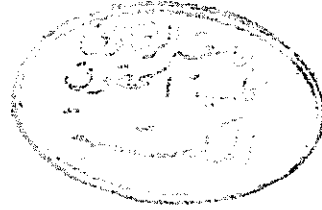




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FACULTY OF LAW



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**CONTENTS**

**ARTICLES**

\* **CONTEMPORARY INTERNATIONAL ECONOMIC  
LAW: (part two).**

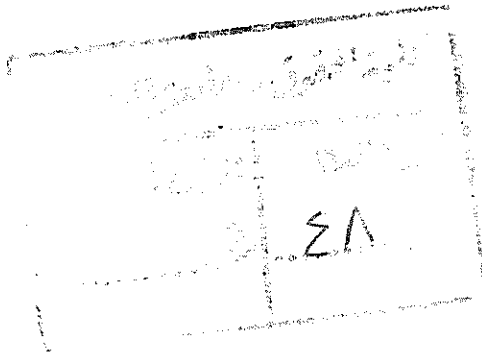
**Hazem H. Gomaa 1**

\* **VALUES CRISES IN THE ISLAMIC SOCIETY :  
ACTUALITY AND THE OBJECTIVE OF THE  
RIGHTFUL SHARI'A**

**El Hosini S. Gad 183**

\* **INTERNATIONAL INVESTMENT IN FREE ZONES IN  
EGYPT ( IN ENGLISH LANGUAGE)**

**Hazem H. Gomaa 1**





EDITOR-IN- CHIEF :       **KAMAL ABO SREEA**  
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# **INTERNATIONAL INVESTMENT IN FREE ZONES AND FREE ZONES IN EGYPT**

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## INTERNATIONAL INVESTMENT IN FREE ZONES AND FREE ZONES IN EGYPT

### Introduction :

This study presents a legal and developmental approach to the Free Zones concept as it has been adopted by developing nations, with special study of free zones in Egypt. An inquiry into its historical and economic foundations, and a reconsideration of its performance in the third world, indicates that certain law and policy measures might contribute to the adaptation of Free Zones to the developmental goals of third world countries. This article intends to show that Free Zones, when designed in accordance with the needs and potentials of a given country, have proven to be valuable means for achieving developmental goals usually attributed to industrialization. Moreover, the study seeks to emphasize that legal analysis may be very worthwhile when structuring, implementing or evaluating Free Zones in developing countries.

The legal and developmental perspective of this study may well be summarized in a single question : How can International Economic Law contribute to the achievement of developmental goals? Applying such an approach to the study of Free Zones, the question becomes : What can legal concepts, institutions and processes do to make the implementation of Free Zones more consistent with the developmental goals that third world countries attribute to them?

Accordingly, this study begins a general introduction to the Free Zones and general evaluation to its importance, then move to concrete legal and policy information aimed at making their operation more consistent with the developmental objectives of third world nations. For such purposes, the article relies on previous analyses, field studies, information, and data available in both legal and non-legal literature on the subject<sup>(1)</sup>. The Egyptian Free Zones in an important part of this study to fill a gap of information in this field.

*The History of The Free Zones :*

Free Zones are a modern adaptation, for industrial purposes, or Free Trade Zones, and have been modeled after the age-old concept of Free Ports (FGs). An Free Port is "an

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(1) There is no one comprehensive legal essay on FIZs in developing countries. The sole studies written from a legal viewpoint are a short article by Jayawardena, Free Trade Zones, 17J. World Trade L. 427 (1983); and a recent note on Latin American FIZs : Note, Foreign Trade zones in Latin America : A Spectrum of possible Uses, 23 Tex. INT'L L.J. 117 (1988). There are also three case studies on the Panamanian, Mexican and Chinese FIZs. See S. Salcedo, An Evaluation of the Panamanian free Trade Zone (May 6, 1988) (LL.M. thesis, available at Harvard Law School Library); Bettwy, Mexico's Development : Foreign Trade zones and Direct Foreign Investment, 22 Comp. Jurid. Rev. 49 (1985); Kiltgaard, Preferential Treatment for Foreign Investment in the People's Republic of China : Special Economic Zones and Industrial Development Districts, 7 Hastings INT'l & comp. L. Rev. 377 (1984), Hassan Omar, wrote the essay Legal Aspects of Free Zones; Alexandria University Faculty of Law 1982, Councillor Omar Wrote two articles in Elahram Electisadi About Port Said Free Zones I will refer to it later on in this article.



area generally encompassing an entire port and its surrounding locality, into which goods of foreign origin may be brought without the imposition of customs duties or subject only to a minimum... tariff, whether such goods are intended for re-export or for local consumption<sup>(2)</sup>.

The oldest known FP established expressly to promote trade was the Roman customs-free port on the Aegean island of Delouse. In 1189, Frederick I established one of the earliest significant Fps when he excused the city of Hamburg from payment of customs duties<sup>(3)</sup>, Fps were also established in harbors located along international trade routes such as Gibraltar (1704), Singapore (1819), and Hong Kong (1848). In 1888, Hamburg became the first port to be granted the special privilege of manufacturing, on the conditions that it not compete with the hinterland and remain export-oriented<sup>(4)</sup>.

The new concept of free trade "zone," as opposed to free "port" or free "city," was introduced by the United

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(2) H. Grayson, *Free Trade Zones and Related Facilities Abroad* 6 (U.S. Dept't of Commerce 1970).

(3) Note, *Foreign Trade Zones : "Everything Except the Customs?,"* 31 U.FLA.L. REV. 725, 727 (1979) [hereinafter Note, *Foreign Trade Zones*].

(4) *Ibid* p. 427.

States in the Foreign Trade Zones Act of 1934<sup>(5)</sup>. The New York Foreign Trade Zone No. 1 was established in 1937 as the first Free Industrial Zone in the world<sup>(6)</sup>. The importance of U.S. FTZs remained rather small until a 1950 act authorized export-oriented processing within the foreign trade zones<sup>(7)</sup>, creating for the first time an FTZ where manufacturing was permitted.

Another development was accomplished in 1959 with the founding of the Shannon FTZ in Ireland. The Shannon FTZ was the first Free Industrial zone (FTZ) created expressly for customs-free export-oriented manufacturing. The FIZ model developed at Shannon was a combination of the FTZ concept with the emerging concept of industrial

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(5) Foreign Trade Zones Act of 1934, Pub. L. No. 73-397, 48 Stat. 998 (codified as amended at 19 U.S.C. (1982)). A free or foreign Trade Zone (FIZ) was described by Congressman Emanuel Celler, principal promoter of the Act, as "an isolated enclosed and policed area in or adjacent to a port of entry, furnished with the necessary facilities for lading or unlading, for supplying fuel and ship stores for storing goods and for reshipping them by land and water-an area within which goods may be landed, stored mixed, blended, repacked, manufactured, and reshipped without payment of duties and without the intervention of customs officials." Bader, Jurisdictional UNCertainty : The American Foreign Trade Zone, 8 N.C.J. Int'l & Com. Reg. 239, 240 (1983) (citing 78 Cong. Rec. 9853 (1934)).

(6) See R. Thoman, Free ports and foreign trade zones 140 (1956), cited in Note, Foreign Trade Zones, op. cit. 14, at 732n. 55.

(7) See generally deKieffer & Thompson, Political and Policy Dimensions of Foreign Trade Zones :Expansion or the Beginning of the End?, 18 Vand. J. Transnat'lL. 481, 483-91 (1985).

estates, i.e., "a tract of land which is subdivided and developed according to a comprehensive plan for the use of a community of industrial enterprises"<sup>(8)</sup>. The Shannon zone also merged the advantages of both of concepts, offering "full infrastructures facilities, including... rental of suitable factory accommodations, and permitting duty free access of raw materials, components and capital equipment and similar facilities for exports"<sup>(9)</sup>. This FIZ model was immediately followed by developing countries such as Port Said (Egypt 1902), Puerto Rico (Mayaguez, 1962) and India (Kandla, 1965)<sup>(10)</sup>. Zones were established subsequently in Taiwan (Kaohsiung), the Philippines (Bataan), the Dominican Republic (La Romana), Mexico (Badajoz California Panama (Colon) and Brazil Manaus). Between 1971 and 1975, twenty-three new FIZs were created in ten developing countries, and from 1976 to 1978 another twenty-one zones were set up in fourteen countries<sup>(11)</sup>. By 1984, there were some seventy-nine zones operating in third world countries, and dozens were under development<sup>(12)</sup>.

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(8) See W. Bredo, *Industrial Estates : Tool for Industrialization* 1 (1960).

(9) J. Currie, *Export Processing Zones in the 1980s : Customs Free Manufacturing* 1 (1985) [hereinafter J. Currie, *EPZs in the 1980s*].

(10) A few years later, the United Nations Economic and Social Commission encouraged the establishment of FIZs as an avenue for export expansion and diversification. See sources cited op. cit. p. 5.

(11) J. Currie, *Investment : The Growing Role of export Processing Zones* 7 (1979) [hereinafter J. Currie, *The Growing Role of EPZs*].

(12) J. Currie, *Epzs in the 1980s*, op. cit. 20, at 3.

As stated above, 1988 figures indicate that there are approximately 107 Free Industrial Zones in fifty-one developing countries today.

*The Concept of Free Industrial Zone (FIZ)*

An FIZ is a designated area, frequently near a port or an airport, which has a basic infrastructure of common facilities and services, is considered for customs purposes as outside the territory of the host nation, and where an incentive package is offered to potential investors for the establishment of manufacturing plants primarily oriented toward foreign markets.

*The Concept of Free Trade Zone*

A more sophisticated development was the concept of the FTZ, as a bounded area (not necessarily a port or a city) that through a legal fiction is considered to be outside the customs jurisdiction of the country where the FTZ lies. FTZs are still used for commercial activities such as storage, exhibition, blending, and packing of goods "in transit" and to facilitate their sale, distribution, or onward shipping without changing the customs tariff classification<sup>(13)</sup>. Through the years, manufacturing has been permitted in certain free zones. The modern concept of FIZs was finally defined when this model of manufacturing FTZs merged with the industrial-estate technique of providing a common infrastructure and facilities to attract

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(13) H. Grayson, op. cit. p. 5.

domestic and foreign investors<sup>(14)</sup>. Thus, FIZs are basically customs-free industrial area.

### *Free zone and Development*

FIZs are frequently considered to be vehicles for implementing export-oriented industrialization strategies.

It is important to bear in mind that the zones are not by themselves a developmental strategy. An FIZ is just an instrument of industrial policy whose success depends on careful design and implementation within the broader framework of a coherent strategy of economic development. Among the main features that make the zone concept attractive for third world countries are its exceptional flexibility to any developmental strategy and its reported capacity to accomplish although on a small scale, certain development objectives commonly ascribed to industrialization.

Actually, many zones in developing countries are expressly created to be export-led, "reserved for the production of goods for the world market"<sup>(15)</sup>. The adaptability of FIZs to outwore-oriented schemes is quite natural : as lower costs of production are characteristic of these areas, products manufactured in the zones may successfully compete in the international market. FIZs,

(14) U. N. Indus. Dev. Org., UNIDO Guidelines for the Establishment of Industrial Estates in Developing Countries 93-94, U. N. Doc. ID/220, U.N. Sales No. E. 78.II. B13 (1978).

(15) Fernandez Kelly, Contemporary Production and the International Division of Labor, in *The Americas in the New International Division of Labor* 206, 222 n.2, (S. Sanderson ed. 1985). op. cit. p. 21.

however, may also fit well within an industrialization strategy based on import-substitution. As the zones are usually a system of exceptions, a correlation might be established between them and tariff protection for domestic industries, so that export-oriented manufactures would enjoy the benefits of an incentive package including duty-free imports.

