this requirement due to Free Zones being often integrated into the country's economy.<sup>419</sup> The Administration is suggested to have some discretion permitting the residents' involvement on the local market, subject to strict adherence to the governmental goals and objectives and strict control by the host state.
- The issues with secrecy and transparency of the regime, which are also relevant to harmful tax practices, will be dealt with in more details below, in the subsection on the banking system.
- The next rule to be implemented is effectively combating tax evasion. Evasion of tax, which is a criminal escape from taxes by unlawful means, have been discussed in Chapter 5.3. As an outcome of that discussion, it was concluded, that due to a lack of universally accepted definition, it is up to the host state to determine which activities resulting in tax evasion by the residents it considers lawful and which not. As long as the activities allowed by the preferential regime coincide with the position of FATF, OECD and other international organizations and outlaw avoidance, such regime is considered safe. For further guidance CIS should refer to the specific anti-avoidance tools and the General Anti-Avoidance Rules, implemented by other jurisdictions as discussed in Chapter 5.3.3.
- And, finally, in shaping the preferential doing business regime, Free Zone Administration is strongly encouraged to follow the general recommendations given by the OECD and other international organizations to reduce harmful tax practices.

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<sup>418</sup> A Lopatova, 'Free Economic Zones: Positive and Negative Aspects of Development' (2002) First International Conference "Transfer of Technologies in Free Economic Zones", May 2002 (Gomel, Belarus)

<sup>419</sup> S Abramchuk, *State Regulation of Free Economic Zones in the Republic of Belarus* (Publishing of S. Lavrov, Brest 2001) 17

## 2. Money laundering

The possibility of preferential business regime abuse by the virtue of legalization of illegally gained profits through various financial operations in Free Zones is another threat to be accordingly addressed by CIS. Compliance with international standards here is also monitored by the OECD and Financial Action Task Force on Money Laundering (FATF).

All issues relating to money laundering have been discussed in Chapter 5.2; here a combined list of recommendations for Free Zones in the target jurisdictions is offered:

- First of all, the host country needs to ensure money laundering is legally defined and civil and (or) criminal liability for it has been provided for.<sup>420</sup> Unlike with tax evasion, defining money laundering is not an issue, as the international community has accepted that the key defining element is that the activity in question should involve legalizing the property or funds of disguised, concealed or illicit origin.<sup>421</sup> Thus, not the definition, but making such activity punishable by law is what constitutes a challenge, requiring political will.<sup>422</sup> This clearly is a matter of governmental competence rather than of the Administration, as Free Zone residents are inevitably subject to countrywide criminal and civil law, and it is illogical for the Administration to outlaw money laundering inside the Zone while the activities are still allowed outside it.
- Secondly, Free Zone Administration (or banks on its behalf) should check the source and origin of residents' funds and income, especially of those coming from abroad. That requirement is not difficult to fulfil; as the Administration on initial stages would undertake a through review of the investment project, which includes assessing the legitimacy of the investor and his funds. The further burden of checking all day-to-day financial transactions of the residents would also be imposed on the banking system, thus
- Thirdly, the Administration should maintain the proper control over residential banking operations. More on this is in the subsection below.
- And finally, as a general guidance in implementing anti-money laundering legislation, the sustainable Free Zone is strongly advised to follow the generic

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<sup>420</sup> See W Witherell, 'International Approaches to Combating Financial Abuse and Promoting Stable Financial Markets' (2002) Vol.5 No 4, Spring *Journal of Money Laundering Control* 14

<sup>421</sup> 'Convention on Laundering, Search, Seizure and Confiscation of Crime Proceeds' 8.11.1990. Available online at <[http://www.coe.int/t/e/legal\\_affairs/legal\\_co-operation/Police\\_and\\_internal\\_security/Council\\_for\\_police\\_matters\\_\(PC-PM\)/ETS141.pdf](http://www.coe.int/t/e/legal_affairs/legal_co-operation/Police_and_internal_security/Council_for_police_matters_(PC-PM)/ETS141.pdf)> accessed 02.09.2008

<sup>422</sup> S Kondo, *Ending Tax Haven Abuse* (2002) OECD publications Available at: <<http://www.oecd.org/dataoecd/60/15/2082521.pdf>> accessed 21.05.2004



suggestions introduced by international institutions, such as the Forty Recommendations by the FATF.<sup>423</sup>

