Economic Policy Reform and Competitiveness Project

ASSESSMENT OF MONGOLIA'S FREE TRADE ZONE PROGRAM AND SITE EVALUATION

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ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
BOO	Build, Operate and Own
BOT	Build, Operate, and Transfer
COP	Chief of Party
DCOP	Deputy Chief of Party
EPRC	Economic Policy Reform and Competitiveness Project
EPSP	Economic Policy Support Project
EU	European Union
FDI	Foreign direct investment
FTZ	Free Economic Zone
FTA	Free Trade Agreement
FTZ	Free Trade Zone
FTZs	Free trade zones
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GoM	Government of Mongolia
GTZ	German Development Agency
IMF	International Monetary Fund
IRR	Internal Rate Return
IT	Information technology
NPV	Net Present Value
P/Ds	Person/days
SEZs	Special Economic Zones
SOP	Standard Operating Procedure
SOW	Scope of work
STTA	Short-term technical assistance
TA	Technical assistance
TORs	Terms of reference
TSG	The Services Group, Inc.
UNDP	United Nations Development Programme
US	United States
WB	World Bank
WTO	World Trade Organization

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EXECUTIVE SUMMARY

Responding to a request from the Ministry of Industry and Trade (MOIT), this assessment:

- Benchmarks the legal and regulatory framework of Mongolia's Free Trade Zone (FTZ) Program against current international best practices and lessons learned[1]
- Compares the processes used in Mongolia for the establishment of FTZs against current best practices
- Evaluates the sites selected for the proposed free trade zones (FTZs) of Altanbulag and Zamyn-Uud
- Provides a summary of findings and recommendations.

Section I of the report provides the background and terms of reference for the assignment. Section II examines current international best practices and lessons learned in the development of FTZs. Section III compares Mongolia's FTZ legal framework against these practices and makes recommendations for improvement. Section IV contains assessments of the proposed Zamyn-Uud and Altanbulag FTZ sites while Section V summarizes the findings and recommendations of the assignment.

Annexes A through G provide additional information and include, *inter alia*, the following:

- List of meetings held in Mongolia
- Strengths, weaknesses, opportunities and threats (SWOT) analysis of Mongolia's Free Trade Zone Program and of the proposed Zamyn-Uud FTZ
- Example of a well-tendered FTZ project from Jordan, the Aqaba International Industrial Estate (AIIE)
- Sample terms of reference for a market demand study that should be conducted as part of a feasibility analysis prior to issuing tenders for Mongolia's proposed FTZs
- Summary of the Dominican Republic experience on free trade zones as a case study
- Slides of the public presentation made on international best practices and lessons learned in FTZs.

Major findings of the assessment include the following:

1. Benchmarking of Mongolia's FTZ Program against current successful international practices shows deficiencies in the legal and regulatory framework as well as in the process being followed to establish FTZs in the country
2. Lack of implementing regulations and procedural definitions encapsulated in Standard Operating Procedures (SOPs) prevents achievement of a minimal transparency and predictability quotient required to operationalize key international best practices
3. A process of due diligence, including a cost-benefit analysis, has not been completed for the proposed Zamyn-Uud FTZ
4. Identifiable funding is not in place to meet off-site infrastructure requirements for the Zamyn-Uud and Altanbulag sites
5. Deviations from international best practices in the process of launching FTZs runs the risk of repeating mistakes made in the past in other countries and may lead to "hidden costs" or the provision of subsidies that the GoM did not foresee or which will have to be granted at the expense of other high priority social needs.

The assessment makes five major recommendations for consideration:

[1] Throughout this report the term "free trade zone" (FTZ) is used to encompass all similar terms such as "free economic zone", "commercial free trade zone", "special economic zone", "free port" and so on. While each term may carry its own specific meaning according to circumstances, the concept being discussed in this report is adequately described by the term "free trade zone".

Recommendation 1: The GoM should consider following best current international practices and undertake an economic cost-benefit analysis of the FTZ projects being contemplated.

Governments carry out economic cost-benefit analyses to:
- Stop bad projects
- Prevent good projects from being destroyed
- Determine if components of projects are consistent
- Assess the sources and magnitudes of the risks
- Determine how to reduce risks and efficiently share risks

Quality of analysis has been shown by the World Bank to be a key determinant of project success; proper analysis will cause the project to be redesigned so that it is less likely to fail. World Bank experience shows that the probability of failure for poorly prepared projects within three years of a project's life is seven times greater than that of well-prepared projects. Within five years, the probability of failure of poorly prepared projects is sixteen times higher than that of well-prepared projects. The lesson learned, therefore, is that governments must "do their homework" before launching a project.

An economic analysis would consider all possible benefits and costs from the perspective of the government, or society. Examples of possible benefits and costs are given below.

Benefits:
- Projected tax revenues
- Revenues from granting a concession, license, right, or production-sharing agreement
- Job creation
- Introduction of new technologies and management know-how
- Backward and forward linkages with other local firms, leading to potential formation of clusters
- Increased incomes.

Costs:
- Losses of tax revenue due to tax breaks
- Expenditures on infrastructure paid by the government
- Negative environmental impact or other negative externalities

Each of the costs and benefits can be quantified for each year at their net present value calculated based on an appropriate discount rate.

With such analysis, the government can determine whether a project is beneficial or not to society and which of several alternatives is the best. Also, the government will have quantified analyses to present to the public in justifying and explaining a project. Based on these analyses the GoM could potentially decide that special FTZs are a venture that it cannot afford and decide to concentrate, instead, on economic reforms that would apply to the country as a whole.

Therefore, it is recommended that the GoM conduct a cost-benefit analysis that would show that the FTZs bring tangible economic benefit to the country as whole, as this is yet to be demonstrated.

Recommendation 2: The GoM should consider following best international practices and undertake a full commercial feasibility study for the Zamyn-Uud Free Trade Zone.

A feasibility study will determine what the market is for the Zamyn-Uud site, develop a master plan concept, identify needed infrastructure and costs, set up a planning and development framework, and determine the most cost effective way of undertaking the development project. Its purpose is to identify to the government and the investor, the most economical viable way of developing the site, providing transparency, certainty, and accountability to all parties. There should be four components to the Zamyn-Uud feasibility study:

Component One: Market assessment
Component Two: Master planning and infrastructure requirements
Component Three: Implementation planning
Component Four: Business planning and financial modeling

Component One: Market demand study
The market assessment will evaluate the potential markets on a local, regional and global basis and will provide a strategy for targeting industrial, commercial and tourism sectors which will be attracted to the Zamyn-Uud FTZ. This assessment will also benchmark the FTZ site against other competitors and identify the competitive advantages of the specific location. This type of preparatory work is invaluable to a government or developer, as it reduces costs by focusing on specific user groups.

When undertaking a market demand study which leads to a targeted promotion strategy, several key questions must be addressed:

- What is required at the site for the development of specific sectors and activities
- What competitive advantages can the Zamyn-Uud FTZ program offer to investors in those specific sectors, and why would an investor select Zamyn-Uud over competing locations
- What are the most promising sectors for promotion
- What are the most promising markets in which Zamyn-Uud should promote itself
- What is the most effective approach to promoting the Zamyn-Uud FTZ as an investment location for these sectors and markets.

Component Two: Master plan and infrastructure requirements
The master plan is an important aspect of the feasibility study as it will identify and optimize physical development solutions for the Zamyn-Uud site and determine the necessary capital investment needed for proper implementation of its infrastructure, consistent with the needs and demands of the user groups. This component should:

- Evaluate the site, surrounding context, land use patterns, local planning processes, adjacencies, and off-site infrastructure and utilities.
- Develop a comprehensive planning framework to identify opportunities and constraints of the new free trade zone site
- Develop a Master Plan, Land Use Plan, Phasing Plan and Development Schedule in accordance with the results of the market demand study and trends
- Evaluate and recommend on-site infrastructure including utility requirements and improvements to meet the new industrial/commercial/tourist requirements of the FTZ. Cost estimates for the new infrastructure/utilities should be included in this assessment. Based on estimates of capital cost requirements, financial analyses should be undertaken to determine the most cost effective manner in which to develop the free trade zone site.

Component Three: Implementation strategy
The implementation strategy is the synthesis of information gathered from the market assessment and the master planning exercise; when consolidated into an integrated implementation plan, it can be easily followed to ensure the proper development of the project. It is also a decision making mechanism as it identifies:

- A list of actions to be undertaken in the near, medium and long term by the proponents and other key actors—such as the Government and other private investors
- An estimate of the resources needed to undertake the actions proposed
- A schedule with time bound milestones that can be used to measure progress against plans
- A proposed mechanism for review, monitoring, and adjustment of the Implementation Plan and milestones, as required.

Component Four: Business planning and financial modeling
The development, proper phasing, operation and institutional structure of the free trade zone are also important to the overall success of the project. A series of financial models need to be developed in this component so that a comprehensive business plan for the site can be prepared and an economic evaluation can be performed. This is the section that will give the GoM the requisite information to negotiate with a developer or investor from a position of strength and help it obtain the best deal for the country.

Recommendation 3: The GoM should consider revising the legal and regulatory framework of its FTZ Program in accordance with best international practices.