*The special sub-zones :*

The versatility of FIZs as an industrial policy tool is also to be noted in the emergence of relatively new forms of zones, such as the concept of special sub-zones. The sub-zones are tailor-made regimes "for companies wishing to utilize the zone concept but unable to relocate to an existing zone". The major distinction between a FIZ and a sub-zone is that the latter is accessible for use by only one firm, which simply designate the part of its facilities which will comprise the sub-zone. Although the sub-zone concept was initially developed in the United States<sup>(16)</sup>, today there are several sub-zone systems in developing nations, such as the Licensed Manufacturing Warehouse Programmed in Malaysia<sup>(17)</sup>, the Vallejo Plan in Colombia, and the Maquiladoras Program in Mexico<sup>(18)</sup>.

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(16) See generally Atkins, Doyle & Schwidetzky, Foreign-Trade Zones : Sub-Zones, State Taxation and state Legislation, 8 Den. J. Int'l L. & Pol'y 445, 448 (1979) (discussing the United States sub-zone concept).

(17) See Econ. & Soc. comm'n for Asia & The Pacific/U.N. Centre for Transnat'l Corp. Joint Unit on transnational corporations, An Evaluation of Export Processing Zones in Selected Asian Countries, U.N. Doc. ST/ESCAP/395, 146 (1985) [hereinafter ESCAP/UNCTC Joint Unit on Transnational Corporations].

(18) See Bettwy, op. cit. 7, at 61 & n. 47 (discussing the Maquiladors Program).

**PART ONE**  
**THE FREE ZONES IN EGYPT**  
**NAME AND LOCATION OF FREE ZONES**  
**IN EGYPT**

***1- THE PUBLIC FREE ZONES :***

ALEXANDRIA. Also Known as al Ameria, this Zone is 17 miles from Alexandria city on the southeastern coast of Mediterranean sea in northcentral Egypt. It is situated in the northeastern area of Africa.

PORT SAID-- At northern end of Suez Canal in northeast Egypt, 180 Miles east of Alexandria, 35 miles north of Ismailia and 85 miles north of Suez.

CAIRO (Nasr City) -- Located in northeastern Egypt on Nile River about 130 miles southeast of Alexandria at El Nasr City, A suburban section of Cairo, eight Kilometers south of Cairo international Airport.

SUEZ-- Usually called Port Tawfik, the Zone is immediately southeast of Suez City. Southern end of Suez Canal 85 miles south of port said encompassing area of Port Tawfik.

ADABIA-- Industrial free zone designated as a second location of the Suez Suez Zone still in the planning stage five miles south of Suez City. Pollution control problems may delay its development, but its location close to the world's shipping lanes and a natural seaport area offer a promising future for this Zone.

ISMAILIA-- A free Zone near the city of Ismailia on the Suez Canal between Port Said and Suez 60 miles from the Cairo Airport and 35 miles from Suez City. Still in the planing stage.

DAMIETTA-- Located on the Mediterranean coast approximately 40 miles west of Port Said, the Damietta Zone now being constructed will be export-oriented toward such historically established industries as wood works, furniture and leather. In addition there are new two free Zones area into Damietta, east if the harbor for the industrial projects established on 190 feddans, the secured in the west for storage will start it's first phase by 60 feddans to be reached.

up to 400 feddans.

MARSA MATRUH-- Free zone only in planning stage on southeastern coast of Mediterranean 300 miles west of Alexandria in northwestern area of Egypt. Plans to develop this Zone have been temporarily shelved. All are free Zones, serving middle east and African markets, including Egypt it self.

#### **NEW FREE ZONES**

##### **CAIRO AIR PORT FREE ZONE**

Free zone near Cairo International Airport is now underway to provide facilities for the establishment of export industry and projects related to aviation servicing and catering.



## **SAFAGA PUBLIC FREE ZONE**

Located close to Safaga Seaport on the Red-Sea, the 125 feddans of phase for industrial and storage projects. It is expected to gain regional & international importance as SAFAGA.

is enjoying growing importance as transit rapidly. It will accommodate both manufacturing, processing and warehousing facilities.

## **2- PRIVATE FREE ZONES AND IT'S EXECUTIVE REGULATION**

Under the law no. 230/1989 it is possible to have a specific area of Egypt declared a private free Zone if a factory site is approved by board of directors of the general authority for investment.

However, to qualify for a private industrial Zone, the applicant must prove a specific need such as the inability to obtain a required raw material in an existing public Zone, unique handling, transportation or population facilities and specially-trained skilled technicians.

The General Authority for Investment (GA) may establish public industrial, commercial and financial free zone projects and designate any factory site as a free zone.

currently, there are 444 approved free Zone projects in Egypt.

## **TYPES OF ACTIVITIES**

To implement it's 1987-92 \$20 billion economic plans, the government has allocated \$8 billion to increase exports.

The funds will be used to finance free zones, extend loans to exporters, and make port improvements. Alexandria has operated a small free zone since the end of world war II. However, growth was small and few firms used the free zone for storage. In 1971 the law on Arab and foreign investments and free zones reorganized the original free zones decree by liberalizing investments and exchange remittance laws and permitting establishment of a number of free zones. The above law was repealed in 1974 and the original plans to include Ismailia near the middle point of the Suez Canal and other potential areas in the free zone program were temporarily postponed but have since been reactivated. Under the law of 1989 No. 230, article (20) the General Authority for Investment may establish free zones where industrial, commercial and financing projects may be undertaken if the Egyptian Cabinet approves the proposal of the authority board of director, besides to establish public free zones. However, the authority board of directors may establish private free zones each of which shall be confined to one project if the nature thereof shall so require, as mentioned above.

In 1990, the Government announced creation of eight new investment zones. The purpose being to create employment opportunities for Egyptians returning from Kuwait and the Gulf region, and to provide investment opportunities for capital being withdrawn from the unstable region. Two of these industrials' zones will be free trade zones at Damietta, Suez. Alexandria and Cairo are designed for light industry, Suez for cold storage and warehousing (with industrial development planned at a future date).

A joint British-Libyan venture, the Marinjac Overseas Co. has made an investment of \$20 million at Port Said that includes a plastic's factory. Connell Brothers Company, Ltd. is an American general trading company operating in Egypt and the major United States manufactures it represents are making substantial shipments of industrial goods to the Egyptians.

The following are some of the other features of Egypt's free trade zones on an individual basis :

**Alexandria (Al-Ameria) :**

One half of the combined area of 6.3 million square meters was committed to approved projects, several of which were in production. Leading investors represent petroleum products, steel fabrication. The most successful operation at Al.

**Port-Said :**

As planed, nearly 100% of the Phase I Project area is committed to development. This zone is probably the most popular of Egypt's free zones but the principal drawback is the lack of additional area for expansion. This problem will be solved by the expansion of the free zone in East of Port Said on the east bank of Suez canal, at Sinai. the zone's projects cover light industry. The 456.000 square feet of Phase I have been allocated to about 85 companies while the 462.000 square feet of Phase II is just beginning to be developed. Land for a stone-crushing cement factory is the first to be committed for an operation in Phase II. A shortage of funds inhibits infrastructure expansion in Phase

II. Financing from domestic sources at Egypt, the United Nations Development Program and the United States Agency for International Development is being sought.

Phase III will consist of development hundreds of Feddans of swamp and canal land near the main highway. The successful operations in Port Said free zone are Miser Tea company, Ferion Products, Miser (ferion gas), Port Said Corporation (iron Framework for metallic, industrial, agricultural and tourist works), Industrial Aluminum Group, Bavaria Company (fire extinguishers), Nader Skin (ready-made clothes), Golden Party (fruit juice production), El Sheikd Company (fiberglass), Arab American Company (building materials, Sun Top (fruit juice) and Khalid Construction Factory (electrical equipment and switches, floor, tiles and cement floors). The recent limited surface area limits the investment after the East-- south expansion there will be more factories in the free zone of Port Said.

**Cairo (Nasr City) :**

About one fourth of the eight square-kilometers comprising the zone is committed to development projects. Arab Otsuka Pharmaceuticals a Japanese subsidiary, is operating successfully. Other companies operating in Nasr City are manufacturers of clothes, textiles and PVC pipes. GA has a 2.000 square-foot manufacturing complex available for tenants. Construction of light industrial factory facilities are completed. Arab Onoka Medicinal Fine. Textiles Egyptian, Pyramids Ready-made Clothes, Korea Tapes & Cassettes, Scribe & Sewana Computer Company, Giza Chemical Industries, Empac (Cardboard), C.I. Francom (Chemicals) and Farm Company (pesticides).

**Sues (Port Tawfik) :**

Virtually all of the Suez zone's 80,000 square-meters are completely devoted to projects at different stage of development. The free zone activities are warehousing, storage. There are some 30 public zone companies operating while several still are in the implementation stages. The private zone of the McDermott Company from the United States, situated 35 Km from the Suez zone and having a \$50 million capital investment, Handles ship repairs and oil cleaning surfaces as well as manufacturing certain marine products, Middle East prefab, duplex Board Company, International Drilling Fluids, United Gulf for Industry (prefabricated housing units), Oceanic contractors, Inc. Petroleum), Pico Investment Company (petroleum), and Sahara Petroleum Company.

**Adabiya :**

This zone is a second location of the Suez free zone. It is established to complement expansion in the Port of Suez area. It has access to both the East and the west shores of the Gulf of Suez this distinguished location will help the free zone to become an important shipping center. The zone would cover 2,250,000 square-meters of a rectangular tract of land eight kilometers south of the urban area of Suez (Port Tawfik). It is bounded on the East by Suez Bay and served by highway access and the availability of a nearby railroad to which it could be linked. The Adabiya zone would absorb some of the current congested storage space at Port Tawfik. Total fees and charges at capacity are estimated at 4.7 million Egyptian pounds (\$2.4 million) and construction costs at \$38.6 million.

**Ismailia :**

The government of Egypt has been able to attract a number of major investors that will make a substantial contribution toward reducing unemployment in the Ismailia area. Preliminary studies show that a free zone at Ismailia can be developed at about 75% of the cost of Egypt's other existing zones. However, zone authorities say they require \$12 million in order to proceed further with building infrastructure. As of October, 1981, the zone was completing its fencing perimeter and constructing an administration building. In June 1995 special attention from the government has been paid to Adabia free zone.

**TRANSPORTATION ACCESS :**

Between the Mediterranean Sea, Nile river, Red Sea and Suez Canal, the free zones have access to excellent railroad system of 4.375 miles. Cairo is a major international airline center, with 50 leading world air carriers calling at Cairo Airport, 15 miles from the capital.

Major shipping lines serving the country such as Egyptian, American, Russian and Turkish companies. Annual traffic in the Suez Canal exceeds 50 million tons; more than \$2 billion is being spent to widen and deepen the Canal, to ease congestion and the steadily growing rate of imports at Alexandria, Egypt's largest and principal port. Two new major ports are being developed on the Mediterranean coast east and west of the main port of Alexandria. One, at the Dekhelia port which is linked to a prime industrial project, construction of an 5800 million

steel complex, a joint Egyptian-Japanese venture which ranks as the largest industrial project undertaken since the start of the 1974 open door policy. Phase one of the project includes construction of a container quay and terminal, a timber quay, and a general cargo quay, each 1.5 kilometer long. The second port venture, at the Demote port, has top priority of the Government, and is being built specifically to relieve congestion at Alexandria. It will handle 7.4 million tons of traffic in its first year of operation and by the year 2.000 it is expected to handle 18.3 million tons of traffic annually. The port will have six berths, will accommodate ships up to 80.000 tons, have 700 meters of secondary berths, two break waters' 1.400 and 520 meters long, a grain silo with a 52.000 ton capacity, and a canal for barges about 4.5 kilometers long. Further mitigating the burdens of Alexandria shipping is the extension of port facilities at Suez. Port Said Safari and El-Arish in the Sinai all now being planned for development.