### 3. Banking system

The importance of the proper control by the Free Zone's Administration over residential banking operations has been already accordingly discussed. An efficient, reliable, easy-to-use but also transparent and accountable banking system is a necessary element of the sustainable preferential business regime.<sup>424</sup> However, to remain in line with international standards, the CIS countries should fight the temptation to over-liberalize banking services in an attempt to attract more investors. For those implementing the Model it is suggested to observe the following rules:

- Refrain from anonymous and numbered accounts. This goes in line with the internationally accepted principle of due diligence, requiring the bank (and Free Zone Administration) to know the actual clients. In CIS and due diligence is somewhat easy to observe, as none of the transitional countries currently offer anonymous accounts. What is more difficult to achieve, is transparency of the regime and the disclosure of the required information to international controlling agencies by Free Zone Administration.<sup>425</sup> This point is discussed in the subsection below.
- The second rule to observe is that in addition to proper identification and verification of the customers Free Zone banks need to keep appropriate records of all relevant transactions and double check any suspicious operations. This should involve extra scrutiny on large sum transfers, transactions with institutions located in International Offshore Financial Centres, and possible tax avoidance transactions. Free Zones, following the above requirement will be inevitably limiting the freedom of residential operations. For the regimes, wishing to stay in line with international regulations, this, however, is a forced measure.
- Same applies to the issue of bank secrecy. Even though, as mentioned above, secrecy and confidentiality of financial transactions are regarded by the investors as highly favourable incentives, a sustainable Free Zone should only provide for the legitimate bank secrecy, which goes together with the principles of "due

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<sup>423</sup> 'The 40 Recommendations' (2003) Available at: <[http://www.fatf-gafi.org/document/28/0,2340,en-32250379\\_32236930\\_33658140\\_1\\_1\\_1\\_1,00.html](http://www.fatf-gafi.org/document/28/0,2340,en-32250379_32236930_33658140_1_1_1_1,00.html)> accessed 02.09.2008

<sup>424</sup> See M Hampton, *Offshore Finance Centres in Small Island Economies: Can the Jersey Model be Replicated by Other Havens?* (3<sup>rd</sup> ed MacMillan Press, USA 2000)

<sup>425</sup> R M Anotine, *Confidentiality in Offshore Financial Law* (Oxford University Press, Oxford 2002) 38

diligence” and “know your client” and refrain from illegitimate bank secrecy, which amounts to harmful practices.

#### 4. Transparency of the preferential regime

Transparency of the preferential business regime in CIS Free Zone is a guarantee for its international acceptance and it is another element of its sustainability. Transparency means not just mere elimination of excessive secrecy, but also securing disclosure and effective exchange of information by Free Zone Administration with other jurisdictions and enforcement bodies.

What important for CIS is to secure an appropriate balance between the interests of Free Zone residents, who in most cases would wish to keep their business private and requirements on transparency and co-operation as stipulated by the international enforcement agencies and other countries. Excessive transparency decreases attractiveness of the Free Zone and investors’ trust in its regime, and lack of transparency puts the regime on a list of non-cooperative jurisdictions, making it an outcast. To balance the two and comply with international standards on transparency, Free Zones in the target jurisdictions should consider the following.

Preferential doing business regime in Free Zones should be open and transparent when the investors are clearly made aware of its legal framework and extent of the preferences. However, disclosure and exchange of information with other jurisdictions and enforcement bodies should only happen within the strict limits: in cases relating to combating criminal activity, such as tax evasion or money laundering. As the Zone’s Administration usually possesses the full information about its residents, the possibility of accidental (or intentional) dissimulating of the confidential information to other institutions is very possible; the state should legally provide for the circumstance when such a disclosure may take place.<sup>426</sup> The argument that international co-operation of the Zone with the rest of the world is a very important element of sustainability is not being disputed. However, the exchange of information should not undermine legitimate expectations of the residents regarding confidentiality of their affairs and protection of privacy.