This recommendation should be implemented if and only if recommendations 1 and 2 have been implemented and the results of this due diligence demonstrate that the implementation of FTZ regimes will bring tangible benefits to the country and society as a whole. Otherwise, we would recommend that the FTZ Program be abandoned and that the GoM focus, instead, on economic policies to benefit the country as a whole.

In its current form, the Mongolian FTZ program suffers from serious conceptual and operational weaknesses that have been found to be highly correlated with failures of these programs in other countries. In our view, ignoring the lessons learned from international experience is not a risk worth taking. Substantial legal and regulatory framework enhancement is required to bring the program to standards of competitiveness and proper positioning at the international level. These enhancements include:

- Modification of the Law on Mongolia on Free Trade Zones (legal framework)
- Preparation and adopting Implementing Regulations (regulatory framework)
- Preparation and adoption of Standard Operating Procedures (SOPs)
- Modification of FTZ site-specific laws for Zamyn-Uud and Altanbulag

Recommendation 4: The GoM should explore a leisure development concession in Zamyn-Uud in response to the identified market niche opportunity and potential investors' interest provided by its proximity to Erlian City in China.

To prepare for such a concession, the GoM should assess its legal framework, regulations and compliance systems on anti money laundering, as well as contract international expertise in leisure-related activities to assist in the negotiation of a concession agreement that could include conditions that would provide for FTZ off-site infrastructure requirements at Zamyn-Uud FTZ

The leisure related activity and the Free Trade Zone (FTZ) should be "ungrouped" to allow the first to proceed at required speed under a concession agreement that should be based on a thorough cost-benefit evaluation process and take into consideration not only investor needs but country returns from the venture(s).

Recommendation 5: The GoM should consider postponement of the tender for the Zamyn-Uud FTZ until completion of a due diligence process that demonstrates tangible benefits for the country is completed according to international practices.

There is currently no market demand study available for Zamyn-Uud that identifies potential users of the FTZ. In the absence of this information, demand projections for infrastructure services—water supply, waste water collection and treatment, electricity, telecommunications and roads—cannot be made. Neither can costs be attached to the provision of these services. Consequently, the GoM does not have an economic analysis that would demonstrate to citizens that tangible benefits are to be achieved by the FTZ project.

If a tender is issued for Zamyn-Uud prior to completion of proper due diligence, potential investors may exploit this deficiency to their advantage. The GoM may find itself in the future facing costs it did not foresee and cannot afford; it will have internalized as its own the negative externalities of the project. As the experience of the Dominican Republic and other countries show, FTZs can be successful but the cost of this success is borne by the rest of the society. In the absence of proper due diligence, the GoM runs the risk of repeating the same mistakes other countries have made in the past.

Therefore, the mission recommends that the GoM, in the interest of its fiduciary duties to safeguard the interest of the country as a whole, transparency and accountability for its actions, delay the Zamyn-Uud tender process until proper due diligence is performed.

SECTION I: INTRODUCTION

A. Background

The Law on Free Trade Zones passed by the Ikh Hural (Parliament) sets out the provisions for the establishment of free trade zones in Mongolia. These provisions cover the usual topics, including the primacy of the constitution of Mongolia and international treaties, the types of activities permitted within free trade zones, incentives such as absence of customs duties, easy business registration procedures etc., and issues related to land ownership and the corporate taxation regime applicable to the zone.

The Law on Free Trade Zones in Mongolia is general, although the sections on zone management are relatively long and specific. These cover free trade zone governance, including the appointment, duties, and powers of a governor and general manager for the zones and their relationship to the central government, Ikh Hural (Parliament) and local government. The Law also provides for an investors' council to represent the businesses within the zone. The governor, appointed by the Prime Minister, has substantial powers, which facilitates registration and licensing of businesses provided that the requirements of the investors are taken into account.

Legislation establishing the Altanbulag and Zamyn-Uud zones has also been passed and there are plans for others. Altanbulag is in Selenge Aimag, close to the Russian border; Zamyn-Uud is close to the Chinese border.

The intent of the Mongolian FTZ regime is in keeping with the underlying logic behind the concept of FTZs – focus development at nodes where excellent business services, infrastructure and access to market can be easily provided, and ensure that the interface between the Government and the private sector is optimized at these nodes in order to allow business to flourish in an adequately regulated but efficient environment. The Mongolian FTZ regime aims to use the tried and tested measures already deployed in a successful way in China's special economic zones, and throughout the world.

B. Terms of reference for the assessment

The assessment responded to a request from the Ministry of Industry and Trade (MOIT) to undertake a "feasibility study" of a free trade zone at Zamyn-Uud. The required deliverables included a pre-feasibility analysis of the economic and financial viability of the Zamyn-Uud FTZ and considerations that Government must take into account in a potential tender for the management of the FTZ. The terms of reference (TORs) also required a benchmarking of Mongolian FTZ processes against international best practices.

Activities carried out during the assignment comprised the following:

- An assessment of the current legal framework for supporting free trade zones and their private management
- An appraisal of the free trade zones in the region with an emphasis on what has worked and why

- An examination of the prospects for such zones in Mongolia to include opportunities and constraints and the kinds of businesses which might be attracted to management of the zone at Zamyn-Uud
- An examination of the kinds of businesses which might establish in the FTZ itself
- Visits to the proposed FTZs sites in Zamyn-Uud and Altanbulag
- Meetings with interested parties in government and commerce
- Presentations of the results of the assessment to MOIT and selected GoM officials
- A public presentation on international experiences in free trade zones and lessons learned
- Draft terms of reference for a full feasibility study.

C. Activities and outputs

Total duration of the assignment was twenty-one days, with work in Mongolia taking place from 1 through 17 February. While in Mongolia, the assignment included meetings with officials from the Government of Mongolia, the US Embassy, USAID, other international donors, and with the Economic Policy Reform and Competitiveness Project. Annex A provides a list of these meetings.

The assignment included site visits to the proposed free trade zones of Zamyn-Uud and Altanbulag as well as a public presentation made on 11 February on international best practices and lessons learned in the establishment, management and operations of free trade zones. Annex G contains the PowerPoint slides used in the public presentation.

D. Structure of this report

Section II of this report examines current international best practices and lessons learned in the development of FTZs. Section III compares Mongolia's FTZ legal framework against these best practices and makes recommendations for improvement. Section IV contains assessments of the proposed Zamyn-Uud and Altanbulag FTZ sites while Section V summarizes the findings and recommendations of the assignment.

Annexes A through G provide additional information and include, *inter alia*, the Dominican Republic experience on free trade zones, an example of a well-tendered FTZ project from Jordan, and sample terms of reference for a market demand study that should be conducted as part of a feasibility analysis prior to issuing tenders for Mongolia's proposed FTZs. The table of contents, at the beginning of this report, provides additional details about the contents of the annexes.

SECTION II: FREE TRADE ZONES: AN EVOLVING CONCEPT

A. Introduction

A free trade zone can be defined as an enclave—either physically or virtually designated—that operates under a special economic regime distinct from the rest of a country. The FTZ regime seeks to provide an enclave of favorable conditions that reduce business transaction costs, promote investment, trade, and employment.

The free trade zone concept appeared at least 2000 years ago. For instance, Ephesus—now in Turkey—welcomed traders and tradesmen with open arms and helped fuel the remarkable developments that took place in the region at that time. Ports, in particular, have been designated as "free ports" for centuries, reflecting their transshipment roles and the need for quick and efficient handling of goods; some, like Hong Kong and Singapore, have grown into city states. The modern concept of a free trade zone was born in Shannon, Ireland, in the 1950's when the Irish Government decided to extend the liberal policies normally accorded to ports and airports to the industrial area adjoining Shannon Airport. This was an effort to create demand for the airport, but the impact of the Shannon Free Trade Zone extended far beyond the local area. The policies adopted in Shannon were steadily upgraded and extended throughout Ireland over the next thirty years, and turned Ireland into the "Celtic Tiger" in the 1990's.

Some eighty free trade zones in thirty countries generated US10 billion worth of trade and provided close to one million jobs in the seventies. These numbers have now increased dramatically: more than one-thousand free trade zones in over one-hundred countries generate a trade value of US$10 billion and provide one million jobs. The mode of operation of the FTZs has also changed. Eighty percent of FTZs are now operated privately; there were none in the seventies.

B. Evolution of free trade zones

Free trade zone regimes[2] have traditionally been based on special treatment in the following areas:

- Customs procedures/duties
- Institutional support/framework
- Tax incentives

The traditional FTZ concept was mostly based on export promotion, with little if any consideration given to backward or forward linkages to the local economy and the site was typically a physically fenced-in enclave. FTZs were often located in remote areas to suit political needs, were built and managed by the public sector, and typically required that seventy to eighty percent of the production of firms located in the zone be exported. The objectives of FTZs were to attract foreign direct investment (FDI), new technology and know-how in exchange for tax breaks and lower labor costs. The distinct and special

[2] Free trade zones are also referred to as free trade zones, free economic zones, special economic zones, etc. For the sake of consistency, this report uses the term free economic zone.

customs treatment and strict physical control over the movement of goods into and out of the FTZ tended to create "another country" within the same country.

Given the change in global trade, falling tariffs and a need for increases in efficiency in the face of global competition, modern FTZ concepts have considerably evolved from the traditional approach.