#### **USER'S FACILITIES :**

Commercial warehousing, ship repair, refining, container and deep water harbor facilities are available at Alexandria, Port Said and Suez, while Cairo has storage and factory plant installations. Annual lease rates for industrial projects are \$3.50 per square meter in Cairo (El Nasr City) and port Said. The annual lease is \$1 in Alexandria (Al Ameria) and Suez (Port Tawfik). For now industrial projects including basic warehousing, comparable rates are \$3 in Cairo and Alexandria, \$2.50 to \$7 in Port Said and \$1.50 to \$7 at Suez. Each investor or user must make a

guaranteed deposit based on gross wages for a year, the amount of annual levy, the estimated customs tapes, duties, rental value of the amount paid to the authority and customs and for security. Part of the deposit is held against the possibility of damage, misuses of infrastructure, and for fines levied for various violations. Port Said has eight cold storage plants at rent of \$4 per square meter and 65 warehouses at \$7 per square meter for warehousing and \$3.50 per square meter for open space for factories and offices. Public warehousing Costs' \$3.50 per square meter annually, a rate fixed by the Port Said Governor. Rents include utilize and maintenance and may be raised up to 25% after a biannual review. Land may not be purchased but may be leased under 25 - to 30 - year leases at rates of about \$75 per square meter annually. Buildings may be constructed on leased premises by the lessee. A Jolie Ville" hotel will be built on six landscaped Feddans near the gate of the Alexandria zone by a Swiss company "Movenpick". To facilitate the construction of a tourist village on Crocodile Island near Luxor, Movenpick is getting a special customs zone that will allow construction materials to be admitted without delay.

#### **UTILITIES, COMMUNICATIONS AND LABOR ACTIVITY**

Sufficient water is available in the free trade zones for industrial use. Energy output has more than tripled with the operation of Aswan High dam. Electricity is 50 cycles and 220/380 volts all over Egypt. a new power station is completed, and it will serve as an Emergency source of electricity power just in case of brief power failure in Cairo



or other near cites. Oil output is increasing gradually, with production more than 400.000 barrels a day. Utility services in the free zones must be paid for in foreign currency. Overseas telephone, cable, Fax. and telex services are easily available. A contract valued \$1.8 billion telecommunications to a French-German consortium is being achieved.

Egypt is famous of its intellectual calipers and clever technicians in Arab world and the surrounding country in the middle east and Africa.

#### **INCOME AND OTHER TAXES :**

Companies operating in the free trade zones are exempt from the normal combined profit tax rates levied on companies not qualifying for the five or ten year tax holiday, and on dividends, interest and royalties paid abroad.

#### **FREE ZONE PROJECTS EXEMPTION :**

Projects operating in the free trade zones are exempt from the normal tax rates levied on companies or individuals investment.

1- According to investment law No. 230/1989, projects established in free zones and dividends distributed by them shall not be subject to the provisions of tax and duty laws in force in Egypt. However, such projects shall be subject to an annual fee of 1% of good's value, entering or leaving the free zone for their account, as administrative fees. Also, Project, the main activity of which doesn't require the entry or exit of goods, shall be subjected to an annual fee of 1% of the gross revenues realized by the project, based on accounts duly certified by a chartered accountant (Article 37

par. 4), but trade in transit goods with a fixed destination is exempted from the annual duty of 1% of the value of goods entering or leaving the free zone. (Article 37 par. 3).

2- Funds invested in free zones shall not be subject to succession tax.

3- All equipment, materials, articles, supplies and means of transportation required by free zones' projects to carryout their works within the free zone are exempted from customs duties, consumption tax and any other taxes.

4- Profits and dividends earned by projects of the free zones are exempted from taxes and duties in force in Egypt.

5- Amounts paid by projects to amounts paid by projects to non-Egyptian personal normally subject to the employment earnings tax on wages, salaries' bonuses, and other such payment are exempted from the general tax on income proved that the duration of their work in Egypt shall not exceed one uninterrupted year. (Article 27/2).

#### **GUARANTEES :**

The government does provide guarantees against war or unrest, nationalization or expropriation, and inconvertibility of currency.

#### **BANKING, EXCHANGE AND CREDIT STATUS :**

Foreign banks may now operate independently in Egypt. United states, European and Arab banks have been granted licenses exclusively to handle foreign currency transactions in Egypt, even it can deal with Egyptian pound.

There are four state-owned commercial banks. These banks also have 51% or more ownership in joint ventures with four foreign banks, including American Express and Barclays International. Free zone banking activities are handled by all national and foreign banks. Egypt was able to concentrate more on economic gains, a number of impressive advances were registered in last decade. Gold and exchange balances surpassed \$1.5 billion for the first time, gross national product grew by 12.5%, natural gas output jumped sharply. Egypt became a net exporter of oil and the payment's balance showed a surplus. Also Surplus of \$3.5 billion payments in 1990 contrasted with the previous huge deficit of \$2.5 billion. The 11% growth in the money supply helped convince the Central Bank it should open the country to foreign bank branches, three of which, including one from the U.S., were given the green light to establish a joint venture permitting foreign branches to deal in local currency for the first time. the foreign branches previously operating in Egypt were allowed to transact business in dollars only as offshore banking units. Exchange market is free for all currencies.

The Export Development Bank of Egypt provides exports with trade financing, export project financing and promotion and export credit guarantees. In addition, the Bank is joining with local insurance companies established an export insurance company.

#### **CAPITAL REQUIREMENTS :**

Under law 159 passed in September 1981 regulating companies that issue shares, a shareholder company (similar to a United States corporation) may be established by three

founder-partners if it meets a minimum capital requirement. It may be established by two persons only as I think, according to logic explanation of the Company Law Provisions (159/1981).

#### **SPECIAL INDUCEMENTS :**

Under the Law 230 for 1989, companies operating in the free zones, as mentioned before, are not subject to customs duties, export duties, income taxes and many capital requirements and are exempt from the need to share 25% of profits with employees as it should be the case for projects working in side the country. Most machinery and equipment may be amortized at 20% annually while machinery and equipment used in new production may be granted an additional 25% of the cost of acquisition. The law exempts free zone companies from the exchange control laws and offers full remittance of profits for heavily exporting projects.

Distributed profits are exempt from the general income tax up to a limit of 0.05% of the invested funds. Foreign personnel are exempt from income tax. Under the Foreign Investment Law 230, tax exemptions may now be granted up to 15 years in the five trade zones instead of eight as previously allowed, whether or not the company may be in operation. A new tax holiday may begin whenever the capital is increased in an Egyptian project. Up to 5% of an individual's original share invested in a company granted on a five-year or ten--year tax exemption is excluded from tax for the duration of the project.

Under the Law No. 230, the five-year exemption may be extended another five year if approved by GA and the Cabinet.

If the investment is in the new industrial zones, land reclamation projects, reconstruction and establishment of new cities or in designated rural areas and have the approval of the Prime Minister, the extension may be for ten years, or a total of 15 years. When capital is invested in medium-- or low-income rental housing, the exemption is for 15 years and the extension is for five years. At termination of a tax holiday, profits distributed to shareholders may be exempt from income tax up to 10% of the investor's original participation and up to 20% if the shares are of companies in which at least 40% of the equity is owned by individual shareholders. Certain types of investments, including investment firms, banks and technical consulting companies, do not qualify for exemption.

Company Law 159 of 1981 extended its advantages for companies established under Law 43 of 1974 to Egyptian companies engaged in industrial activities and employing a minimum of 50 persons. The same advantages assumed to be extended to projects established according to the new Investment law 230/1989. This Interest derived from investment bonds issued by public sector banks and from loans to the Government or industry-owned State enterprises or interest earned from bank.

deposits as well as interest earned from savings and commercial bank deposits are exempt from the normal 40.55% tax on income from capital. Goods produced in the

free trade zones that are shipped into Egypt are entitled to a 50% exemption of duties if their components are at least 40% Egyptian.

The 10% sales tax levied on all goods and service other than farm produce, industrial raw materials and specified necessities for businesses with annual sales exceeding \$11.000, is refunded on exported items. Generally, as of May 4, 1991, sales tax rates range from 5% on such items as coffee, detergents and fertilizer to 30% on VCRs, large cars, cosmetics and similar luxuries for businesses with annual sales over \$16.000.

Investment Law 230/1989 grants an additional tax holiday to new joint companies formed for expansion of the national economy. Companies outside the free trade zones are eligible for a five-year tax holiday that can be extended to eight years by the Minister of Economy for certain industries.

The emphasis is on high-technology production and manufacturing and any form of assembly, finishing mixing or repackaging is permitted. Free zone project agreements are reviewed periodically, after up to 40 years for industry and every 10 years for warehousing.

For more information about the regulations of the Free Zones In Egypt, the appendix to this article relevant to the subject in the Egyptian Law in force.

## PRIVILEGES OF INTERNATIONAL INVESTMENT IN FREE ZONES :

Some years ago, UNIDO passed a resolution encouraging developed countries to establish and strengthen policies for the redeployment of relatively less competitive industries to developing nations<sup>(19)</sup>. The relocation of industrial activities to third world nations in fact occurred, but in a different and perhaps unforeseen way, by phenomena known as off-shore assembling and vertical integration. A considerable part of such international industries set up in Free Zones.

Commentators have insistently argued that both the concerned developing and developed countries have benefited from such a partial industrial redeployment<sup>(20)</sup>. The former received new investment flows for export manufacturing, with positive effects in employment generation and foreign exchange earning. the latter retained international competitiveness in certain industries, lowered prices for consumers and conserved jobs in high-tech stages of production.

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(19) See, Sauvant, *op. cit.* pp. 127-28.

(20) See, e.g., Balasa, *Inter-Industry Trade and the Inegration of developng Countries in the world Economy*, in *On the Economics of Inter-Industry Trade* 245 (H. Giersch ed., 1978); Laird, *Intra-Industry Trade and the Expansion, Diversificantion and Integration of the trade of Developing Countries*, in *International Trade and Third World Development* 166 (P. Ghosh ed. 1984); J. Grunwald & K. Flamm, *op. cit.*; M. Casson, *Multinationals and World Trade : Vertical Integration and the Division of Labour in World Industries* 11 (1986).

## **PART TWO**

### **LAW AND POLICY FOR INTERNATIONAL INVESTMENT IN THE FREE ZONE**

Several Legal and policy instruments have already been successfully adopted by one or more countries. Others have not yet been tested in the context of individual zones but are thought to be potential useful for solving certain specific problems that Free Zones are facing today. None of these instruments is supposed to be applicable in all zones, but they all should be considered by developing nations engaged in adapting the zone concept to meet their own needs and possibilities.

Of course, it must be borne in mind that even a well designed and efficiently operated FZ is far from being a panacea. A country must carefully evaluate the economic feasibility of a zone and its potential social and economic impact before seriously considering an appropriate strategy for zone development. Conducting a detailed social cost-benefit analysis in advance to evaluate the advantages and disadvantages advantages of setting up a zone in a particular location is advisable. All policy recommendations discussed below are suggested with the assumption that the outcome of such an evaluation has shown the viability of establishing an FZ in the concerned country.

At this point, it should be remembered that the success of a particular free zones does not depend solely upon a



positive evaluation of its economic feasibility or on an adequately structured and implemented law and policy framework. Several social, economic, and political factors, both internal and external, may alter the circumstances, deciding the zone's fate in unpredictable ways. Governments would be well advised to follow closely any internal or external development that might affect the operation of the zones and to evaluate, in view of the particular circumstances, whether a variation in individual zone policies should be implemented.

In order to maximize the zone's effects on economic life and industrialization, a developing country should see zone industrial policy as a branch of its overall industrialization scheme instead of looking at zone policy as a separate strategy. Zone industrial policy should be coordinated with the country's industrialization strategy, and Free Zones must be considered another instrument to accomplish the industrialization goals of the country. This is not to say that Free Zones are only feasible in the context of an export-oriented scheme, or that zone policy must necessarily be consistent with the individual industrialization policies in force in the rest of the country, as exceptional regimes will often be in force within the bounded area.

As for the in-zone industrial policies, developing country governments should always bear in mind the existence of various forms of investment likely to be found in Free Zones. Those forms of investment are Holly owned subsidiaries, infra-firm assemblers, international subcontractors, and free-lance local industries. It would prove valuable for zone policy-makers to test the compatibility of every proposed zone policy with each of these types of zone investors, in order to guarantee that zone regulations will be appropriate and applicable to any and all zone manufacturers.