Finally, overall exchange of financial information and transparency of the regime is also linked to the use of double taxation treaties. Previously it has been advised that a sustainable Free Zone should offer this preference very sensibly, as excessive use of double tax treaties can create problems with exchange of tax information and mutual co-operation amongst jurisdictions. A positive example is

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<sup>426</sup> See R Stokes, A Arora, ‘The Duty to Report Under the Money Laundering Legislation Within the United Kingdom’ (2004) May *The Journal of Business Law* .303

Cyprus: despite of a high number of double tax treaties it concluded, the government ensured compliance with the OECD Model Convention for Double Taxation Treaties, which explicitly provides for the exchange of tax information with other partner countries.<sup>427</sup>

Summarising this sub-section on compliance with international standards restricting Free Zones, it is submitted that the above suggestions are neither absolute nor exhaustive for two simple reasons. First of all, international standards do constantly change and the jurisdictions establishing Free Zones should bear this in mind. Second, the international standards, even though being strongly encouraged in application, are still not mandatory and compliance with them is subject to the discretion and good will of the host country. And in this batter field of regulatory competition it is up to the actual jurisdictions how to utilize those to their best advantage.

Concluding this section of the Model, it is stipulated that the sensible legal regulation of preferential business regime in a Free Zone, being made up of a combination of factors, is a key element contributing to Zone's sustainability, effectiveness, image and overall success. Above the suggestions for legal regulation of administrative and financial preferences were made and favourable taxation which Free Zones in CIS can implement was outlined. These recommendations are neither ultimate nor exhaustive, serving just as a minimum guidance. Inevitably, all the discussed features are bound to serve as appealing incentives for Free Zone investors. But without clear regulation and strict legal enforcement even the most important provisions remain merely declaratory. The final decisions whether and to what extent to follow these remains solely with the jurisdictions.

### **6.3 Termination of a Free Zone**

This Chapter has already looked at the birth and functioning of a Free Zone and offered recommendations for a Regulatory Free Zone Model to be implemented in CIS. This Model will not be complete without considering the issues relating to termination of a Free Zone and cessation of the preferential doing business regime.

Any investor choosing a Free Zone like to have a clear indication of not only the extent of preferential business regime, but also of its duration. Ideally, one would hope for an indefinite life of a Free Zone. Economic and political situation in the host state, however, is subject to change and as easily as Free Zones can be "born" they can also

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<sup>427</sup> S Stavrinakis, 'Financial Regulation in Cyprus' (2001) in N Courtis, *Financial Regulation in Offshore Centres* (Central Banking Publications, London, 2001) 33

“die.”<sup>428</sup> The investors should always be prepared for the possible withdrawal of the preferential regime and this Regulatory Free Zone Model will provide for assurance mechanisms, guaranteeing investors’ maximum protection on this occasion. In order to ensure smooth termination of the Zone, the Administration at very early stages of the Zone’s creation should pay due attention to the following three points:

1. When a Free Zone is being planned, very careful consideration should be given to the specified duration of the preferential business regime.

Throughout this research various Free Zone Models of all possible durations have been analyzed, ranging from short-lived UK Enterprise Zones (10-15 years) or medium-lived Ukrainian Free Zone (30-50 years) to Free Zones of unlimited duration, which is normally the case with Zones in the target jurisdictions. Each mode of duration has its advantages and disadvantages discussed in Chapter 1. What is important is that Free Zone’s duration should be well thought of through all levels, agreed on and accordingly communicated to the potential residents at the time of Free Zone’s establishment.

Despite the desire to advice on the most appropriate Free Zone duration time for CIS, this thesis will refrain from it, as suggesting a universally applicable term of Free Zone operation is hardly possibly, even for such a narrow category of States as the target jurisdictions. Indeed, for how long the particular country guarantees a preferential business regime in a chosen Free Zone will ultimately depend on the nature and type of the Zone, aims and objectives of the government, its determination and ability to provide for the preferences without adverse effect on the nation-wide economy.<sup>429</sup>

In some cases a short-life Free Zone may be more appropriate, like the example of the UK Enterprise Zones. In other cases, a Free Zone should rather be of a permanent or unspecified duration to continuously work to the benefit of a host State, like the Irish Free Zone in Shannon. In all cases, determination of the Free Zone duration is dependent on the local situation and is totally up to the government. What has to be ensured is that the investors are clearly informed about the intended duration prior to taking up the residency in a Free Zone.

Considering the researched models of Free Zones already established in CIS, it is noted that on many occasions the target jurisdictions will be unable or unwilling to clearly stipulate the duration term, either due to the state failing to decide on this matter or attempting to deliberately avoid the issue in hopes to attract more residents. And even

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<sup>428</sup> V Adrianov, ‘Special Economic Zones in World Economics’ (1997) 3 *Economics and manufacturing* 133.