FTZs now place a great emphasis on leveraging all of the attributes of a location to the maximum to offer potential industrialists and producers – both local and foreign – a superior physical and regulatory environment in which to conduct their business. Physically they are more of an integrated multi-use complex that use master planning as a means to ensure balanced development and to manage competing or incompatible activities within the site.

FTZ policies have also evolved to include low vs. no taxes, multi-market zones based on the multi-use nature (industrial, tourism, commercial) of the complexes as opposed to the traditional industrial-type enclaves. This recognizes the need for integrated industrial and living areas, a need for flexible and responsive spaces and services and a set of simplified procedures within a strong but fair and transparent regulatory environment. The newer zone concept concentrates its competitive positioning on the ability to accommodate rapid change and take full advantage of the increasing proportional value of logistics.

The combination of high quality infrastructure suitable to the needs of the incoming investors, master planning and a predictable/transparent enabling environment are the basic common factors in successful FTZs throughout the world. The proper sequencing and packaging of these three elements represent the universe of international best practice in FTZ development.

The following sections present these elements and their importance when considering the structuring of an FTZ program.

C. The legal and regulatory framework of free trade zones

The legal and regulatory framework of an FTZ program usually consists of three levels of legal instrument – the FTZ Law or Laws, a set of FTZ Regulations, and a set of FTZ Operational Procedures. The main purpose of having a clear segmentation of these instruments is to ensure that while the FTZ regime is flexible and responsive to the needs of the investors and the public good, there is sufficient permanence built into the regime to allow it to prosper in a sustained fashion over time. The key message that potential investors want to hear is consistency, transparency, predictability.

On the other hand, the public sponsor of the regime wants to ensure that the activities undertaken in the FTZ will be conducted according to appropriate standards of health and safety, and that they will contribute to the overall benefit of the country, its people and the economy. In successful FTZs it is obvious that these two sets of objectives meet – a high quality environment attracts high quality investors, and vice-versa.

At the highest level—the FTZ Law—the FTZ regime provides norms or defines several areas. These are discussed below.

C1. Overall objectives of the program

Usual objectives of FTZs are to:

- Increase the competitive position of the country in non-traditional production
- Provide jobs in order to alleviate unemployment or under-employment problems in the country as well as assist in income creation
- Attract FDI as a means to stimulate technology transfer and act as a catalyst for local businesses engagement in production of non-traditional goods
- Provide the government with a test bed of economic measures that could be expanded to the rest of the economy.

Clarifying objectives is critical to defining the physical configuration and regulatory framework for a well-conceived FTZ program.

C2. Designation criteria

The FTZ Law will usually incorporate clear references to the designation criteria required for FTZ status along with the decision-making body responsible for designation. The FTZ Law usually specifies designation criteria such as:

- Compatibility with the area's overall land use plan
- Minimum physical design standards
- Proposed development schedule
- Financial and technical references of the development group
- Infrastructure and other requirements from national and local authorities
- Impact on off-site infrastructure and services

C3. Qualifying and eligible activities

The law or implementing regulations will normally identify a negative list of prohibited activities and/or a list of restricted activities, along with the process by which the latter would be approved. Trends in FTZ development now support the broadest possible range of activities, with restrictions on FTZ activities based on environmental or other conditions connected with sustainability or the public good.

C4. Investment controls and incentives

While control of private investment is not the core function of an FTZ Authority, it is important to protect public investment in infrastructure and land from speculation. The Government is making an investment and deserves the planned returns—be they in the form of financial or economic benefit. FTZ authorities also specify planned investment periods, inspection criteria, and monitoring conditions. These are normally stated in the Law and further operationalized within the implementing regulations.

Free trade zone authorities also offer additional incentives to producers in the form of tax breaks, expedited customs transactions and land approvals, and suspension of taxes until they actually become due. These are described in the Law, and access to these incentives is normally secured by the investor by registering with the FTZ Authority.

C5. Rights and obligations of FTZ enterprises

These provisions normally establish that as long as the enterprise is operating within the stipulations of the FTZ law and implementing regulations as well as the law of the land it has a right to "quiet enjoyment" of its place of business. In addition to the normal public health and safety reporting requirements, FTZ enterprises will be asked to report on levels of economic activity. This allows the FTZ Authority to measure the impact of the regime and to use the data to convince the Government to extend successful features of the special regime to the rest of the country. These reporting requirements can include, among others:

- Periodic reporting on job numbers,
- Export levels
- Local expenses
- Foreign exchange requirements
- Use of public utilities and consumption levels.

C6. Rights and obligations of the FTZ manager

With the increasing role of private sector developers in the development of FTZs worldwide, many FTZ Laws now specifically provide for the appointment of managers/developers of FTZs. Private developers are encouraged to:

- Build, lease, and sell land/buildings without government interference on prices
- Install on-site infrastructure following established and clearly identified requirements of local authorities
- Establish complementary for-fee services for users within the zone without government interference in prices, e.g., customs brokerage, personnel recruitment, construction supervision services, cafeterias, child care centers, transportation of goods and people to and from the zone, security, maintenance, etc.

Similarly, the FTZ Law may stipulate that the private developer or operator must provide the FTZ Authority with the following:

- On-site customs facility built at the manager/developer cost
- Registering with the FTZ authority a copy of standard lease/purchase agreements as well as any governing contracts (maintenance, compulsory/optional services)
- Reporting to the FTZ authority on each lease/purchase agreement executed
- Assurance of sound environmental management of the property.

At the next level of the legal and regulatory framework, regulations establish the conditions under which the mandates of the law will be implemented. The implementing regulations should not only operationalize the law but should also clearly define the processes and sequence of regulatory compliance, e.g., ensure that business registration/compliance monitoring is uncoupled at the entry point while providing timely identification of the monitoring conditions to be applied once operations begin. Another key element of current FTZ regulatory environments is the establishment of clear time lines for answers to the investor's submittal of forms for approvals[3]. Normally this approach is implemented by one specialized agency under a single point of contact, and it ensures a predictable and transparent system that eliminates the "ping-pong" approach to approvals—making the investor go from one place to another without effective and satisfactory issue resolution.

At the next level—the Standard Operating Procedures (SOPs)—define the actual internal workflow of the regulatory framework. SOPs are designed to instruct officers responsible for implementing regulations on how to do their jobs. SOPs standardize workflow and help eliminate discretionary applications of regulations to insure transparency. SOPs are the "on the ground" operationalization of the law and its regulations. As such, it is of crucial importance that the officers in charge of implementing the workflow processes defined in the SOPs clearly understand them and actually participate in their preparation. A further step to ensure work process standardization is preparing external and internal "dialogue" forms and templates that clearly set out the sequence of internal steps of the work flow. The submission and acceptance of a specific form from an investor should trigger a series of internal process as defined by the SOPs.

C7. Institutional framework

International best practices clearly show the key role of a well-defined institutional framework for the success of an FTZ program. The institutional framework normally provides the policy nerve center of the program as well as its regulatory umbrella. Traditionally, FTZ regulatory bodies have fallen within one of the following three categories:

- Centralized departments within ministries, e.g., Taiwan and Mexico
- Public corporations under special laws, e.g., The Philippines, Thailand, Jordan
- Units in provincial/state governments, e.g., Turkey, China, Malaysia

These traditional organizational forms, however, are undergoing modifications that include:

- Centralized FTZ authorities, e.g., Thailand, Philippines, Jordan
- Reorganization under corporate law, thereby eliminating civil service limitations on compensation packages, hiring, and firing conditions for personnel, e.g., Dominican Republic, Costa Rica
- Autonomous budget, e.g., The Philippines, Thailand, Indonesia, Dominican Republic, Costa Rica.
- Private sector representatives on the Board, sometimes with a majority as in many cases in Latin America; additional examples include: The Philippines, Indonesia, Dominican Republic, Costa Rica
- Enhancing on-site presence to ensure better service and support to managers, developers, and users, e.g., The Philippines, Thailand, Malaysia and Costa Rica.
- Expanded of responsibilities of existing authorities, e.g., The Philippines, Jordan, Dominican Republic

[3] The Aqaba Special Economic Zone Authority launched in 2001 set this approach as a priority. The organization has recently won the Silver Winner Award for excellence in workflow for the Middle East North Africa (MENA) Region.

C8. Contracts with zone developers

Contractual forms can be stipulated within the legal framework or established on a concessionaire basis that could take the form of a tender process. As zone development is a real estate venture, land access and disposition processes should be clearly laid-out with the life of contract falling within a 30 to 50 year period. Contracts will usually fall within three generic types:

- Build, Operate and Transfer (BOT) or Build, Operate and Own (BOO) concession agreement
- Simple lease or related contract over a long-term period
- Equity-shifting joint venture

The main components of contractual forms usually cover at a minimum:

- Rights of developer/manager
- Obligations of developer/manager
- Development schedule
- Financial commitments
- Operating commitments
- Government obligations:
- Off-site infrastructure provisions
- Consolidation of land for long-term lease
- Financing of some on-site infrastructure
- Development rights on other properties or related projects
- Tax and other concessions
- Investment promotion support

D. Why free trade zones fail and lessons learned

Examination of international experience in FTZ programs points towards the following as the predominant reasons for failure:

Public sector development of zones

- Physical development not phased
- Subsidized or over-designed facilities
- Poor locations (expectation of developing a "growth pole" for a region)
- Politically-driven decision-making process
- Poor maintenance and lack of support services
- Lack of promotional support.