At the same time, host countries may find it advisable to follow closely those new trends and recent developments in transitional trade and investment that are likely to affect the behavior of each of these different types of zone investors. It may also be useful to consider the advisability of formulating separate sets of rules for each of these groups of investors in an effort to maximize benefits to be obtained from Free Zones.

### *1- Labor Regulations And Human Rights :*

Formulating an employment policy for the zones is certainly a difficult task. Both the importance that developing countries assign to the aim of generating employment and the fact that cheap labor is regarded to be the most relevant consideration for transitional investors in FIZs make it particularly difficult to reconcile the frequently conflicting interests between employers and workers. This concern is exacerbated by the fact that most developing

countries suffer from chronic unemployment. Policy-makers frequently find themselves facing the dilemma of either improving the standard of living of current workers or liberalizing labor regulations in order to attract new investments that will in turn generate more employment. The rationale of developing countries seems to be to protect the labor standards of zone workers to the extent that they will not discourage potential investors from setting up in the Free Zones.

There are, of course, certain problems in labor relations that employment law and policy are clearly in no position to solve. These limitations may be easily noticed when discussing the characteristics of the zones' work forces. the preference of zone manufacturers for young, inexperienced, and unmarried women is unlikely to be changed through the adoption of specific policies to induce companies to alter the composition of their work force. Even if the country's concern is that the typical zone worker may be more subject to abuses, the protection granted by the implementation of labor laws might be as far as the law could go.

Something that developing countries should always consider when structuring employment policies for Free Zones is that the most relevant comparative advantage that the country may offer to transitional investors is relatively cheap labor, which can materially lower a company's production costs, thereby increasing its international competitiveness. Policy-makers should always bear in mind that the burden employment rights will place on the enterprise's operational costs must not significantly reduce

the zone's relative advantage in labor costs. However, cases of non-observance of international labor treaties and human rights violations have been reported in the zones. Host countries should realize that certain internationally accepted employment rights, not frequently recognized in Free Zones, are not considered critical by zone investors. A moderate minimum wage, reasonable hours, and annual holidays are some of the working conditions that transitional investors would typically not even discuss. Labor policies allowing worker exploitation are thus not necessary to appeal to potential zone investors.

On the other hand, experience shows that foreign companies would not expect certain employment rights to apply in Free Zones, and, therefore, these rights cannot be granted without the zone's losing some attractiveness. Unionization, job security, and participation in corporate governance have proven to be conflicting issues for zone enterprises. This fact does not necessarily mean that those rights will never be granted in the case of zone workers, but it highlights the challenge for lawmakers to regulate labor in a way that would not diminish the zone's attractiveness to foreign investors.

Another important fact to consider is that, although the suspension of certain labor and union regulations is supposed to benefit investors, such suspension would not necessarily constitute an advantage for zone enterprises. As wages paid to zone workers are frequently low, poor labor conditions may generate a hostile working environment that would repel, rather than attract, potential investors.

A particularly delicate matter for both zone companies and workers is that of the employer's discretion to cancel at will an employee's contract. Developing countries should realize that this point is frequently considered to be non-negotiable by foreign enterprises, although job security has been granted in some successful Free Zones. In any case, countries might be interested in trying various methods, such as encouraging fixed-term employment contracts or establishing automatic compensation for employees discharged without a good cause, to alleviate the problem.

Regarding the number of jobs that a zone industry may generate, it might be concluded that labor-intensive operations need not be induced, as they constitute the largest number of industries in Free Zones every where. The best way of increasing the total number of jobs generated by zone activities is to maximize their potential macroeconomics effects through increasing forward and backward linkages with the domestic economy, not with the service sector, but also with domestic industries.

Finally, given the interest of third world Countries in developing local expertise, in producing for the international market, they may also be willing to induce participation of nationals in key managerial and technical positions. Nevertheless, policy makers should be aware of the fact that most zone enterprises are simply structured assembly plants that need very few high-level employees. As most foreign companies operating in the zones are vertically integrated, the relevant management and technical decisions are ordinarily made by corporate headquarters, rather than by

the local subsidiary. However, there seem to be possibilities for generating jobs at the managerial level in Free Zones operations for well educated, skilled and experienced natives.

#### ***II- Tax Law and Policy in Free Zones :***

Most zones are regarded as tax havens, as foreign companies may receive income or own assets without paying the ordinary tax rates upon them, or may simply enjoy tax holidays. A very important tax policy implication of this study is that tax holidays need not be offered to attract foreign investors to Free Zones, or at least not to the extent that they are granted in several countries. Various reasons have been pointed out to support such a conclusion.

1) One is that zone locations in themselves offer a significant comparative advantage in production costs vis-a-vis other places, so no additional substantial incentives are required to attract foreign companies.

2) Moreover, tax credit and tax sparing systems existing in several industrial countries make it useless to grant local tax immunities, as zone profits will be taxed in the company's home country<sup>(21)</sup>.

Several studies have concluded that a complete exemption from local taxes does not significantly influence Transitional companies investment decisions. Furthermore,

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(21) See for the Author & Soheir Abdel Aal, "The Circumstances of Investment in Egypt, Analyses study". Foreign Investment in Egypt Conference, Egyptian Society of International Law & S. Kamel Economic Studies Center (El Azhar University) 1992.

certain successful Free Zones do not offer tax concessions at all, yet do not lose their appeal to foreign investors. Some evidence suggests that an acceptable regime for Free Zones may include taxes to the extent that they would not prevent potential investors from setting up in the zones. On the other hand, it seems that the less complicated a tax regime is, the less harmful it will be considered by manufacturing enterprises. Hence, developing countries may consider imposing a low-rate income tax on zone operations, in lieu of all other taxes applicable in the rest of the country.

An alternative system would be to adopt a case-by-case regime that considers the treatment of local taxes in the investor's home country, e.g., tax crediting or tax-sparing, when deciding whether or not to tax its zone operations. Policy-makers should notice that this regime, in spite of being theoretically more efficient, implies additional expenses in gathering, processing and updating information on the tax systems in force in the investors' home countries. Moreover, imposition of the high tax that may result from such a case-by-case approach would probably generate a serious risk of dealing with transfer-pricing practices. The fact that Free Zones typically are duty-free areas, where low, if any, taxes apply and where foreign exchange restrictions are not in force, virtually preserves zone operations from transfer pricing practices.

### *1- Tax-spanning Conventions :*

An important system that all gird world countries should explore when dealing with the problem of double taxation is that of tax-sparing conventions. Through these agreements the potential home country "grants a credit not only for the tax paid but for the tax spared by incentive legislation in the developing country"<sup>(22)</sup>. The system would allow host nations nominally to establish in the zones the same tax rate that is in force in the rest of the country. The system grants to the investor an additional financial incentive for the difference, without generating extra costs for the developing nation. Tax-sparing treaties are being strongly promoted by international organizations, but they are still far from being widely accepted by developed or newly industrialized countries.

### *2- Tax-stability Agreements :*

Another legal mechanism that tax-policy makers in developing nations might be willing to consider consists in so-called tax-stability agreements. Through these instruments, host developing countries may agree with zone investors not to raise the income tax rate and not to create additional taxes for a given period, in exchange for a promise by the zone company to reach certain economic

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(22) U.N. Dep't of Int'l Econ. & Soc. Aff., U.N. Model Double Taxation Convention between Developed and Developing Countries at 104, U.N. Doc. ST/ESA/102 (1980).



goals. Examples of potential goals would create a certain number of jobs, or to export goods of a given value. The country's obligation may or may not be secured by a local or foreign institution, and any dispute could be submitted in advance to international arbitration.

*Customs privileges in Egypt :*

Free of import duties, excise taxes, emergency taxes, individual taxes, company taxes on industrial profits from business and trade and from withholding taxes. Import and exports moving into or out of the free Zones are subjects to a 1% tax (3% for non manufacturing projects). For specific types of industries essential to the economy and with no domestic competition, the rate may be reduced to as little as 0.2%. Companies producing in the free trade Zones may sell into Egypt outside the Zone areas but goods are treated as if imported from other countries. Goods containing 100% local material and entering Egypt from the Zones are exempted from duties. Free storage is granted for free trade Zone users up to eight days. Goods produced in the free Zones may enter Egypt at 50% of the customs duties rates if their components are at least 40% Egyptian. One stumbling block to investment in the Zones has been a series of disputes between customs officials and the investment authority over which items can be imported duty-free. To facilitate settlement of disagreements, accustoms authority is being established at the general authority for investment in Cairo. A list of 80 imports covering essential, non-essential and consumer items requires prior licensing

when imported into areas of Egypt outside the free Zones. Other handicaps have been customs delays in processing documents and harbor congestion at the port of Alexandria because of lack of sufficient docking berths. Dekhila harbor and Damietta port are equal alternates.

### ***III- International Law of Property Protection and Technology Policy in Free Zones :***

The issue of encouraging the appropriate technology for the zones is also controversial. Developing countries want to attract new technologies precisely because the countries know very little about them. Yet these nations seem in no position to specify what technologies they are interested in attracting. This problem is aggravated by the fact that most countries consider technology transfer to be a limited aim, if an aim at all, when establishing Free Zones. It has been suggested repeatedly that labor-intensive technologies usually are more applicable to the country's goals in establishing an Free Zones and guarantee that the investor fetes the full benefit of the zone's relative advantages. Although this is likely to be the case, it has been pointed out that such technologies need not be induced by specific policies; zone investors use them anyway when they are more economical.

Experience shown that technology transfer is not an issue when defining zone policies with respect to foreign investors. Reasons include the fact that most transitional companies in the zones are vertically integrated plants where low-tech assembly operations take place. Moreover, the country's aim of generating employment through zone

manufacturing implies that labor-intensive technologies would be preferred to capital-intensive high-tech processes. It would be, of course, extremely difficult to evaluate at this point whether the relatively low interest of developing countries in encouraging transfer of technology at the zones is counter-productive. Evidence seems to support the arguments for paying little attention to this issue. A further rationale for such a position is that technology transfer regulations may unnecessarily generate an additional burden on foreign investors, with no effective benefit for the country<sup>(23)</sup>.

Those who are still not convinced by these arguments should be prepared to answer questions on the advisability of compelling investors to "transfer" standardized and even obsolete technology, such as that in mature products, and technical knowledge corresponding to particular stages of production, such as that of vertically integrated industries. More importantly, one may end up being confronted with questions on whether policies directed towards technology transfer have succeeded in the past, and on whether some degree of transfer has spontaneously occurred in successful zones despite the absence of exacting regulations.

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(23) One author has argued that "the elimination of restrictions on the transfer and use of technology is a fundamental prerequisite for the promotion of exports of manufactures from developing countries". See Lacarte, *Aspects of International Trade and Assistance Relating to the Expansion of Employment in Developing Countries*, in *International Trade and Third world Development* 141 (P. Ghosh ed. 1984).

A different approach to the question of the appropriate technology for the zones might be a negative one, namely to define what technological processes and what products are not to be allowed in the zones, according to the country's capabilities and objectives at a given time. Defining inappropriate technologies seems to be less complicated a task for policy-makers and a system particularly appealing to the liberal regimes existing in most Free Zones.

It has been argued that off-shore manufacturing in developing countries may be risky for transitional companies, specifically in the case of subcontracting, as valuable technology may leak to competitors. Even though most investments in Free Zones are low-tech manufacturing plants, it is not extraordinary to find zone industries where technical knowledge is specially important. A similar argument might be made regarding trademarks and trade names, particularly in the case of the garment and soft drink industries found in several zones. The risk of technology leaking is heightened by the fact that some regulations that adequately protect technical knowledge, inventions, and commercial names.