<sup>429</sup> S Shuleiko, *Institutional Factors in the System of Foreign Investments of National Economy (Conceptual Analysis)* (Gomel, Belarus 2001) 42, 43

when the term has been initially proclaimed, it is subject to change in line with the local situation. Leaving aside the allegations of bad faith, the changes or cancellations of the preferential business regime are often beyond Administration's control. The only acceptable solution for a sensible investor to understand that a very attractive preferential regime cannot last forever and for the host country to do its best to protect by law investors' legitimate interests and expectations.

2. In cases when the host State does not specify the life term of a Free Zone and creates a Zone of unlimited duration, it should legislatively provide for a maximum guaranteed application of the preferences from the moment of resident's registration—the time, during which the regime cannot be changed or cancelled in relation to specific investors.

This provision is necessary to safeguard investors' interests, as during the Free Zone duration, its legal regulation changes, often in detriment to the residents. To avoid this, the government should guarantee the unchanged application of the preferential conditions to all companies established in a Free Zone for a certain period of time past incorporation, ideally for at least 5 or 10 years. During this period all the initial exemptions and preferences should continue to apply regardless of the actual changes affecting the regime.

When such a provision is introduced, both sides are the winners: the government, which retains the possibility to amend or withdraw the preferential regime in a reasonably short period of time without infringing residents' rights,<sup>430</sup> and the investors, who receive protection from detrimental changes during the prescribed time.

This "stand-still" rule is especially useful for CIS, where the legal regulation of business regime changes rapidly and unpredictably. Introduction of this norm has been attempted in Belarus, where Free Zones are created for unspecified duration, and the government guaranteed non-application of any new legislative provisions adversely affecting the investor for the first five years of operation.<sup>431</sup>

The common problem for the target jurisdictions is the judicial enforcement of this rule and clear legal determination of the changes adversely affecting the investors which should be misapplied. Belarus struggled in this area, as the authorities ignored the rule and applied the amended legislation against Free Zone residents while the judiciary have not effectively dealt with protection of investors' rights.

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<sup>430</sup> B Paton, 'Technoparks in Ukraine: Results, Problems, Future Perspectives' (2004)  
Available at <<http://www.investments.com.ua>> accessed 28.08.2008

<sup>431</sup> S Abramchuk, *State Regulation of Free Economic Zones in the Republic of Belarus* (Publishing of S. Lavrov, Brest 2001) 44

Another potential drawback of this guarantee is that it effectively creates various classes of residents to whom different legal norms are applied. The principle of equality before law could potentially be contradicted here, not to mention an obvious problem with control and enforcement.

3. Finally, if the host State ultimately decides to terminate the Free Zone of unlimited duration or withdraw the preferential business regime before the expiration of the guaranteed duration time, the Administration should provide for certain assurance mechanisms, aiming to help the strangled investors to cope with the consequences of the regime withdrawal.<sup>432</sup> These could include, but are not limited to:

- Give as much notice as possible. An advance notice offers investors the opportunity to re-think the strategy and decide what to do with the investment project: to remain and continue operation under non-preferential conditions or to relocate to another jurisdiction.
- If the regime is terminated prior to the guaranteed time, offer some compensation to the residents. This could include either temporary financial incentives or administrative help with relocation. Extent of the compensation depends on a good will and ability of the host state; however in CIS it is likely to remain limited considering that the most likely reason for regime withdrawal would be an economic one.
- After the preferential regime ceases to exist, allow and encourage the enterprises to remain and function on its territory, even under the standard business conditions. As learnt from the experience of the UK Enterprise Zones, provided the investors are treated fairly, many of them might choose to remain in the country and not to relocate.
- In case investors decide to relocate, Free Zone Administration should provide for easy and efficient transfer of property to a different jurisdiction, without bureaucratic obstacles or penalizing taxation.

Being thoroughly considered and provided for by law at the time of Free Zone's birth, the above mentioned guarantees not only ensure a Free Zone's smooth and relatively painless termination, but also secure the necessary investor protection, making the Zone and its preferential regime sustainable and trustworthy.