Uncompetitive policies

- Reliance on tax holidays and exemptions
- Rigid eligibility requirements
- Ownership restrictions and controls
- Excessive performance requirements

Lack of partnership approach

- Reliance on public sector funding; no private sector participation

D1. Lessons learned

Based on the cumulative experiences of the past forty years, there are lessons to be learned. These can be summarized as follows:

Strategic considerations

- Ensure that a full feasibility study is completed that provides reasonable results based on a net present value analysis (NPV) for investors and an economic analysis that clearly establishes the costs and benefits for the country
- Use the FTZ program as a test bed to pilot reforms that may be expanded to the rest of the country
- Avoid a "tax haven" approach, as it does not represent a priority item on the investor's decision-making process
- Establish a "procedural haven" that is predictable, transparent, and has built-in accountability elements for both the government and the investor.

Institutional framework: management structure

- Autonomous and independent decision-making capability in setting policy ensures a quick turn-around for field operations
- One single organization with a clear mandate to regulate FTZ operations
- Flexible compensation and hiring practices are key to maintain top level performance
- Sufficient resources and budgetary autonomy
- Close relationship with other national agencies that include mechanisms for coordination
- Close relationship with the private sector, including participation at the Board level
- A promotional rather than regulatory ethos should be the essential institutional driving force.

Legal powers and functions

- Centralized responsibility for zone designation, enterprise approval and operations
- Power over other agencies to coordinate licensing and infrastructure provisions
- Divestiture of public sector responsibility for FTZ development and emerging role as promoter and facilitator
- Availability of funding powers for off- and on-site infrastructure development (if required)
- Reliance on private sector to undertake routine regulation and control.

E. Free Trade Zones as trade policy instruments

Free Trade Zones can bring many economic benefits: foreign exchange earnings, productive jobs, foreign direct investment (FDI), technology transfer, and the development of linked industries outside the zones. There are also costs associated with free trade zones: building of infrastructure, tax incentives in some cases, and foregone revenues in the case when exclusive rights are granted. Guiding principles must be guide the design of successful FTZ regimes.

Careful analysis and evaluation must support key decisions. Without sufficient analysis, the Government cannot be certain it is getting the best deal for society—that concession fees received by the Government are as high as possible, and that any incentives given are really necessary. In considering a free economic zone proposal or any other type of large investment project, two types of evaluations are necessary. A ***financial analysis*** evaluates the costs and benefits of a project from the perspective of a firm. Given that such projects are intended to be led by private-sector profit-making firms, it is important to ensure that a proposed project will be profitable for the participating firms. An ***economic analysis*** evaluates the costs and benefits of a project from the perspective of the government, or of society. When choosing among alternatives, the investment project alternative should be chosen that has the highest benefit-cost ratio, NPV, or IRR. These analyses should always be conducted against the counterfactual – what would be the result if the project were not undertaken?

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The factors that go into the government's calculation of costs and benefits are different from those of the firm. For instance, the government is concerned about tax revenues, job creation, spin-offs to other sectors in the economy, environmental impacts, etc., while the firm will be interested more narrowly in direct costs and revenues.
Three types of related calculations can be made: the benefit-cost ratio, the net present value (NPV), and the internal rate of return (IRR).
A government (or firm) should support a project if the benefit-cost ratio is greater than one, or the NPV is positive, or the IRR is sufficiently high.

Designing and implementing free trade zones should follow detailed, step-by-step international best practices, to ensure that appropriate legal, regulatory, and institutional regimes are created. Zones are complex business endeavors with long horizons from the time when large investments are made to the time when positive returns are received. To succeed, FTZs depend on stable and clear laws, regulations, and institutions. Rushing to establish a free trade zone without following a step-by-step systematic approach may lead to the creation of an FTZ that does not achieve its potential in terms of benefits for society and returns for investors, or that fails completely.

Creation of zones should be viewed within a framework of sound economic policies for the country. While it is true that zones can achieve foreign exchange earnings, productive jobs, FDI, technology transfer, and the development of linked industries, zones by their nature tend to be localized and do not solve the problems of the country in other locations. Eventually, as zones move up the value-added curve, they cannot operate in the absence of sound economic policies in the country. In analyzing the scenarios for FTZ development, careful, thought needs to be given to the question of what economic activities can be facilitated by comprehensive policy reforms and which require a specialized zone. FTZ design must also avoid creating distortions in the overall economy, as it may be the case with special tax incentives.

SECTION III: REVIEW OF MONGOLIA'S LEGAL FRAMEWORK FOR FREE TRADE ZONES

Having examined best current international practices on FTZ design and management, this section benchmarks the Mongolian Free trade zone regime against them. The benchmarking or comparison of Mongolia's legal framework shows that it falls short from current international best practices requirements for FTZ legislation.

Areas of improvement that should be addressed include:

- The Law does not have a full set of implementation regulations to insure transparency and predictability
- The role of the private sector is virtually ignored
- The Law is probably non-compliant with WTO requirements
- No provision is made for the future separation of regulatory and development roles
- No clear criteria are provided for registration of enterprises and support services
- The tax regime for all FTZs is not described in the Law.

Exhibit III-1, the remainder of this section, provides a detailed analysis of the Mongolia FTZ legal regime. The exhibit provides the legal reference (article), its contents, current best practice, and recommendations for improvement of Mongolia's FTZ legal framework.

Exhibit III-1: Best Practice Requirements of FTZ Legislation

Legal Reference	Contents	Best Practice	Recommendation
Article 1, Law of Mongolia on Free trade zones	Purpose of Law is to regulate.	An FTZ Law should specifically state as a purpose the encouragement of the participation of the private sector in FTZ development and operation.	Law should be amended to include the role of the public and private sectors.
Article 2, Law of Mongolia on Free trade zones	Mentions other Laws and Treaties that apply with respect to FTZs in Mongolia	One Law enabling an overall FTZ Authority to regulate and sometimes develop FTZs. All other aspects regulated in Govt issued regulations	Detailed regulations need to be drawn up for the designation and development of FTZs in Mongolia.
Article 3.4, Law of Mongolia on FTZs	Activities in the FTZs. Mentions export orientation of activities in FTZs.	Under WTO agreements FTZ cannot offer any special treatment on the basis of export orientation. FTZs do not discriminate on the basis the export or other orientation of their users. Full access is granted to the domestic market for goods and services produced in the FTZ.	Removal of all references to “export orientation” from the FTZ Legislation and Regulations.
Article 4, Law of Mongolia on FTZs	FTZ tax customs and foreign exchange incentives. No specifics are given on taxation incentives.	Low rates of corporate income tax for FTZ enterprises, suspension of import tariffs until goods are imported to the domestic territory, relaxed foreign exchange conditions, efficient and transparent means of regulatory control.	Income tax and foreign exchange relief as well as customs service performance conditions should be specified in the Law.
Article 5, Law of Mongolia on FTZs	Creation and dissolution of FTZs	The basic criteria for FTZ designation is normally mentioned to guide the decision making body.	Elaborate to include criteria.
Article 6 and 7, Law of Mongolia on FTZs	Governor of each FTZ is appointed by the Prime Minister. Governor regulates, develops and operates the FTZ, and may delegate the enterprise registration function to a private company.	Normally a national FTZ authority is established that regulates all FTZs. This limits the burden on the Prime Minister’s office. Development and operation of the FTZ is the function that is usually passed on to the private sector, while regulation is maintained as a public function.	The separation of regulatory and development functions of the FTZ regime should be a medium to long-term aim of the legislation. While it is not unusual for publicly developed FTZs to be used to commence regime development, the current Law should be amended to reflect a prominent role for private sector FTZs
Article 8, Law of Mongolia on FTZs	General Manager of each FTZ reports is an official representative of and reports to the Governor.	Normally, provision would be made for private management.	Clarify that private management is allowed and encouraged.

Exhibit III-1: Best Practice Requirements of FTZ Legislation

Legal Reference	Contents	Best Practice	Recommendation
Article 9, Law of Mongolia on FTZs	A Council of Investors may be established to protect their interests and support FTZ development.	Typical division of responsibilities is as follows: FTZ Authority regulates and sometimes develops FTZs. Private sector operator develops and operates individual FTZs. An association of users represents the interests of users to the other two parties.	Clarification of roles should be included in an amended Law.
Article 10, Law of Mongolia on FTZs	Establishment of an independent Inspection Unit in each FTZ.	Inspection and monitoring functions and mechanisms of the FTZ Authority are established clearly for transparency purposes.	Clarification should be provided through an amendment of the Law or regulations to be issued in the near term.
Article 11, Law of Mongolia on FTZs	Describes how the costs of FTZs will be met through a separate Govt budget. Does not say that the budget may be applied for FTZ development.	Best practice is to have the sources and uses of funds specifically described so that it is clear what is expected to be publicly funded and privately funded.	This article should be clarified to allow private developers to see what the Govt will and will not provide in terms of funding.
Article 12, Law of Mongolia on FTZs	Describes the relationship between the Governor, local government and the Hural. This is characterized as one of cooperation and joint implementation of industrial infrastructure project of importance to the FTZ.	Normally, the responsibilities of the FTZ Authority, the local municipality, and other national agencies relevant to the needs of the FTZ are specified in the FTZ Law to avoid confusion.	Clarify these responsibilities in a subsequent regulation.
Article 13, Law of Mongolia on FTZs	Registration of companies in the FTZ.	Registration procedures are normally contained in a separate regulation. The Law should clearly identify the high-level criteria for registration, including any negative lists that may exist, and time-bound processing.	Clarify criteria for registration and issue regulations for registration procedures.
Article 15, Law of Mongolia on FTZs	Other business activities are allowed in the FTZ related to FTZ business activities. State Ikh Hural decides.	Criteria for admission to the FTZ are clearly stated.	Clarify criteria for admission of support services.
Article 16, Law of Mongolia on FTZs	Governor decides on all land terms in the FTZ. No policies mentioned.	The service level objectives of the FTZ are specified to provide guidance to the operator on how to provide agreeable terms to prospective investors.	Clarify policies with respect to the intended markets for the FTZs.