Zone investors have been concerned about the protection of their intellectual property rights. Reliability of patent and trademark regulations appears to be a significant consideration in the investment decision. Developing countries that do not have currently in force an intellectual property system considered acceptable by international standards may evaluate the advisability of signing the most relevant international treaties on the matter, notably the

Paris Convention for the Protection of Industrial Property of 1883, the constraints imposed by such conventions by and large have been of minor significance. The conventions have left enough leeway, for example, that countries can refuse to issue patents on certain types of products such as drugs, can fix the life of the patent as they choose, can subject an application to search or not, can define the terms that represent "abuse" of the patent, and can limit the rights of the abusive patent-holder.

Convention for the Protection of Industrial Property, Mar. 20, 1883, 25 State 137, and to adapt their regulations to the model trademark and copyright laws proposed by the World Intellectual Property Organization (WIPO)<sup>(24)</sup>.

Zone policies should be translated into a systematic and consistent body of unambiguous, public, legally non contentious rules and regulations. Furthermore, enforcement of the investor's rights should be as expeditious and effortless as possible.

The main concern of transitional investors is to protect themselves against the risk of expropriation. One alternative is a constitutional guarantee against nationalization. Such a provision may allow certain exceptions related to extraordinary circumstances, provided there is prompt, adequate and just compensation. The system has been

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(24) For a discussion of WIPO's proposed Model Copyright Law, see State Department Copyright Panel Examines WIPO Copyright Law, 37 Pat. Trademark & Copyright J. (BNA) No. 914, at 258-59 (Jan. 19, 1989).

complemented in some countries with a right to make a claim subsequently before an international court<sup>(25)</sup>.

Another type of legal safeguard is that of investment insurance provided by governmental institutions of developed countries. For instance, the Overseas Private Investment Corporation (OPIC) offers coverage to U.S. investors against losses resulting from currency inconvertibility, expropriation, war, revolution, or insurrection. A previous agreement with the concerned country is required, according to which OPIC will compensate the insured investor and will and will subjugate the company's claim against the country<sup>(26)</sup>. Also The Arab Establishment for Investment Insurance, belongs to The Arab League. And on the international level (MIGA) belonging to The World Bank.

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(25) This is theoretically the case of the state parties to the 1969 American Convention on Human Rights, which declares : "No one shall be deprived of his property except upon payment of just compensation, for reasons of public utility or social niterest, and in the cases and according to the forms established by law". American convention on Human Rights, Nov. 22, 1969, art. 21, para. 2, 9 I.L.M. 673. Any person may file a petition with the Inter-American Commission on Human Rights Claiming Violation of such right (article 44), which might submit the case to the Inter-American court of Human Rights, whose jurisdiction is binding for those countries that have declared so under Article 62 of the Convention. For an overview of the Inter-American Human Rights system, see T. Buergenthal, R. Norris & D. Shelton, *Protecting Human Rights in the Americas : Selected Problems* (1982).

(26) See J. Barton & B. Fisher, *International Trade and Investment : Regulating International Business* 5-7 (1986) at 915-16.

As foreign investors frequently give importance to the availability of investment insurance, developing countries that still do not participate in such regimes should carefully evaluate the advisability of adopting such a policy. Countries that are willing to examine these and other alternatives might be well advised to consider the fact the degree of political risk exposure of zone investors tends to be low, particularly in the case of vertically integrated industries<sup>(27)</sup>.

#### *IV- Settlement of Disputes :*

Another major concern of transitional investors is the settlement of disputes with the host government. It is the settlement of disputes with the host government. It is obvious that they are reluctant to be settled by the local courts.

Arbitration arrangements provide a solution that several developing nations have found to be the most convenient. Disputes are submitted to privately chosen arbitrators, or to one of the existing centers for international

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(27) In a celebrated 1977 article, David Bradley wrote that "among the most powerful deterrents against expropriation is the vertical integration of a multinational in which the parent company controls either the supply channels or the market outlets of its subsidiary's products". See Bradley, Managing Against Expropriation, 55 Harv. Bus. Rev. 75, 81 (July-Aug. 1977).

arbitration, notably the International Center for the Settlement of Investment Disputes (ICSID)<sup>(28)</sup>.

Given the flexibility of the ICSID rules the concerned state must consent to the Center's jurisdiction after the dispute arises-a considerable number of developing countries have found it convenient to become members. Egypt is a party to this systems. It host also the Middle East branch of the UNCETRAL.

Such systems reduces the risk of having the investor's home government involved in eventual disputes. All countries having no serious incompatibilities with the Center's rules might be well advised to evaluate carefully this and other alternatives for establishing reliable of dispute resolution.

Other types of legal safeguards against economic risks, such as tax stability agreements and industrial property regulations, have been highlighted above and need not be revisited. The challenge for policy makers when considering these and other mechanisms is to grant investors broad protection with no detriment to the country's rule of law. The internal stability of the country and its legal system seem to be the natural limits.

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(28) The ICSID is an intergovernmental agency created in 1966 by the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States, to solve investment disputes when one party is a state. The Centre's awards are not subject to review by the courts of the contracting state. For an overview of the role of ICSID in solving investment disputes, see Soley, *ICSID Implementation : An Effective Alternative to International Conflict*, 19 *Int's Law*. 521 (1985); and Delaume, *ICSID Arbitration and the Courts*, 77 *AM. J. Int'l L.* 784 (1983).



*Economic confederations of Free Industrial Zones :*

Response of developing countries to balance-of-payment deficits have included attempts to reduce foreign exchange expenditures, attract fresh foreign capital, and increase foreign currency earnings through exports. Because outflows of foreign currency are difficult to reduce after they have reached a certain level, and because foreign capital flows are likely to be quite insignificant, given the difficulties for developing countries in meeting their current obligations, policies tending to increase and diversify exports play a very important role in developing nations. These countries must increase significantly their export earnings as a means of attaining economic growth and improving their debt situation.

Some debtor countries promote export industries not in the context of an industrialization strategy, but as a desperate effort to meet their foreign exchange imperative.

The lack of industrialization is characteristic of third world countries, industrialization is common objective among them. During the last two decades they have implemented two broad models of industrial development, known as import-substitution and export-oriented startgies<sup>(29)</sup>. Although very few developing

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(29) Import-substitution generally consists of the protection of local industries supplying the local market with manufactured goods which in the past were imported. Export-oriented startgies focus on the promotion of industries that orient a substantial part of their production to foreign markets.

nations have adopted either one of these models exclusively, most have opted to encourage one or the other.

There are several instruments of industrial policy that developing countries may utilize when implementing an industrialization strategy. Ordinarily, policy instruments are selected depending on whether the country intends to foster an export-oriented or an import-substitution strategy. There are, nevertheless, a number of policy instruments which, if adequately structured, are flexible enough to fit well into either scheme. Among the latter type of "neutral" industrial policy instruments, Free Industrial Zones have proven to be a significant source of foreign currency, it is likely that some developing countries are establishing them in an attempt to confront increasing deficits in their balances of payments as said above.

A study by the Organization for Economic Cooperation and Development (OECD) defines an Free Industrial Zone as an administratively and sometimes geographically designated area enjoying special status allowing for the free import of equipment and other materials to be used in the manufacture of goods earmarked for export; the special status generally involves favorable legal provisions and regulations creating incentives for foreign investments<sup>(30)</sup>. By 1992, there were some 177 FIZs operating in fifty-two developing countries Worldwide figures offered by Dorothy and Walter Diamond are even more impressive reporting

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(30) A. Basile & D. Germidis, Investing in free wxport processing zones 20 (1984).

some 518 free trade zones in 86 countries. However, these include free ports and zones not intended for manufacturing and FIZs located in industrial nations.

This rapid expansion is probably related to early support from U.N. Organizations<sup>(31)</sup>, and to a widespread belief in the certain success of FIZs in attracting foreign investment, contributing to an export drive, and stimulating employment.

In a 1974 report to the Agency for International Development (AID), said that an understanding of the role of law in society is of fundamental importance in undertaking development studies, as the implementation of development policies is effected through and the Legal processes of society.

*(Extraterritoriality) on two separate Country:*

Free Zones are deemed to enjoy an "extraterritorial" status, i.e., a juridical fiction that exempts activities held in a designated area from the application of rules and regulations in force in the rest of the country. Several factors appear to justify such a qualification. The most relevant being the customs-free character of the zones, according to which "for all intents and purposes movements to and from free trade zones and domestic tariff areas constitute movements

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(31) U. N. Conf. on Trade and Dev., The use of free zones as a means for expanding and Diversifying exports of manufacturees from the developing countries, U. N. Doc. TD/B/C.2/125, (1973); U.N. Indus. Dev. Org., Handbook for the establishment of free exports processing zones in developing countries, U.N. Doc. UNIDO/IOD. 31 (1976).

between two countries"<sup>(32)</sup>. The extra territoriality is reinforced by the fact that the establishment of an Free Zones is frequently complemented by the creation of a relatively autonomous public entity to governing industrial and commercial activities within the zones.

Another target, is that Free Zones are usually considered to be policy enclaves, in which the government can implement policies not necessarily consistent with those applied in the rest of the country. In fact, the zones have been regarded by some countries, such as Egypt, as instruments to implement policies designed to isolate the export sector from the local economy, based on the concept of import substitution and liberalization the economic life from the red tabs of the pirocracy. Similarly, China and other countries have found in the zones an opportunity to open their doors to foreign investment, without altering the domestic economic scheme. Egypt found Free Zones as step to privatization, to abandon the socialist economic philosophy.

A factor reinforcing the notion of extra territoriality is the special incentive measures offered within the zones. Adhoc tax and labor regimes create an important distinction between the two legal frameworks under which zone industries and domestic manufacturers operate. The dissimilarity is even greater in those countries where dispute

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(32) Jayawardena, Supra note 7, at 428.

resolution agreements, submitting to international arbitration any controversy involving zone investors<sup>(33)</sup>.

But extra territoriality is not only a legal status. Other factors, such as physical boundaries, internal policing devices, few linkages with the local economy, and the dominance of Transitional Companies reinforce the appearance of zones as foreign enclaves.

Developing countries have faced several problems as a consequence of the extra territoriality of the zones. Some are primarily legal, including the inconvenience of running two distinct legal systems with rather different policies in force<sup>(34)</sup>. The problem is particularly acute because some basic principles orienting the economic policies of most developing countries are inconsistent with the zone concept itself or with the aims of the country when establishing Free Zones.

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(33) Sri Lanka is a signatory to the 1965 Convention on Settlement of Investment Disputes between States and Nationals of states. See J. Currie, EPZs in the 1980s, *supra* note 20, at 136.

(34) A good illustration of this problem, in a developed country may be found in decisions involving U.S. FIZs, where jurisdictional uncertainty on the application of federal and state laws has been reported. For instance, one New York federal court held U.S. patent law applicable to zone-based transactions, *G.D. Scarle & Co. V. Byron Chemical Co.*, 223 F. Supp. 172, 174 (E.D.N.Y. 1963). Whereas a New York state court held that local regulations on liquor trade do not apply in Foreign Trade Zones. During *V. Valente*, 267 App. Div. 383, 46 N.Y.S. 2d 385 (1944). See generally Bader, *op. cit.* 17, at 246-245; Note, Foreign Trade Zones, *op. cit.* 14, at 739-748.

There are also social problems that emerge as a consequence of the country-within-a-country status. For example, cultural alienation has been reported in the Mexican-U.S. border region, supposedly originating from the industrial "yankeezation" of zone operations<sup>(35)</sup>. Reportedly, when offshore activities are "seen from the distant capital, Mexico City, the border region appears more nearly integrated with the United States than with Mexico<sup>(36)</sup>.

***The Product Life Process and Comparative Advantage :***

David Ricardo demonstrated, in early nineteenth century, the mutual benefits from bilateral trade between countries when each of them specializes in the production of goods of which it has a comparative advantage<sup>(37)</sup>. According to the law of comparative advantage, a country trading with another country must export those goods in which, comparatively, it has the lowest production costs and must import those goods in which, comparatively, it has a disadvantage. Benefits for both economies are derived from such an exchange. Developing countries following Richard's theory would specialize in producing those goods

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(35) See Meissner, op. cit. 83, at 261.

(36) J. Grunwald & K. Flamm, op. cit. 101, at 230.