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<sup>432</sup> A Bogatyriov, *Investment Law* (Russian Law, Moscow 1992) 164, 165

In conclusion to this final chapter and the thesis a Regulatory Free Zone Model is offered, which as a guide can be used by CIS and some Eastern European countries in transition setting up their own Free Zones. Drafting the Model the provisions to be implemented by the target jurisdictions at the stages of Free Zone's creation were outlined as well as the regulation of its preferential business regime and termination of the Zone.

It was emphasised that the appropriate legal regulation of the preferential business regime offered by a Zone, playing the key role in its success and sustainability, is not the only influential factor. All aspects of a Free Zone should be carefully planned and evaluated beforehand with the use of a SWOT analysis; the nation-wide business legal regulation should be stable and transparent; overall regulation of Free Zone residents should be responsibly reduced; Free Zone should have a complex orientation and the host state should use diversified approach to target not just foreign but also domestic investments; the Zone is to be accordingly promoted domestically and abroad and maintain links with neighbouring countries and other Free Zones; and the Administration has to ensure close co-operation of private and public sectors. All these general elements influencing Free Zone success shall be balanced with wisely regulated preferential business regime, which, incorporating the best world practices, should be accordingly adopted to the conditions of transitional economies of the target jurisdictions.

## CONCLUSION

One of the most important ways to ease economic crisis for countries with transitional economy is investment attraction. International experts suggest that when the amount of foreign investments exceeds 3% of a country's Gross Domestic Product, it produces a substantial positive effect on its economy.<sup>433</sup> Among numerous available instruments used to facilitate the investment activity, Free Economic Zones occupy a notable and very significant place.

Providing for a special preferential doing business regime within a designated territory and offering its residents a wide range of fiscal and non-fiscal incentives, Free Zones have been successfully utilized by many prosperous jurisdictions in attempts to attract additional capital and boost its activity, improve trade balance, develop new technologies or simply revive economically depressed regions.

Gaining increasing popularity in the developed world, Free Zones are branded by some researchers as a "missed opportunity"<sup>434</sup> for CIS. Indeed, many of the target jurisdictions wishing to set up Free Zones face understandable difficulties due to insufficient expertise and lack of theoretical and practical guidance in appropriate legal regulation of all aspects of the preferential doing business regime.

The purpose of the present research was to remedy this situation by developing a Regulatory Free Zone Model, a general template containing suggestions which could be used as a guide by countries of the Commonwealth of Independent States wishing to set up and sustainably run their own Free Zones.

In order to achieve that objective, theoretical and practical issues surrounding Free Zone as a way of business organization were analyzed first by looking at its definition, typologies and historical development. Then, drawing upon the elements of doing business regime as suggested by the World Bank, various existing Free Zones worldwide were looked at and examples of legal regulation, contributing to their successful operation were outlined. Next, emphasising compliance with international provisions restricting Free Zone and the need for adaptation of the successful practices to suit the conditions of a transitional economy in the target jurisdictions, the findings were compiled into a structured Model, providing general guidance and practical advice on how a Free Zone can be set up, legally regulated throughout its duration and terminated. The Proposed Regulatory Free Zone Model, an innovative contribution of our research, is thoroughly presented in a conclusive Chapter 6.

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<sup>433</sup> A Bogatyriov, *Investment Law* (Russian Law, Moscow 1992) 3

<sup>434</sup> C Baissac, 'Look again at EPZ impact' (2004) *FDI Magazine* Available at : [http://www.fdimagazine.com/news/fullstory.php/aid/854/Look again at EPZ\\_impact.html](http://www.fdimagazine.com/news/fullstory.php/aid/854/Look_again_at_EPZ_impact.html)> accessed 28.08.2008



Throughout this research a number of theoretical and practical issues surrounding this topic were raised and addressed, such as the definition and features of a successful Free Zone, the variety of factors specific to the target jurisdictions affecting the sustainability of preferential business regime, difficulties arising in legal transplanting, downsides of the “race to the bottom” approach to regulatory competition and, finally, the feasibility of introducing such a sustainable Free Zone, which can operate at a certain level indefinitely was assessed.

Answering the main question on how to set up and regulate a sustainable Free Zone in CIS, the author found himself in the shoes of *[the policy analyst, who would present to the policy maker a picture of the Zone that would be less caricatural,...but also more complex]*.<sup>435</sup> Indeed, the proposed Regulatory Free Zone Model turned out to be more than complex.