Exhibit III-1: Best Practice Requirements of FTZ Legislation

Legal Reference	Contents	Best Practice	Recommendation
Article 17, Law of Mongolia on FTZs	Taxation and tax exemption in FTZs. The income tax exemptions for each FTZ are left to the individual laws for the FTZs.	Any exemptions granted should be clearly stated, automatic, and should not require complicated compliance measures. Trends are moving towards simple, low tax rates on corporate profits rather than limited time exemptions that encourage movement once they expire.	Review the main Law to provide a simple transparent tax regime that can be applied to all future FTZs.
Article 4, Law on Altanbulag FTZ	Income tax exemptions for Altanbulag FTZ. Foreign companies receive different exemptions relative to local companies.	As stated above, these are usually kept simple, with standard and automatic applicability.	Treatment of “foreign” companies should be investigated to see if it is in contravention of WTO requirements.
Article 4, Law on Zamyn-Uud FTZ	Article 18.2 of the Mongolian FTZ Law (related to border check points) does not apply to the Zamyn-Uud FTZ.	N/A	Need to check on the hierarchy of Law here.

SECTION IV: THE ZAMYN-UUD AND ALTANBULAG FREE TRADE ZONES

This section presents the factors to be considered in the site selection process of a free trade zone and evaluations of the proposed sites for the Zamyn-Uud and Altanbulag Free Trade Zones.

The location of a free trade zone is a key factor in determining its success, as the site location contributes to the FTZ's attractiveness as an investment opportunity. The critical factors are: i) easy access to and from the site, ii) market demand, preferably in the vicinity of the site, iii) amenable site topography to reduce development costs, and vi) infrastructure availability.

When selecting a free trade zone site, there are a number of factors that should be assessed, weighted and ranked to compare it to other potential sites. These are discussed below.

A. Factors for assessment and selection of sites for free trade zones

Exhibit IV-1 presents a check-list of factors that need to be considered in the process of site selection for a free trade zone.

Exhibit IV-1: Check list for site selection of a free trade zone

Physical characteristics of the site	
• Location	
• Topography	
• Soil quality	

- Availability of land for potential expansion
- Surrounding area and development pattern

Planning and development constraints

- Planning policy for the region and municipality
- Land uses issues
- Zoning issues
- Development rules
- Development process issues

Land

- Public ownership
- Private ownership
- Assembled land
- Multiple ownership
- Cost, including purchase costs of undeveloped parcels
- Development potential

Access

- Easy access to and from site
- Capacity to handle heavy vehicles
- Railway access on or near site
- Distance and quality of access to seaport

Infrastructure: on and off-site

- Water availability and cost to bring to site
- Wastewater disposal and cost
- Electrical power availability and cost
- Telecommunications availability and cost

- Availability and cost of other utilities

Environmental issues

- Contamination
- Leaching
- Disposal
- Effects on the natural environment

Proximity to labor, housing, and market

- Distance from urban regions
- Labor force in close proximity
- Method of getting labor force to site
- Adequate housing in vicinity of FTZ
- Adequate market demand in region
- Opportunity to link or piggy back with existing market

B. Site evaluation of Zamyn-Uud

B1. Zamyn-Uud location

The proposed site for the Zamyn-Uud Free Trade Zone is located near Mongolia's southern border with China. The city of Zamyn-Uud has a population of 10,000 inhabitants, and is very much dependent upon the commercial activity generated by the neighboring city of Erlian in China. The major employer in Zamyn-Uud is the Government of Mongolia, which employs approximately 700 people to manage and operate the Mongolian Railway. In this location, the railway is very important as it: i) handles goods and products being transported from Russia to China (3.4 million tons in 2003 with projected growth to be 10 million tons by 2010), ii) facilitates direct cross-border trade with China, and iii) has a container loading and unloading facility to overcome the difference in rail gauge of the Mongolian and Chinese railway systems. Some twenty wagons a day are loaded/unloaded at the facility; handling capacity of the transshipment facility is 60-80 wagons a day.

Three to five kilometers from Zamyn-Uud, the city of Erlian is experiencing fast economic growth. Its current population is estimated at one-hundred thousand residents and expected to double 2,010. Per capita GDP of the city is estimated at 9,500 Yuan; projected to increase to 15,000 Yuan by 2,010.

The city of Erlian serves as a major trading center for Zamyn-Uud and the rest of Mongolia. The flow of visitors has grown substantially during the past five years and an estimated one million visited the city during 2003. The city expects the flow to increase to two million visitors a year by 2,010. To accommodate this influx, city plans include aggressive development of retail, commercial, industrial and entertainment facilities, doubling of existing hotel capacity, finishing construction of a dinosaur museum, and building an airport facility which is set to open within the next five years.

B2. Physical characteristics of the Zamyn-Uud site

Zamyn-Uud FTZ is 900 hectares in size and is located three kilometers east of the main town and three kilometers north of Erlian City, China. The topography of the site is flat and consists of a sandy top layer. A full engineering study must be done to determine the detailed structure of the soil; however, first impressions suggest that because of the favorable topographic conditions of the site, the cost of development and construction would be reasonable. There is enough land for potential expansion and there appear to be no competing land uses.

B3. Planning and development constraints

A clearly articulated regional development plan is not in place for the Zamyn-Uud province. The proposed Zamyn-Uud FTZ does not have a master plan specifying zoning, associated densities or design guidelines. However, Article 3.2 of the site specific free trade zone law gives as-of-right permission for industrial, tourism, and trading uses for the zone. Article 3.3 of the FTZ law goes further and allows the establishment of a casino on the site. This land use is conditional, and makes the developer obtain special approvals from the government before it can be permitted.

It appears that the FTZ is meant to be the catalytic force to stimulate development in the region. Although not clearly established within the site specific free trade zone laws, the objective of the FTZ is to make Zamyn-Uud a growth pole. Missing in the FTZ law is the necessary legal and development framework to establish a clear definition of the approval process: development criteria, conditions, process, and timeframes. In order to remove arbitrary decision making and make the process transparent, the law should incorporate the following:

- Name the approving body for specific requirements
- Specify the required content of approval requests (master plan, land use, zoning, design, and construction)
- Establish time lines for approvals once all required information is submitted and accepted by the authorizing board.

This is particularly important to private developers who require a clear set of planning guidelines for site development plans. Slow, inconsistent approvals in this area could represent serious financial constraints to on-site development, as construction needs to be undertaken at a rigorous pace in order to avoid unnecessary cost expenditures.

Land issues. Development of FTZs requires clearly established development conditions, market-based prices, and land disposition processes. Mongolia is a large country with an abundance of land but still very much hampered by restrictive policies in land ownership practices. The recent creation of an agency responsible for land management and evaluation is a positive step towards helping define land ownership and control.

The Zamyn-Uud FTZ site is currently owned by the State of Mongolia. Neither the general law on free trade zones nor the law for the Zamyn-Uud FTZ defines in detail the land disposition process. Section 7.1.7 of the general FTZ law assigns the Zone Governor powers to dispose of land and issue land ownership as well as land use permits (Section 7.1.10), but does not establish the land disposition or the certification processes. The Administration of Land Affairs Agency created in 2003 is the national organization responsible for land management and land evaluation. Land values for the Zamyn-Uud FTZ site have not yet been determined and as there are no other industrial, commercial or tourism uses of adjacent parcels there is no reference point to determine land values. It is recommended that the GoM conduct a valuation analysis to help establish approximate land values for the site. At a minimum, a clear and transparent process for land assessment and assignation needs to be put in place for developers to follow.

The Law on Mongolian Citizens Ownership of Land limits quantities of land ownership to nationals by percentage and location. Land access is authorized through the Administration of Land Affairs Agency. Foreign ownership of land is restricted by the 1992 Mongolian Constitution. A newly approved Land Law allows for long-term lease arrangements for foreigners that can last up to one-hundred years. The terms of a lease are tied to the lessee's operations; if operations cease the lease conditions and terms are terminated, with leaseholds reverting to the state.