(37) The theory of comparative advantage was explained in the famous book, D. Ricardo, *The Principles of political Economy and Taxation* (1911). Cited in J. Amado "FIZ : Law and industrial development in the new international division of labour", *University of Pennsylvania journal of international Business Law*, pp. 89.

containing a high proportion of domestically available natural resources<sup>(38)</sup>.

More than a century after Ricardo, the Swedish economist Bertil Ohlin, following some insights of his teacher Eli Heckscher, developed the so-called "Factors-allocation theorem". According to this theorem, countries will have a comparative advantage in exporting those goods that use their more abundant factors of production-labor, capital, etc.-more intensively<sup>(39)</sup>. The Heckscher-Ohlin theorem clarified why developing countries will concentrate in producing and exporting labor-intensive goods, whereas industrialized countries will produce capital intensive goods. Hence, the factor endowment of a country also determines its specialization in production and commerce.

#### *The Product Life Cycle :*

In the same field there are new theories demonstrate that research endowments-i.e., skilled labor, research and development (R & D) expenditures, etc.-do contribute to trade promotion and country specialization. The most celebrated of these theories was developed by Raymond Vernon and is known as the product life-cycle model<sup>(40)</sup>.

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(38) Hirsch, Hypotheses Regarding Trade between Developing and Industrial Countries, in the International Division of Labour : Problems and Perspectives 65, 66 (H. Giersch ed. 1974).

(39) P. Lindert & C. Kindleberger, International Economics 31 (1982).

(40) The first explanation of this theory may be found in Vernon, International Investment and International Trade in the Product Cycle, 80 Q. J. Econ. 190 (1966).

According to Vernon, products have a life cycle that can be divided into a series of phases.

1) The “early” phase, where a new skill-intensive product is introduced to the home market and subsequently exerted to high-income countries.

2) The “growth” phase, foreign markets are becoming more familiar with the product, and local demand for local demand for domestic production is satisfied by licensing or establishing subsidiaries.

3) Finally, in the “mature” phase, the innovative advantage of the home country is lost, while overseas producers in low-income countries gain a comparative advantage in production costs and begin to export the product to third markets and even to the product’s home country.

As with the natural endowment and factor allocation of the country, research endowment will also determine a specialization in exports of manufactures, following the product life cycle. Developing countries will produce and export “mature” products, while industrialized countries will typically manufacture products in their earlier phases.

The aforementioned theories imply that developing countries should specialize in manufacturing and trading those goods that more efficiently utilize their own endowments. This indicates that countries may benefit from adopting industrial and commercial policies, such as establishing FIZs, which are oriented toward fully exploiting their comparative advantages.



## HORIZONTAL & VERTICAL INTERNATIONAL INTEGRATION

Horizontal integration exists where one group of countries specializes in a certain set of industries and another group in a set of comparable industries, whereas vertical integration cuts across industrial processes through overseas- as-simply operations

Since Adam Smith, the theory of division of labor has postulated that if a person has a relative advantage in some activity, there is an efficiency gain, both for him and for the whole society to be derived from his specializing in it<sup>(41)</sup>. Accordingly, a person may decide to specialize in order to acquire or develop a relative advantage<sup>(42)</sup>. The division of labor concept has been raised to the international level and adapted to the theory of comparative advantage. If a country has a comparative advantage in the production of certain goods, there is an exporting them. Hence, resource-based and labor-intensive products would constitute the obvious first choice for a populous and capital-poor developing country, in order to integrate its economy into the international division of labor<sup>(43)</sup>.

The United Nations Industrial Development Organization (UNIDO) recognized in a 1982 report, competitive pressures in industrial markets have "forced most producers of standardized (or Mature) electronic

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(41) Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776).

(42) See E. Phelps, *Political Economy : An Introductory Text* 99 (1985).

(43) Scheid, *The Export Needs of Developing countries and the Need for Adjustment in Industrial Countries*, in *The New International Division of Labour : Problems and Perspectives*, op. cit.

products to continue their search for ways to transfer parts of their operations to developing countries where costs are lower<sup>(44)</sup>. This new specialization in production is also influenced by comparative advantages of developing nations in the production of resource-based and labor-intensive goods, sometimes complemented or accentuated by incentive measures designed to increase a country's comparatively lower production costs<sup>(45)</sup>. Moreover, the new division of labor through vertical integration entails and increase in transitional trade among affiliated firms.

***The Privileges of the Free Zones :***

This study examines the targets of developing countries when establishing Free Zones in their territories? What can local entrepreneurs expect of their eventual participation? What interest do industrial countries will to establish Free Zones in the Third World? This study examines the aims of the establishment of Free Zones in developing countries from the perspective of the main parties in the international trade and investment process.

**A) The Aims of Establishment of Free Zones in Developing Countries :**

It is possible to identify some general motivation applicable to most of developing countries in establishing Free Zones. It is clear that each country ranks these aims according to its particular needs and capabilities.

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(44) U.N. Indus. Dev. Org., Changing Patterns of trade in world industry : An Empirical Study on Revealed Comparative Advantage at 6, U.N. Doc. ID/281, U.N. Sales No. E. 82. II.B1 (1982).

(45) UNCTAD U.N. Indus. Dev. Org., Incentives for Industrial Exports at 4, U.N. Doc. TD/B/C.2/184, (1982).

a) Foreign exchange generation and result of export promotion; most of FZ were established during the massive shift to export-orientation and were designed to enhance foreign commerce. Export-promotion includes either the search for new markets for local products or export diversification through the promotion of non-traditional trade.

b) To promote exports, they imply the objective of yielding positive effects on the country's balance of payments<sup>(46)</sup> through the generation of substantial hard currency influxes.

c) Reduce unemployment : Free Zones are also created to reduce domestic unemployment. Some countries have specifically provided that one purpose of creating Free Zones is to safeguard employees' interests against possible exploitation by establishing adequate labor policies.

d) Encouraging Foreign Investment : Developing countries consider Free Zones as a means to attract foreign investment by offering lower production costs. The influx of foreign capital and expertise facilitates the development of an industrial export-oriented sector in the country, as multinationals are considered to be in a better position to open foreign markets for local products.

e) Exploitation of Natural Resources : The exploitation of local resources other than labor is becoming an increasingly important concern when establishing the zones.

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(46) See generally U.N. Conf. on Trade and Dev., Export Processing Free Zones in Developing Countries : Implications for trade and Industrialization Policies. U.N. Doc. D/B/C.2/211/Rev.1, (1985) UNCTAD : EPFZs in Developing Countries.

Some countries have even adopted a policy of requiring a minimum local content that is fixed when the authorization to set up in the zone is granted.

f) Industrialization targets : As instruments for industrial development, Free Zones share the general developmental goals attributed to industrialization.

g) Regional Development : Many Free Zones suppose to be located in relatively poor regions of the country because they facilitate industrial decentralization and regional development. In Egypt this target seems to be difficult to be understood, in spit of President Mubarak declared many remarkable privileges, facilities and exemptions for investments to be established in upper Egypt as a poor region no one of the executives take practical steps toward this target.

h) Export Industries Deregulation : Some developing countries consider FIZs possibility for insulating the export sector from various regulatory policies intended to protect domestic industries. Through the zones, as samuel Bettwy puts it, "by carving out specifically legislated areas, a developing country can gracefully operative a dual economy.

i) "Open Market" Policy Testing : FIZs may also be viewed as "laboratories" for testing open-market economic policies that may be later applied in the whole country. this occurred in countries such as Egypt, where FIZs clearly contributed to a shift from protectionism to an open economy.

j) Political Objectives : The implementation of Free Zones may be motivated in part by political or geopolitical

considerations. For instance, it has been reported that the Chinese zone bordering on Shenzhen and Hong Kong is part of a long-term strategy to intensify the process of economic osmosis before Great Britain hands over the administration of Hong Kong in 1997.

k) Free Zones as an incentive for Domestic Investors : Some developing countries still see FIZs as a game that only host governments and foreign investors can play. However, the recent history of several zones has shown that domestic investors may successfully participate, particularly through international subcontracting, in joint ventures or export-oriented free-lance industries. Experiences in countries such as Colombia, India, and more recently South Korea, have shown that positive effects may arise from allowing domestic investments in the zones. Among the benefits are an expected increase in linkages with the domestic economy, acquisition of industrial and marketing expertise at international standards, development of local entrepreneurship and management skills, and an increase in foreign exchange earnings that will remain in the country.

There are various other factors driving developing countries' governments not only to allow local investments, but also encourage domestic participation. A preference by foreign investors to engage local business people as partners in joint ventures has been reported. An articulated contraction of capital flows from industrial countries may be another consideration for garnering local participation; local investments are now permitted even in countries that originally banned them. This is the case with Pakistan, which recently shifted from a 100% - foreign - owned capital requirement to encouraging domestic participation through joint-ventures.

Local entrepreneurs view the zones as an alternative investment opportunity that may lead to successful competition in foreign markets. Lower production costs vis-a-vis and other location in the country might also constitute an incentive to seek access to the local market.

a) duty-free regime : Domestic investors may enjoy the benefits of being exempted from paying customs duties when purchasing capital goods and intermediate products. This would lower production costs, giving the local entrepreneur an advantage both for international and local sales. Although domestic investors operating within the customs territory of the country enjoy the benefits of low wages and access to raw materials, FIZs offer them the additional advantages of an incentive package, i.e., infrastructure facilities, tax benefits, financial incentives, free exchange regulations, labor incentives, etc.,

b) International Competitiveness Status : Lower production costs, resulting from duty-free imports and special incentives, determine a lower final FOB price, on that makes zone industries more competitive in the world market.

In addition, special arrangements such as joint ventures and international subcontracting allow domestic entrepreneurs an opportunity to develop managerial skills to operate at international standards.

c) Dual Economy Operation : Local entrepreneurs may be willing to support the establishment of FIZs as a means to ensure that protectionist measures sheltering their domestic industries remain in place while they take advantage of lower costs of production, both for exports and domestic sales.

***Free Zones?? Industrialized Countries :***

Industrial countries have encouraged the development of FIZs in third world countries, by creating special tariff structures allowing goods that were previously exported to be imported subject to ad valorem tariffs levied only on the value added abroad, exclusive of the value originated in the home country. For instance in 1983, U.S. imports of assembled goods under the so-called "806-807" classifications (articles previously exported for repair, alteration, processing, or assembling abroad) amounted to \$21.8 billion, of which the total value originating in the United States was only \$5.5 billion.

**Some of the reasons given to Justify such an indirect support are identified below.**

a) Hone Market Defense : John Grunwald and Kenneth Flame have found that production arrangements abroad have allowed certain U.S. businesses to remain competitive in the face of serious threats from imports. In fact, given the high wages of low-skilled labor in developed countries some labor-intensive industries have had to transfer production stages to FIZs in order to protect their positions in home markets against foreign competitors.

b) Foreign Market Competitiveness : The principle mentioned above also allows the industries of developed countries that shift labor-intensive production to FIZs in developing countries to gain or regain competitiveness in foreign markets. Mark Casson has recently written that proximity to export-processing Free Zones may be a competitive advantage to a mature exogamy because such proximity reduces that economy's overall cost of production relative to those of other mature industrial economies.

c) Lower Consumer Prices : As a general rule, lower costs of production result in lower prices to consumers, another benefit that an industrial economy may obtain as a result of foreign assembling and manufacturing in third world FIZs. For example, it has been estimated that the gain in welfare to U.S. purchasers of semiconductors, as a result of the internationalization of such industry, has been about ten percent of the value of consumption.

d) Geopolitical Considerations : The rationale of encouraging the implementation of FIZs may sometimes be found in geopolitical considerations. For instance, the geopolitical importance of Egypt and South Korea the United States is listed among the favorable international circumstances that made it possible for those countries to develop a competitive industry. The development of each was initially based on the implementation of FIZs.