First of all, before drafting the actual Model, what exactly a Free Zone is had to be researched to explained its features, types and classifications and suggest a cumulative definition relevant to the target region. Then the components of a key feature of any Free Zone: its preferential doing business regime, were analyzed. The structure of the regime is very helpfully provided for by the World Bank in Doing Business Report. But the components themselves did very little to indicate which exactly provisions should be implemented by the target jurisdictions to set up and run Free Zones sustainably.

To find further guidance, a representative selection of Free Zones worldwide was analyzed, covering various economies and Free Zone types, and the successful elements in legal regulation of preferential doing business regime, which could positively impact Free Zones in CIS were outlined. Identifying the examples, the author faced a dilemma: once found, what does one do with a successful rule? Can it be merely transplanted into the target jurisdictions without any modifications? Would a legal norm, from a developed economy survive and appropriately work in the developing one?

Legal transplanting is very common in many jurisdictions and lawmakers rely heavily on foreign law for their own changes. However, even the “father of legal transplants,” Watson admits that the same legal rule operates differently in two countries.<sup>436</sup> More over, it operates to a different effect even within one.

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<sup>435</sup> Claude Baissac, ‘A Critique of Cost-Benefit Analysis in the Evaluation of Export Processing Zones’ (Presentation at WEPZA Round Table on EPZs in Vienna, 15 April 1996. The Flagstaff Institute 2004) <<http://www.wepza.org>> accessed 28.08.2008

<sup>436</sup> A Watson, ‘Legal Transplants and European Private Law’ (2006) vol 4.4, December *Electronic Journal of Comparative Law*. Available online at <<http://www.ejcl.org/ejcl/44/44-2.html>> accessed 28.08.2008

Acknowledging the view that the borrowing should be taken from proximate systems, rather than from the distant ones, a decision was made where possible to confine the range of the researched jurisdictions to near Europe. But limiting the research to just the CIS countries was not beneficiary to the Model, as if the solutions could have been found within these systems, this would have already been done; so this research had to look at other jurisdictions. Besides, if to follow Legrand,<sup>437</sup> a proper comparison has not a unifying but a multiplying effect.

Finding a norm which might positively affect Free Zones, however, is half the task: to be transposed inside the CIS legal systems the provision has to be accordingly adapted, since a rule once transplanted is different in its new home. As development of an appropriate legal rule involves a wide group of “formants,” such as legal policymakers, practicing lawyers, judiciary and the legal scholars,<sup>438</sup> this thesis did not undertake the burden to adjust the norm, leaving it for each individual country to do.

The Regulatory Free Zone Model being rather general to be implemented in a number of countries is also specific enough to fit the conditions of the target recipients. Achieving this objective necessitated the analysis of various Free Zone types established in CIS, with proper consideration of their political, economic and legal situations. Supplementing the findings with the legal SWOT analysis of a Belarusian Free Zone in the case study in Chapter 4 potential strengths, weaknesses, opportunities and threats for all Free Zones in the target region were outlined and discussed.

Having provided for a theoretical background of a Free Zone, considered the relevant issues specific to the target region and identified the regulatory norms transposition of which is liable to positively influence sustainability of a CIS Free Zone, Sustainable Regulatory Free Zone Model has been drafted. Prior to that, however, the present research considered an issue of compliance with international regulations restricting Free Zones. In recent years, concerns at international level have arisen due to some jurisdictions being perceived as allowing or even actively encouraging money laundering and unfair tax competitions through lax regulatory regimes.<sup>439</sup> Undoubtedly, different tax treatment of similar income streams across the countries serves as a strong incentive for investors to relocate capital and business activity into Free Zones. Free Zones in CIS experiencing the increased pressure to comply with international

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<sup>437</sup> P Legrand, ‘The Impossibility of “Legal Transplants”’ (1997) 4 *Maastricht Journal of European and Comparative Law* 111, 125

<sup>438</sup> P Monasteri, ‘The “Weak Law”: Contaminations and Legal Cultures (Borrowing of Legal and Political Forms)’ (2003) 13 *Transnational Law and Contemporary Problems* 575

<sup>439</sup> J Alworth, D Masciandaro, ‘Public Policy: Offshore Centres and Tax Competition: The Harmful Problem’ (2004) in D Masciandaro, *Global Financial Crime: Terrorism, Money Laundering and Offshore Centres* (Banco de Espana, Spain 2004) 194, 195

regulations against money laundering and harmful tax competitions and the recommendations for that had to be incorporated into the Model.