B4. Site access

Access roads. Detailed transportation planning for the new FTZ has not yet occurred but should be done as part of a comprehensive feasibility study. There are currently no roads leading into the site from the town of Zamyn-Uud but there is a main road in close proximity that leads to Erlian City. This access road to China has two lanes and is in fair condition. If used for the FTZ, the road will need to be upgraded to handle heavy transport and four-lane traffic. Additional road construction will be required to handle current and future traffic between the zone, the rest of the country, and Erlian City. A major road network connecting Zamyn-Uud to the North/South Mongolian highway is currently under construction and is projected to be ready by 2008.

Railway access. A railway transshipment facility, located three kilometers from the site, currently handles containerized cargo between Mongolian to Chinese trains. If the FTZ is to be successful as a trade center, railway tracks and a service road will need to be constructed from the train facility to the site to provide efficient links to seaports and the European market.

B5. Off-site infrastructure and utilities

Requisite off-site infrastructure is currently not available in Zamyn-Uud and poses a financial burden on potential development of the FTZ. Additionally, sources of finance for required off-site infrastructure have not been identified. Usual practice is for the municipality or the public sector to provide essential off-site infrastructure leading to the FTZ property; developers then pay for the linkages and connections to service their land and specific buildings.

Electricity. Zamyn-Uud is connected to the national grid by means of a 10-megawatt transformer substation; the city currently uses one megawatt, leaving nine megawatts of unused capacity. The transformer is approximately five kilometers away and electrical lines come within fifty to one-hundred meters from the proposed site making connections relatively easy.

As there is no feasibility study of potential power demand from users of the zone, it is difficult to assess if the installed capacity will be sufficient. Free trade zones are heavy users of electrical power and usual practice for FTZs is to have an independent dedicated transformer substation. Power demand projections and an independent and dedicated transformer substation need to be considered as part of a feasibility study for the FTZ site. Similarly, tariffs for electricity need to be established so that potential businesses have a clear idea of their potential cost structures. At present, the estimated cost of electricity is US$.06 per kilowatt.

Water. Current water supply is not enough for Zamyn-Uud, much less to serve the needs of potential users within the proposed FTZ. Current water supply capacity for the city of Zamyn-Uud is 1,300 cubic meters per day. The terms of references for a study on water resources development for Zamyn-Uud estimates summer water demand at 900 cubic meters per day; winter demand is 1,200 cubic meters per day due to increased use for heating systems. The same study notes that the existing water supply capacity can only accommodate seventy percent of demand in the winter and that suspension of water services is a common occurrence. Zamyn-Uud's current annual rate of population growth—over nine percent—will further strain the existing water supply capacity.

Normal practice in FTZ development calls for water use demand projections as part of a feasibility study. This has not been done for the Zamyn-Uud site. It is usual practice to project future water demand based on the types of businesses that would be potentially interested in locating in the zone—the market demand study. If existing water supply capacity is not enough to serve projected needs, it is also usual practice to provide a firm commitment of when, in what quantities, and at what cost water supply will be available to developers and businesses in the zone. This matter requires urgent attention as it will lead to less than optimal development of the site.

Waste water service. Current sewerage collection and treatment barely accommodate the needs of Zamyn-Uud. There is no market demand study to identify potential businesses of the zone and, consequently, no way of estimating needs in this area. There is a sewage treatment plant capable of handling 1,000 cubic meters of waste per day. According to government officials, there are plans to construct a new sewage treatment facility of the same capacity; its completion is expected in 2008.

The Zamyn-Uud free trade zone will need a waste water system suitable to the businesses that will be established in the zone. Ideally, the site should have its own sewage treatment facility. The requirements of the system can be determined after a market demand is completed to identify the needs of potential users.

Telecommunications. A twelve-channel fiber optic cable currently serves Zamyn-Uud needs. Two channels accommodate the existing demand of the local community, leaving ten channels potentially available for the FTZ. Currently, cable does not run to the free trade zone site. Once it does, connections would have to be run from the boundaries of the free trade zone to the facilities and buildings within the property. Ideally, the free trade zone should have its own telecommunication system to make it competitive in a global market. The system should be separate from the network that services the local users in the city of Zamyn-Uud.

B6. Labor availability

There is no market demand study on which to base estimations of demand by broad labor categories from potential businesses that would locate in the zone. Access to a readily available labor pool and support for their training are key elements in the marketing and success of an FTZ. This is not present in Zamyn-Uud, unless Chinese workers from adjacent Erlian are considered. The Zamyn-Uud Free Trade Zone Law does not address these issues.

B7. Environmental issues

Polluting activities were not observed during the Zamyn-Uud/ Erlian City visit; however, no environmental impact assessment (EIA) has been prepared for the FTZ site. An EIA will need to be undertaken to identify issues and factors of potential concern to the site. The user groups proposed for the FTZ will determine the amount of intervention that will be needed. If the uses on the site are polluting, mitigating measures will be identified in the EIA which will set out standards and conditions for building, waste discharge, leaching, disposing of industrial waste and how to reduce their impact on the natural environment.

B8. Leisure-related designation and tourism opportunities for the Zamyn-Uud Free Trade Zone

Leisure-related designation. The Government of Mongolia (GoM) is currently considering the option of permitting the site to be designated a 'Leisure-related' location either as a whole or in part. Under Article 3.3 of the Site Specific Law for the Zamyn-Uud Free Trade Zone, this type of special activity is not automatically permitted on the site. A developer who wants to develop leisure activities in the free trade zone is required to obtain special permission from government authorities. This may permit the GoM to negotiate vigorously with the developer to control the extent, type, and spin-offs of such a land-use designation and obtain the most favorable concession agreement possible for the country.

Tourism opportunities. Erlian, in China, has an aggressive tourism and development plan; Mongolia has an opportunity with the Zamyn-Uud FTZ to piggyback on this growth. Given the geographic location of Zamyn-Uud Free trade zone in relation to China's Erlian City, the development of the site for a resort facility with leisure activities may be financially savvy. Tourist and leisure activities support a host of primary, secondary, and tertiary industries which would benefit the Mongolian economy. However, it would be more advantageous for an FTZ with leisure activities to be situated on or adjacent the Chinese border so that a variety of cross-border issues could be eliminated.

If the Zamyn-Uud FTZ is to be considered as a resort facility with leisure activities targeting Chinese and foreign markets, the Government of Mongolia will need to investigate how the free trade zone can capitalize on its proximity to the border and address the following:

- Enact legislation on anti money-laundering (AML), develop, and implement compliance systems for effective supervision of casino operations in proximity to the Chinese border
- Contract specialists to help negotiate the terms of the potential concession(s) for the casino(s)
- Separate or de-link the potential casino/entertainment transaction from the FTZ transaction in order to take advantage of the existing opportunities.

Additional cross-border issues that need to be addressed include: how the movement of people will be handled from the border of China to the site, how visas will be issued in a speedy manner and on a temporary basis, and how the movement of people in and out of Zamyn-Uud will be monitored.

B9. Zamyn-Uud tender: Observations and recommendations

It is evident from all the documentation reviewed that the necessary due diligence has not yet been undertaken to assess the feasibility of the Zamyn-Uud Free Trade Zone. Because of this, it is not advisable for the Government of Mongolia, at this time, to move forward with a tender for the development of the 900-hectare site.

It is in the interest of the government to follow a best practice methodology and:

- Identify the zone's competitive advantage and the potential market best suited for the site
- Conduct a market demand study to assess the interest of businesses that could potentially locate in the zone
- Prepare a cost-benefit analysis
- Amend the FTZ legal and regulatory framework to bring it closer to current international practice
- Undertake a non-prejudiced feasibility study that would include the cost of meeting infrastructure requirements of the site—electrical power, water and waste water services, and access roads
- Develop financial and economic models based on a cost and benefit analysis to arrive at the best options and development scenario for the free trade zone.

Once these steps are performed, the GoM will be able to prepare a site specific tender, if warranted, to select the most appropriate developer for the zone and maximize the government's financial return on the property.

Currently, the GoM intends to issue a tender for the Zamyn-Uud Free Trade Zone during the month of March. The purpose of the tender is to identify an investor that would: i) undertake a feasibility study (including a country cost-benefit analysis and environmental impact assessment, ii) develop the site including all on/off-site infrastructure, and iii) manage and operate the free trade zone. The GoM is considering releasing the land for a 50-year concession period with a 40-year extension, for a potential 90-year period. This concession period is being considered without prior assessment.

There are significant consequences to a tender of this nature. Without proper due diligence, the GoM will not have all the requisite information to package and market the development opportunity nor to measure whether the offers received represent the best deal for the country. By going to tender with incomplete information the Government of Mongolia will:

1. Transmit to the market that the GoM has not fully assessed the opportunity, encouraging less competitive behavior on the part of potential bidders
2. Risk structuring the tender in a less than optimal fashion, building in inefficiencies into the contract that will serve both sides poorly in the future
3. Find it more difficult to assess the value of the terms being offered
4. Risk assuming responsibility for meeting "hidden costs" or providing subsidies it did not foresee and cannot afford
5. Set the stage for a less than transparent process of development and management of the zone
6. Provide a poor precedent for future development of free trade zones in the country.