#### ***LAW AND POLICY IMPLICATIONS FOR ZONE STRATEGY***

Several Legal and policy instruments have already been successfully adopted by one or more countries. Others have not yet been tested in the context of individual zones but are thought to be potentially useful for solving certain specific problems that Free Zones are facing today. None of these instruments is supposed to be applicable in all zones, but they all should be considered by developing nations engaged in adapting the zone concept to meet their own needs and possibilities.

Of course, it must be borne in mind that even a well designed and efficiently operated Free Zones is far from being a panacea. A country must carefully evaluate the



economic feasibility of a zone and its potential social and economic impact before seriously considering an appropriate strategy for zone development. Conducting a detailed social cost-benefit analysis in advance to evaluate the advantages and disadvantages of setting up a zone in a particular location is advisable. All policy recommendations discussed below are suggested with the assumption that the outcome of such an evaluation has shown the viability of establishing an Free Zones in the concerned country.

At this point, it should be remembered that the success of a particular Free Zones does not depend solely upon a positive evaluation of its economic feasibility or on an adequately structured and implemented law and policy framework. Several social, economic, and political factors, both internal and external, may alter the circumstances, deciding the zone's fate in unpredictable ways. Governments would be well advised to follow closely any internal or external development that might affect the operation of the zones and to evaluate, in view of the particular circumstances, whether a variation in individual zone policies should be implemented.

In order to maximize the zone's effects on economic live and industrialization, a developing country should see zone industrial policy as a branch of its overall industrialization scheme instead of looking at zone policy as a separate strategy. Zone industrial policy should be coordinated with the country's industrialization strategy, and Free Zones must be considered another instrument to accomplish the industrialization goals of the country. This is not to say that Free Zones are only reasible in the context of an export-oriented scheme, or that zone policy must

necessarily be consistent with the individual industrialization policies in force in the rest of the country, as exceptional regimes will often be in force within the bounded area.

As for the in-zone industrial policies, developing country governments should always bear in mind the existence of various forms of investment likely to be found in Free Zones. those forms of investment are wholly owned subsidiaries infra-firm assemblers, international subcontractors, and free-lance local industries. It would prove valuable for zone policy makers to test the compatibility of every proposed zone policy with each of these types of zone investors, in order to guarantee that zone regulations will be appropriate and applicable to any all zone manufacturers.

At the same time, host countries may find it advisable to follow closely those new trends and recent developments in transitional trade and investment that are likely to affect the behavior of each of these different types of zone investors. It may also be useful to rules for each of these groups of investors in an effort to maximize benefits to be obtained from Free Zones.

### ***I. Labor Regulations and Human Rights :***

Formulating an employment policy for the zones is certainly a difficult task. Both the importance that developing countries assign to the aim of generating employment and the fact that cheap labor is regarded to be the most relevant consideration for transitional investors in FIZs make it particularly difficult to reconcile the frequently conflicting interests between employers and workers. This

concern is exacerbated by the fact that most developing countries suffer from chronic unemployment. Policy-makers frequently find themselves facing the dilemma of either improving the standard of living of current workers or liberalizing labor regulations in order to attract new investments that will in turn generate more employment. The rationale of developing countries seems to be to protect the labor standards of zone workers to the extent that they will not discourage potential investors from setting up in the Free Zones.

There are, of course, certain problems in labor relations that employment law and policy are clearly in no position to solve. These limitations may be easily noticed when discussing the characteristics of the zones' work forces. The preference of zone manufacturers for young, inexperienced, and unmarried women is unlikely to be changed through the adoption of specific policies to induce companies to alter the composition of their work force. Even if the country's concern is that the typical zone worker may be more subject to abuses, the protection granted by the implementation of labor laws might be as far as the law could go.

Something that developing countries should always consider when structuring employment policies for Free Zones is that the most relevant comparative advantage that the country may offer to transitional investors is relatively cheap labor, which can materially lower a company's production costs, thereby increasing its international competitiveness. Policy-makers should always bear in mind that the burden employment rights will place on the enterprise's operational consist must not significantly reduce the zone's relative advantage in labor costs. However, cases

of non-observance of international labor treaties and human rights violations have been reported in the zones. Host countries should realize that certain internationally accepted employment rights, not frequently recognized in Free Zones, are not considered critical by zone investors. A moderate minimum wage, reasonable hours, and annual holidays are some of the working conditions that transitional investors would typically not even discuss. Labor policies allowing worker exploitation are thus not necessary to appeal to potential zone investors.

On the other hand, experience shows that foreign companies would not expect certain employment rights to apply in FIZs, and, therefore, these rights can not be granted without the zone's losing some attractiveness. Unionization, job security, and participation in corporate governance have proven to be conflicting issues for zone enterprises. This fact does not necessarily mean that those rights will never be granted in the case of zone workers, but it highlights the challenge for lawmakers to regulate labor in a way that would not diminish the zones' attractiveness to foreign investors.

Another important fact to consider is that, although the suspension of certain labor and union regulations is supposed to benefit investors, such suspension would not necessarily constitute an advantage for zone enterprises. As wages paid to zone workers are frequently low, poor labor conditions may generate a hostile working environment that would repel, rather than attract, potential investors.

A particularly delicate matter for both zone companies and workers is that of the employer's discretion to cancel at will an employee's contract. Developing countries should

realize that this point is frequently considered to be non-negotiable by foreign enterprises, although job security has been granted in some successful Free Zones. In any case, countries might be interested in trying various methods, such as encouraging fixed-term employment contracts or establishing automatic compensation for employees discharged without a good cause, to alleviate the problem.

Regarding the number of jobs that a zone industry may generate, it might be concluded that labor-intensive operations need not be induced, as they constitute the largest number of industries in Free Zones everywhere. The best way of increasing the total number of jobs generated by zone activities is to maximize their potential macroeconomics effects through increasing forward and backward linkages with the domestic economy, not only with the service sector, but also with domestic industries.

Finally, given the interest of third world countries in developing local expertise, in producing for the international market, they may also be willing to induce participation of nationals in key managerial and technical positions. Nevertheless, policy makers should be aware of the fact that most zone enterprises are simply structured assembly plants that need very few high-level employees. As most foreign companies operating in the zones are vertically integrated, the relevant management and technical decisions are ordinarily made by corporate headquarters, rather than by the local subsidiary. However, there seem to be possibilities for generating jobs at the managerial level in Free Zones operating for well educated, skilled and experienced natives.

## *II. Tax Law and Policy in Free Zones :*

Most zones are regarded as tax havens, as foreign companies may receive income or own assets without paying the ordinary tax rates upon them, or may simply enjoy tax holidays. A very important tax policy implication of this study is that tax holidays need not be offered to attract foreign investors to Free Zones, or at least not to the extent that they are granted in several countries. Various reasons have been pointed out to support such a conclusion.

1) One is that zone locations in themselves offer a significant comparative advantage in production costs vis-a-vis other place, so no additional substantial incentives are required to attract foreign companies.

2) Moreover, tax credit and tax sparing systems existing in several industrial countries make it useless to grant local tax immunities, as zone profits will be taxed in the company's home country.

Several studies have concluded that a complete exemption from local taxes does not significantly influence Transitional companies investment decisions. Furthermore, certain successful Free Zones do not offer tax concessions at all, yet do not lose their appeal to foreign investors. Some evidence suggests that an acceptable regime for Free Zones may include taxes to the extent that they would not prevent potential investors from setting up in the zones. On the other hand, it seems that the less complicated a tax regime is, the less harmful it will be considered by manufacturing enterprises. Hence, developing countries may consider imposing a low-rate income tax on zone operations, in lieu of all other taxes applicable in the rest of the country.

An alternative system would be to adopt a case-by-case regime that considers the treatment of local taxes in the investor's home country, e.g., tax crediting or tax-sparing, when deciding whether or not to tax its zone operations. Policy-makers should notice that this regime, in spite of being theoretically more efficient, implies additional expenses in gathering, processing and supdating information on the tax systems in force in the investor's home countries. Moreover imposition of the high tax that may result from such a case-by-case approach would probably generate a serious risk of dealing with transfer-pricing practices. The fact that Free Zones typically are duty-free areas, where low, if any taxes apply and where foreign exchange restrictions are not in force, virtually preserves zone operations from transfer pricing practices.

### ***1- Tax-spanning Conventions :***

An important system that all third world countries should explore when dealing with the problem of double taxation is that of tax-sparing conventions. Through these agreements the potential home country "grants a credit not only for the tax paid but for the tax spared by incentive legislation in the developing country". the system would allow host nations nominally to establish in the zones the same tax rate that is in force in the rest of the country. the system grants to the investor an additional financial incentive for the difference, without generating extra costs for the developing nation. Tax-sparing treaties are been strongly promoted by international organizations, but they are still far from being widely accepted by developed or newly industrialized countries.

### ***2- Tax-stability Agreements :***

Another legal mechanism that tax-policy makers in developing nations might be willing to consider consists in so-called tax-stability agreements. Through these instruments, host developing countries may agree with zone investors not to raise the income tax rate and not to create additional taxes for a given period, in exchange for a promise by the zone company to reach certain economic goals. Examples of potential goals would create a certain number of jobs, or to export goods of a given value. The country's obligation may or may not be secured by a local or foreign institution, and any dispute could be submitted in advance to international arbitration.

### ***3- International Law of Property Protection and Technology policy in Free Zones:***

The issue of encouraging the appropriate technology for the zones is also controversial. Developing countries want to attract new technologies precisely because the countries know very little about them. Yet these nations seem in no position to specify what technologies they are interested in attracting. This problem is aggravated by the fact that most countries consider technology transfer to be a limited aim, if an aim at all, when establishing Free Zones. It has been suggested repeatedly that labor-intensive technologies usually are more applicable to the country's goals in establishing a Free Zone and guarantee that the investor fetes the full benefit of the zone's relative advantages. Although this is likely to be the case, it has been pointed out that such technologies need not be induced by specific policies; zone investors use them anyway when they are more economical.



Experience shows that technology transfer is not an issue when defining zone policies with respect to foreign investors. Reasons include the fact that most transitional companies in the zones are vertically integrated plants where low-tech assembly operations take place. Moreover, the country's aim of generating employment through zone manufacturing implies that labor-intensive technologies would be preferred to capital-intensive high-tech processes. It would be, of course, extremely difficult to evaluate at this point whether the relatively low interest of developing countries in encouraging transfer of technology at the zones is counter-productive. Evidence seems to support the arguments for paying little attention to technology transfer regulations may unnecessarily generate an additional burden on foreign investors, with no effective benefit for the country.

Those who are still not convinced by these arguments should be prepared to answer questions on the advisability of compelling investors to "transfer" standardized and even obsolete technology, such as that in mature products, and technical knowledge corresponding to particular stage of production, such as that of vertically integrated industries. More importantly, one may end up being confronted with questions on whether policies directed towards technology transfer have succeeded in the past, and on whether some degree of transfer has spontaneously occurred in successful zones despite the absence of exacting regulations.

A different approach to the question of the appropriate technology for the zones might be a negative one, namely to define what technological processes and what products are not to be allowed in the zones, according to the country's

capabilities and objectives at a given time. Defining inappropriate technologies seems to be less complicated a task for policy-makers and a system particularly appealing to the liberal regimes existing in most Free Zones.

It has been argued that off-shore manufacturing in developing countries may be risky for transitional compares, specifically in the case of subcontracting, as valuable technology may leak to competitors. Even though most investments in Free Zones are low-tech manufacturing plants, it is not extraordinary to find zone industries where technical knowledge is specially important. A similar argument might be made regarding trademarks and trade names, particularly in the case of the garment and soft drink industries found in several zones. The risk of technology leaking is heightened by the fact that some host countries do not have industrial property regulations that adequately protect technical knowledge, inventions, and commercial names.

Zone investors have been concerned about the protection of their intellectual property rights. Reliability of patent and trademark regulation appears to be a significant consideration in the investment decision. Developing countries that do not have currently in force an intellectual property system considered acceptable by international standards may evaluate the advisability of signing the most relevant international treaties on the matter, notably the Paris Convention for the Protection of Industrial Property of 1883. The constraints imposed by such conventions by and large have been of minor significance. The conventions have left enough leeway, for example, that countries can refuse to issue patents on certain types of products such as

drugs, can fix the life of the patent as they choose, can subject an application to search or not can define the terms that represent "abuse" of the patent, and can limit the rights of the abusive patent holder.