The issue of regulatory competition becomes relevant here. Arguably, a CIS jurisdiction operating a Free Zone will be tempted to enter the “race to the bottom,” where countries fighting for the capital attraction compete in reducing the regulatory barriers until they reach the bottom line, coming in conflict with the OECD and FATF rules on money laundering and harmful tax competitions.<sup>440</sup> Even though some researchers suggest that the regulatory competition between states is generally unconstrained by international regimes like GATT, Subsidies Code or US trade law,<sup>441</sup> the OECD and international community has a considerable potential in persuasiveness. The advice to CIS on this matter is as follows: while ensuring utmost compliance with Forty Recommendations and other international regulations restricting Free Zones, they should refrain from “race to the top”—excessive, unnecessary following the above rules, which restricts preferential business regime and damages the image of the Free Zone.

As a final outcome of this research, appreciating the complexity of the above issues, a sustainable Regulatory Free Zone Model which can be used as guidance by CIS setting up their own Free Zones have been proposed by combining the best practices and modifying the successful experience to fit the conditions of transitional economies. The Model provides comments and recommendations on the whole process of establishment and functioning of a Free Zone from its birth to death, emphasising the need for sustainable legal regulation of preferential business regime and a wide range of administrative, financial, tax and other preferences.

Referring to the main issue: is it really possible to introduce a sustainable Free Zone Model, which can operate indefinitely in a taken jurisdiction? And if the answer to that is yes, does the proposed Regulatory Model belong to that type? Suggesting the affirmative answer for the first question, this thesis leaves the second question open to be answered by those CIS countries which will, hopefully, utilize the findings of the present research. Diffusion of law, after all, involves not one-way, but multiple exchanges and globalisations, including those of peoples, laws and legal traditions.<sup>442</sup> Here one can only affirm Aspden, who suggested that a successful Sustainable Free

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<sup>440</sup> P Dodd, R Leftwich, ‘The Market for Corporate Charters: Unhealthy Competition Versus Federal Regulation’ (1980) 53 *US Journal of Business Law*. 259

<sup>441</sup> J Trachtman, ‘International Regulatory Competition, Externalization, and Jurisdiction’ (1993) 47 *Harvard International Law Journal*. 470

<sup>442</sup> P Shah, ‘Globalization and the Challenge of Asian Legal Transplants in Europe’ (2005) *Singapore Journal of Legal Studies* 346

Zone of the future [will need to be well regulated with the government having the will and means to enforce those regulations.]<sup>443</sup>

It is hard to argue with the statement supported by many<sup>444</sup> that the overall success of Free Zones in transitional economies depends not only on the extent of preferential doing business regime in a taken jurisdiction, but also on the overall local and global political and economic situation. Not disputing that argument, it is stressed that in other equal conditions, the foreign and domestic investors are much more likely to get established in such a well constructed and regulated Free Zone of good reputation where the preferential doing business regime is reliable, simple and stable, not depending on local bureaucrats or “czar” with veto power over any decisions of the regulating bodies.

Truly, the investments’ inflow into any economy depends on multiple factors and a Free Zone is far from being a panacea<sup>445</sup> capable of instantly solving the country’s problems. However, as an essential remedy helping to overcome the crisis, establishment of Free Zones should be accordingly considered and provided for by the target jurisdictions. As even though a Free Zone option has not yet proven to be successful in CIS, this will, undoubtedly, happen, the same as it is now happening in other European countries, formerly “the latecomers to Free Zones.”<sup>446</sup>

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<sup>443</sup> J Aspden, ‘Financial Regulation in the Isle of Man’ (2001) in N Courtis, *Financial Regulation in Offshore Centres* (Central Banking Publications, London 2001) 61

<sup>444</sup> H Grubel, ‘Free Trade Zones and Their Relation to GATT’ (1984) in R H Snape, *Issues in World Trade Policy* (Macmillan Press, USA 1984) 146

<sup>445</sup> B Gusakov, *Economic Effectiveness of Investments* (Minsk, Belarus 1998) 23

<sup>446</sup> C Radaelli, ‘Policy Narratives in the European Union: The Case of Harmful Tax Competition’ (1998) Working Papers RSC No 98/34. (EUI, Florence) 17

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