If, however, the GoM proceeds with the tender without undertaking proper due diligence, then the tender documents should include at a minimum the following evaluation criteria so that bidders understand that they have to demonstrate that the deal is indeed beneficial to the country as well as meeting their needs:

- Up-front concession fee (good faith money)
- Performance bond equal to one year of the FTZ operating expenses
- Development plan showing how the site will be developed over a 10 -year period
- Market study indicating demand and rates of development
- Construction plan and detailed costs
- Financial plan with evidence of financial capability
- Staffing plan for FTZ development and operation
- Annual lease payment to the FTZ Authority
- Royalty to be paid to the FTZ Authority as a percentage of revenue.

C. Proposed Altanbulag Free Trade Zone

C1. Altanbulag background

Altanbulag is located on Mongolia's northern border with Russia. The city of Altanbulag has a population of approximately 4,000 residents and is connected to the city of Ulaanbaatar by a 400 kilometer, two-lane highway. The highway is in relatively good condition but requires upgrading and maintenance in some areas. Sukhbaatar, a city of about 30,000, is located 20 kilometers south of Altanbulag, with an existing inter-urban transportation service linking the two cities. Within Siberian Russia, the city of Ulan Ude, with a population of one million is 270 kilometers to the north of Altanbulag. In close proximity to Ulan Ude is the city of Naushki, which serves as a transshipment point for goods destined to Europe.

C2. Physical conditions

The Altanbulag Free trade zone site is 500 hectares in size and is situated approximately two kilometers east of the city center. Unlike Zamyn-Uud, its terrain is hilly, with steep slopes in some areas. Altanbulag's top soil appears to be sandy; however, detailed soil analyses need to be undertaken to confirm the land composition.

C3. Master plan concept

Although a detailed feasibility study has not yet been done for the Altanbulag free trade zone site, a preliminary feasibility study, including a market demand component and a master plan has been prepared by the Ideal Group of Mongolia. According to the master plan, the proposed land uses for the site are administrative, trade and exhibition-related, retail, office and commercial, industrial, leisure, and container dock facilities. Lease rates for the site are dependent upon activities but run in the range of US $2-15 per square meter per month. Industry was assigned the lowest rental rate while entertainment and exhibition facilities accounted for the highest. The site development strategy also called for the packaging and tendering off of the site's infrastructure and utilities such as the electricity, telecommunication and heating/power stations.

C4. Cost projections for infrastructure and utilities

The total development costs for the Altanbulag Free trade zone site are estimated at US$567 million. Of these, US$38 million are identified as on-site primary infrastructure requirements or direct capital costs. In addition to these infrastructure requirements, 25 kilometers of railway track is to be provided onsite to connect the main line to the free trade zone. Projected cost of this link is US$25 million. An airport, proposed at a cost of US $8 million, has a projected completion date of 2006. Utility costs are to be established below retail so as to make the Altanbulag FTZ more attractive to prospective investors.

C5. Labor availability

The Master Plan identified the population base from Selenge, Darkhan-Uul and other surrounding areas as main sources of labor for the Altanbulag FTZ. According to the master plan document, Selenge's registered unemployed was 822 at the end of 2002, although the report points out that the unofficial number is far higher. Based on these numbers, there is a sufficient labor base to help set up the FTZ in Altanbulag.

C6. Environmental issues

No polluting activities were observed during the Altanbulag visit. An environmental impact assessment (EIA) has not yet been prepared for the site and will need to be conducted before construction begins. Mitigating measures will need to be developed to limit pollution, waste discharge, leaching, the disposal of industrial waste, and to maintain a healthy natural environment. Proper environmental management will also minimize cross-border environmental issues.

C7. Recommendations for the Altanbulag Free Trade Zone

Altanbulag does not appear to face the same development pressures or tender urgency as the Zamyn-Uud FTZ. In general terms, Altanbulag's FTZ is far more advanced than Zamyn-Uud's.

Growth projections and infrastructure. A feasibility study and detailed master plan has been prepared for Altanbulag. Although the feasibility study/master plan is a fairly thorough document, the growth/investment projections appear to be on the optimistic side and there is no evidence of a medium/low case scenario with accompanying mitigating measures. The strategy of packaging off-site infrastructure elements such as heating, and telecommunication is problematic as Mongolia's regulatory framework for the operations of independent power plants (IPPs) is still being developed. Other off-site infrastructure/utility items such as sewage disposal system and road networks are identified with capacity and estimated costs; however, the document does not specify the source of funding for these services. It does, however, recommend modifications to the general FTZ law in order for the GoM to address this area.

Infrastructure costs are based on estimated user inflow, mix and their respective demand levels. Assuming the user inflow projections are correct, the estimated costs presented in the document are reasonable and in line with normal development costs. However, the investment absorption rates appear to be optimistic. A comprehensive analysis of a high, medium and low case scenario should be undertaken for the site to determine the most beneficial absorption rates and costs of infrastructure.

The construction of an airport and railroad linkages would make Altanbulag FTZ a multi-transportation site and could turn it into a potential logistic hub. Attention must be paid to the estimated costs and timing of these activities, as they must be realistic in nature. Demand projections are the key success drivers of the project. As both the airport and railroad links are tied to them, the timing of these investments should be carefully monitored.

Land use and allocation. In Altanbulag, the allocation of land appears to be somewhat unbalanced. For example, the master plan assigns 13% of the total land for FTZ administrative buildings. This is a relatively large allocation of land for a function that normally requires little space. Developers will prefer to maximize commercial land use, minimize administrative use, and increase densities in order to generate higher revenues.

Labor force. The feasibility study assumes that better working conditions to be provided in the Altanbulag FTZ will attract migration. A more realistic probability is that labor will initially come from the Sukhbaatar region, located 20 kilometers south of Altanbulag.

SECTION V: FINDINGS AND RECOMMENDATIONS

This section presents the findings and recommendations of the mission based on a review of the legal and regulatory framework of Mongolia's Free Trade Zone Program, visits to he proposed FTZ sites of Zamyn-Uud and Altanbulag, interviews held in Mongolia, and analysis of available documentation.

In summary, major findings include the following:

1. Benchmarking of Mongolia's Free Trade Zone Program against current successful international practices shows deficiencies in the legal and regulatory framework as well as in the process being followed to establish free trade zones in the country
2. Lack of implementing regulations and procedural definitions encapsulated in Standard Operating Procedures (SOPs) prevents achievement of a minimal transparency and predictability quotient required to operationalize key international best practices
3. A process of due diligence, including a cost-benefit analysis, has not been completed for the proposed Zamyn-Uud Free Trade Zone
4. Identifiable funding is not in place to meet off-site infrastructure requirements for the Zamyn-Uud and Altanbulag sites
5. Deviations from international best practices in the process of launching FTZs runs the risk of repeating mistakes made in the past in other countries and may lead to "hidden costs" or the provision of subsidies that the GoM did not foresee or which will have to be granted at the expense of other high priority social needs.

Recommendation 1: The GoM should consider following best current international practices and undertake an economic cost-benefit analysis of the FTZ projects being contemplated.

Governments should carry out economic cost-benefit analyses to:

- Stop bad projects
- Prevent good projects from being destroyed
- Determine if components of projects are consistent
- Assess the sources and magnitudes of the risks
- Determine how to reduce risks and efficiently share risks

Quality of analysis has been shown by the World Bank to be a key determinant of project success; proper analysis will cause the project to be redesigned so that it is less likely to fail. World Bank experience shows that the probability of failure for poorly prepared projects within three years of a project's life is seven times greater than that of well-prepared projects. Within five years, the probability of failure of poorly prepared projects is sixteen times higher than that of well-prepared projects.

The lesson learned, therefore, is that governments must "do their homework" before launching a project.

An economic analysis would consider all possible benefits and costs from the perspective of the government, or society. Examples of possible benefits and costs are given below.

Benefits:

- Projected tax revenues

- Revenues from granting a concession, license, right, or production-sharing agreement
- Job creation
- Introduction of new technologies and management know-how
- Backward and forward linkages with other local firms, leading to potential formation of clusters
- Increased incomes"

Costs:
- Losses of tax revenue due to tax breaks
- Expenditures on infrastructure paid by the government
- Negative environmental impact or other negative externalities

The issue of whether to grant any tax incentives is an important one. According to Prof. Gitte Heij of the Melbourne University and Asia Research Center:

"Tax is not that important for multinationals; of the 26 factors listed, tax incentives ranked only 18th. Foreign investment laws, foreign exchange conversion, dividend repatriation, political and economic stability and labor skills all ranked higher."
[http://wwwarc.murdoch.edu.au/asiaview/sep99/heij.html]

This argument has been confirmed by many other studies on foreign direct investment. "Good" investors are concerned about a number of things and taxes are only one of them. A transparent institutional environment, secure property rights, etc., are at least as important as tax incentives. Complex tax exemptions often lead to arbitrariness and discretion in their application; this does not help transparency and may discourage "good investors" while encouraging "bad investors".

Each of the costs and benefits can be quantified for each year at their net present value calculated based on an appropriate discount rate. With such analysis, the government can determine whether a project is beneficial or not to society and which of several alternatives is best. Also, the government will have quantified analyses to present to the public in justifying and explaining a project. Based on these analyses the GoM could potentially decide that special FTZs are a venture that it cannot afford and decide to concentrate, instead, on economic reforms that would apply to the country as a whole.

In summary, it is recommended that the GoM conduct a cost-benefit analysis that would show that the FTZs bring tangible economic benefit to the country as whole, as this is yet to be demonstrated.