Convention for the Protection of Industrial Property, Mar. 20, 1883, 25 State. 1372. and to adapt their regulations to the model trademark and copyright laws proposed by the World Intellectual Property Organization (WIPO).

Zone policies should be translated into a systematic and consistent body of unambiguous, public, legally non continues rules and regulations. Furthermore, enforcement of the investor's rights should be as expeditious and effortless as possible.

The main concern of transitional investors is to protect themselves against the risk of expropriation. One alternative is a constitutional guarantee against nationalization. Such a provision may allow certain exceptions related to extraordinary circumstances, provided there is prompt, adequate and just compensation. The system has been complemented in some countries with a right to make a claim subsequently before an international court.

Another type of legal safeguard is that of investment insurance provide by governmental institutions of developed countries. For instance, the Overseas Private Investment Corporation (OPIC) offers coverage to U.S. investors against losses resulting from currency inconvertibility, expropriation, war, revolution, or insurrection. A previous agreement with the concerned country is required, according to which OPIC will compensate the insured investor and will subjugate the

company's claim against the country. Also The Arab Establishment For Investment Insurance, belongs to The Arab League. And on the international level (MIGA) belonging to the World Bank.

As foreign investors frequently give importance to the availability of investment insurance, developing countries that still do not participate in such regimes should carefully evaluate the advisability of adopting such a policy. Countries that are willing to examine these and other alternatives might be well advised to consider the fact that the degree of political risk exposure of zone investors tends to be low, particularly in the case of vertically integrated industries.

#### ***4- Settlement of Disputes :***

Another major concern of transitional investors is the settlement of disputes with the host government. It is the settlement of disputes with the host government. It is obvious that they are reluctant to be settled by the local courts.

Arbitration arrangements provide a solution that several developing nations have found to be the most convenient. Disputes are submitted to privately chosen arbitrators, or to one of the existing centers for international arbitration, notably the International Center for the Settlement of Investment Disputes (ICSID).

Given the flexibility of the ICSID rules-the concerned state must consent to the Center's jurisdiction after the dispute arises-a considerable number of developing countries have found it convenient to become members. Egypt is a party to this systems. It host also the Middle East branch of the UNCETRAL.

Such systems reduces the risk of having the investor's home government involved in eventual disputes. All countries having no serious incompatibilities with the Center's rules might be well advised to evaluate carefully this and other alternatives for establishing reliable methods of dispute resolution.

Other types of legal safeguards against economic risks, such as tax stability agreements and industrial property regulations, have been highlighted above and need not be revisited. The challenge for policy makers when considering these and other mechanisms is to grant investors broad protection with no detriment to the country's rule of law. The internal stability of the country and its legal system seem to be the natural limits.

#### ***5- Considerations of Foreign Investment in Free Zones :***

Some years ago, UNIDO passed a resolution encouraging developed countries to establish and strengthen policies for the redeployment of relatively less competitive industries to developing nations. the relocation of industrial activities to third world nations in fact occurred, but in a different and perhaps unforeseen way, by phenomena known as off-shore assembling and vertical integration. A considerable part of such international industries set up in Free Zones.

Commentators have insistently argued that both the concerned developing and developed countries have benefited from such a partial industrial redeployment. The former received new investment flows for export manufacturing, with positive effects in employment generation and foreign exchange earnings. The latter retained international competitiveness in certain industries, lowered prices for consumers and conserved jobs in high-tech stages of production.

**LAW NO. 8 OF THE YEAR 1997 PROMULGATING  
LAW ON INVESTMENT GUARANTEES  
AND INCENTIVES**

**Chapter: 3**

**Free Zones**

**ARTICLE: 29**

A free zone which covers a whole city shall be established by virtue of a law.

Public Free Zones shall be established by virtue of a decree of the Cabinet upon the proposal of the competent administrative quarter, for the establishment of projects that are licensed whatever their legal form.

A decree of the competent administrative quarter may be issued concerning the establishment of private Free Zones, each confined to a single project, if the nature thereof necessitates so doing. The competent administrative quarter may approve changing one of the projects which are set up in the country, into a private Free Zones, in the light of the controls to be determined in the executive statutes of this Law.

A decree issued for the establishment of the free zone shall comprise an indication of its site and limits.

The Public Free Zone shall be managed by a Board of Directors to be formed and its Chairman to be appointed by a decree of the competent administrative quarter.

The Board of Directors shall be concerned with implementing the provisions of this law, its executive statutes, and the decisions to be issued by the aforesaid quarter.

**ARTICLE:30**

The competent administrative quarter shall set the policy to be followed by the Free Zones. It shall have the power to issue whatever decisions it considers necessary for realizing the purpose for which these zones are set up, and in particular the following:

a. Setting the systems and regulations necessary for managing the Free Zones.

b. Setting the conditions for granting the licences and for occupying the lands and realties, the rules on entry and exit of goods, the provisions on recording them, the charges collected for occupying the places they are deposited in and for examining the documents as well as for the verification thereof, and the system concerning control on and guarding these zones, besides collecting the dues payable to the State.

**ARTICLE:31**

The Board of the Public Free Zone shall be concerned with licencing the establishment of projects. Licencing the project to exercise the activity shall be granted by virtue of a decree to be issued by the Board Chairman of the Zone.

The licence shall comprise an indication of the purposes for which it is granted, its validity period, and the amount of financial guarantee payable by the licensee. The Licence shall not be assigned wholly or partially except with the approval of the Authority issuing it. Refusing to grant the licence or disapproving its assignment shall be issued with a justified decision. The concerned party may complain against such refusal/disapproval to the competent administrative quarter according to the rules and procedures prescribed in the Executive Statutes of this Law.

The licensee shall not enjoy the exemptions or privileges prescribed in the Law except within the limits of the purposes indicated in the licence.

### ARTICLE:32

Subject to the provisions prescribed in the Laws and Regulations on preventing dealing in and circulating certain goods or materials, goods which are exported abroad by the Free Zone projects or imported to exercise their activity shall not be subject to the rules on imports and exports, nor to the customs procedures for exports and imports. Nor shall these goods be subject to the Customs Taxes, the General Tax on Sales and other taxes and duties.

All articles, equipments, machines, and means of transport which are necessary for exercising the activity licenced for the projects inside the Free Zones shall be exempted from Customs Taxes, the General Sales Tax and other taxes and duties, with the exception of passenger cars.

The Executive Statutes of this Law shall determine the procedures for goods transport and insurance, from beginning to unload them until their arrival at the Free Zones, and vice versa.

The competent administrative quarter shall have the power to allow the entry of local and foreign goods, materials, replacement and spare parts, and raw substances as owned by the project or by third parties, from inside the country to the free zone temporarily for repairing them or for carrying out industrial processes on them then returning them inside the country, without such goods and materials being subject to the import rules which are applicable thereto as indicated in the Executive Statutes of this Law.

The Customs Tax shall be collected on the repair value according to the provisions of Customs Law.

The provisions of article 33 of this Law shall apply to the industrial processes.



**ARTICLE:33**

Import into the country from the Free Zones shall be in accordance with the general rules on import from abroad, and Customs Taxes shall be payable on goods which are imported from the free zone to the local market as though they were imported from abroad.

With regard to the products imported from the Free Zones projects and comprising local components as well as other foreign components, the Customs Tax basis in their respect shall be the value of the foreign components at the prices ruling at the time of their exit from the free zone into the country, providing the Customs Tax due on the foreign components shall not exceed the tax payable on the final product imported from abroad.

The foreign components are represented in the imported foreign parts and materials according to their condition at their entry into the free zone, without reckoning the operating costs in this zone.

The free zone, with regard to the freight, shall be considered the country of origin concerning the products manufactured in it.

**ARTICLE:34**

The Customs director for the free zone shall notify the Chief of the Zone of the unjustified "Under & Over" cases other than what is indicated in the Bill-of-Lading, in the number of parcels or their contents, or the conserved or bulk goods, if they are received in the name of the free zone.

A decree of the competent administrative quarter shall be issued regulating the responsibility for the cases prescribed in the previous clause and the percentage of tolerance in them.

**ARTICLE:35**

Projects which are established in the Free Zones, and the profits as distributed by them shall not be subject to the provisions of fiscal and duties laws ruling in Egypt.

However, these projects shall be subject to an annual duty of 1% (one per cent) of the value of commodities on their entry, for storage projects, and of the value of commodities on their exit, for manufacturing and Assembly projects. Transit goods trade of which the destination is determined shall be exempted from this duty. Projects of which the main activity requires no entry or exit of goods shall be subject to an annual duty of 1% (one per cent) of the total revenues realized thereby, based on the accounts as approved by a certified accountant.

In all cases, the projects shall pay services' charges as determined in the executive statutes of this Law.

**ARTICLE:36**

Companies exercising their activities in the public Free Zones shall not be subject to the provisions prescribed in Law No. 73 of the year 1973 and Law No. 159 of the year 1981.

**ARTICLE:37**

Maritime Transport Projects which are established in the Free Zones shall be exempted from the conditions concerning the nationality of the ship owner and of those working of it, as prescribed in the Maritime Trade Code, and Law No 84 of the year 1949 Concerning the Registration of Merchant Ships.

Ships which are owned by these projects shall be exempted from the provisions of Law No. 12 of the year 1964 concerning the establishment of the Egyptian General Organization For Maritime Transport.

**ARTICLE:38**

The Licencee shall cover the buildings, machines and equipment with insurance against all accidents risks. He shall also remove them, at his own cost, within the period determined by the Board of the Zone, according to the rules to be set by the competent administrative quarter.

**ARTICLE:39**

Entering or residing in the Free Zones shall be in accordance with the conditions and terms to be determined by the Executive Statutes of this Law.

**ARTICLE:40**

The provisions of Law No. 173 of the year 1958 stipulating the obtainment of a work permit before taking up a job with foreign quarters, and law No. 231 of the year 1996 concerning certain provisions regulating the work of Egyptians with foreign quarters shall not apply to Egyptian workers of the projects set up in the Free Zones.

**ARTICLE: 41**

No person shall exercise a trade or a profession in the Public free zone, for his own account permanently except after obtaining a permit therefor from the Board chairman of the Free Zone according to the terms and conditions to be determined in this Executive Statutes of this Law and after setting the fees as shall be determined in these statutes and which shall not exceed five hundred pounds a year.

**ARTICLE: 42**

The Labour Contract signed with the workers in the Free Zones shall be drawn up in quadruplicate of which one copy shall be handed to each one of the two parties, a third copy shall be deposited with the Free Zone Management, and the fourth with the Labour Office in the Free zone. If

the contract it drawn up in a foreign Language, an Arabic translation thereof shall be attached to each of these two copies.

**ARTICLE: 43**

Projects set up in Public Free Zones shall not be subject to the provisions of Law No. 113 of the year 1958, and to article 24 as well as chapter 5 of Part III of the Labour Law.

The Board of Directors of the Competent Administrative Quarter shall set up the rules regulating personnel affairs in such projects.

**ARTICLE: 44**

The provisions of the Social Insurance Law, as promulgated by Law No. 79 of the year 1975 shall apply to the Egyptian workers employed with projects exercising their activities in the Free Zones.

**ARTICLE: 45**

Whoever violates the provisions of article 41 of this Law shall be liable to punishment with a fine of not less than Two thousand pounds and not exceeding Five thousand pounds.

No criminal action shall be brought concerning these crimes except upon a written request from the competent administrative quarter.

A composition may be carried out by the said Quarter with the violator during examination of the action, in return for payment of an amount equivalent to the minimum limit of the fine amount, the composition shall result in ending the criminal action.

**ARTICLE: 46**

The Provisions of Articles (8), (9), (10), (11) and (20) of this Law shall apply to investments in the Free Zones.