Recommendation 2: The GoM should consider following best international practices and undertake a full commercial feasibility study for the Zamyn-Uud Free Trade Zone.

A feasibility study will determine what the market is for the Zamyn-Uud site, develop a master plan concept, identify needed infrastructure and costs, set up a planning and development framework, and determine the most cost effective way of undertaking the development project. Its purpose is to identify to the government and the investor, the most economical viable way of developing the site, providing transparency, certainty, and accountability to all parties. There should be four components to the Zamyn-Uud feasibility study:

Component One: Market assessment
Component Two: Master planning and infrastructure requirements
Component Three: Implementation Planning
Component Four: Business planning and financial modeling

Component One: Market demand study
The market assessment will evaluate the potential markets on a local, regional and global basis and will provide a strategy for targeting industrial, commercial and tourism sectors which will be attracted to the Zamyn-Uud FTZ. A thorough market assessment will also benchmark the free trade zone site against other competitors and identify the competitive advantages of the specific location. This type of preparatory work is invaluable to a government or developer, as it reduces costs by focusing on specific user groups.

When undertaking a market demand study which leads to a targeted promotion strategy, several key questions must be addressed:

- What is required at the site for the development of specific sectors and activities
- What competitive advantages can the Zamyn-Uud FTZ program offer to investors in those specific sectors, and why would an investor select Zamyn-Uud over competing locations
- What are the most promising sectors for promotion
- What are the most promising markets in which Zamyn-Uud should promote itself
- What is the most effective approach to promoting the Zamyn-Uud FTZ as an investment location for these sectors and markets.

Component Two: Master plan and infrastructure requirements
The master plan is an important aspect of the feasibility study as it will identify and optimize physical development solutions for the Zamyn-Uud site and determine the necessary capital investment needed for proper implementation of its infrastructure, consistent with the needs and demands of the user groups. This component should:

- Evaluate the site, surrounding context, land use patterns, local planning processes, adjacencies, and off-site infrastructure and utilities.
- Develop a comprehensive planning framework to identify opportunities and constraints of the new free trade zone site
- Develop a Master Plan, Land Use Plan, Phasing Plan and Development Schedule in accordance with the results of the market demand study and trends
- Evaluate and recommend on-site infrastructure including utility requirements and improvements to meet the new industrial/commercial/tourist requirements of the free trade zone. Cost estimates for the new infrastructure/utilities should be included in this assessment. Based on estimates of capital cost requirements, financial modeling should be undertaken to determine the most cost effective manner in which to develop the free trade zone site.

Component Three: Implementation strategy
The implementation strategy is the synthesis of information gathered from the market assessment and the master planning exercise. When consolidated into an integrated implementation plan, it can be easily followed to ensure the proper development of the project. It is also a decision making mechanism as it identifies:

- A list of actions to be undertaken in the near, medium and long term by the proponents and other key actors—such as the Government and other private investors
- An estimate of the resources needed to undertake the actions proposed
- A schedule with time bound milestones that can be used to measure progress against plans
- A proposed mechanism for review, monitoring, and adjustment of the Implementation Plan and milestones, as required.

Component Four: Business planning and financial modeling
The development, proper phasing, operation and institutional structure of the free trade zone are also important to the overall success of the project. A series of financial models need to be developed in this component so that a comprehensive business plan for the site can be prepared and an economic evaluation can be performed. This is the section that will give the GoM the requisite information to negotiate with a developer or investor from a position of strength and help it obtain the best deal for the country.

Recommendation 3: The GoM should consider revising the legal and regulatory framework of its FTZ Program in accordance with best international practices.

This recommendation should be implemented if and only if, recommendations 1 and 2 have been implemented and the results of this due diligence demonstrate that the implementation of FTZ regimes will bring tangible benefits to the country and society as a whole. Otherwise, we would recommend that the FTZ Program be abandoned and that economic policy focus, instead, on country-wide policy measures.

In its current form, the Mongolian FTZ program suffers from serious conceptual and operational weaknesses that have been found to be highly correlated with failures of these programs in other countries. In our view, ignoring the lessons learned from international experience is not a risk worth taking. Substantial legal and regulatory framework enhancement is required to bring the program to standards of competitiveness and proper positioning at the international level. These enhancements include:

- Modification of the Law on Mongolia on Free Trade Zones (legal framework)
- Preparation and adopting Implementing Regulations (regulatory framework)
- Preparation and adoption of Standard Operating Procedures (SOPs)
- Modification of FTZ site-specific laws for Zamyn-Uud and Altanbulag

Recommendation 4: The GoM should explore a leisure development concession in Zamyn-Uud in response to the identified market niche opportunity and potential investors' interest provided by its proximity to Erlian City in China.

To prepare for such a concession, the GoM should assess its legal framework, regulations and compliance systems on anti money laundering, as well as contract international expertise in leisure-related activities to assist in the negotiation of a concession agreement that could include conditions that would provide for FTZ off-site infrastructure requirements at Zamyn-Uud FTZ

The leisure related activity and the Free Trade Zone (FTZ) should be "ungrouped" to allow the first to proceed at required speed under a concession agreement that should be based on a thorough cost-benefit evaluation process and take into consideration not only investor needs but country returns from the venture(s).

Recommendation 5: The GoM should consider postponement of the tender for the Zamyn-Uud FTZ until completion of a due diligence process that demonstrates tangible benefits for the country is completed according to international practices.

There is currently no market demand study available for Zamyn-Uud that identifies potential users of the free trade zone. In the absence of this information, demand projections for infrastructure services—water supply, waste water collection and treatment, electricity, telecommunications and roads—cannot be made. Neither can costs be attached to the provision of these services. Consequently, the GoM does not have an economic cost-benefit analysis that would demonstrate to citizens that tangible benefits are to be achieved by the FTZ project.

If a tender is issued for Zamyn-Uud prior to completion of proper due diligence, potential investors will exploit this deficiency to their advantage. The GoM may find itself in the future facing costs it did not foresee and cannot afford; it will have internalized as its own the negative externalities of the project. As the experience of the Dominican Republic and other countries show, FTZs can be successful but the cost of this success is borne by the rest of the society. In the absence of proper due diligence, the GoM runs the risk of repeating the same mistakes other countries have made in the past.

Therefore, the mission recommends that the GoM, in the interest of its fiduciary duties to safeguard the interest of the country as a whole, transparency and accountability for its actions, delay the Zamyn-Uud tender process until proper due diligence is performed.

ANNEX A: MEETINGS HELD DURING 2 TO 16 FEBRUARY 2004

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Meetings held with GoM officials:

Date	Name	Position	Organization	Location
2/2/04	Enebish Dashtsoo	Governor	Governorship of Zamyn-Uud Sum	Zamyn-Uud
	D. Galsandorj	Director Trade Policy and Cooperation Department	Mongolia Ministry of Industry and Trade	Zamyn-Uud
	L. Gumenjav	Director Trade, Business and Cooperation Department	Ministry of Industry and Trade Administration of Zamyn-Uud Free Economic Zone	Zamyn-Uud
	B. Zoltuya	Trade policy and Cooperation Department	Ministry of Industry and Trade of Mongolia	Zamyn-Uud
	D. Badam-Ochir	Development Policy & Investment Department	"	Zamyn-Uud
	D. Mijidsuren	General Director	Ideal Group Co. Ltd.	Zamyn-Uud
	B. Tanantsetseg	Deputy Managing Director of Unit	International Freight Forwarding Center of Mongolian Railways	Zamyn-Uud
	Li Fenghua	Deputy Chief	Erlian Foreign Affairs Office	China
	Ch. Davaadash	Consul General Erlian City, China		China
3/2/04	Banzragch	Director	Zamyn-Uud Customs Office	Zamin-Uud
5/2/04	D. Erdenebat	Head	Mongolia Administrative Office of Altanbulag Free Trade Zone	Ulaanbaatar
	B. Chimedtseren	Vice Chairman Industrial Policy and Coordination Department	Ministry of Industry and Trade	Ulaanbaatar

Date	Name	Position	Organization	Location
	A. Tamir	Industrial Policy and Coordination Department	Ministry of Industry and Trade of Mongolia	Ulaanbaatar
	S. Otgonbat	Vice Chairman	Investment and Foreign Trade Agency	Ulaanbaatar
	Chimgee Luvsandorj	Director	Supervision Department Bank of Mongolia	Ulaanbaatar
6/2/04	Enebish	Secretary of Working Group on Regional Development	Ministry of Finance and Economy	Ulaanbaatar
	Batbayar Jamyangiin	Deputy Director General	Mongolian Customs General Administration	Ulaanbaatar
	Yo. Batsaikhan	Deputy General Director	Mongolia Railways	Ulaanbaatar
	Ganhuleg Baldan	Senior Official	General Department of National Taxation	Ulaanbaatar
9/2/04	Batsaikhan	Deputy	Railway Authority	Altanbulag
	Otgontsogt	Land Management Office	Altanbulag Soum Governor's Office	Altanbulag
	Davaasambuu	Deputy	Customs Office Selenge Province	Altanbulag
11/2/04	Shairai Batsukh	Chairman	Administration of Land Affairs, Geodesy, and Cartography	Ulaanbaatar
	Batbileg Chinzorig	International and Internal Cooperation	Administration of Land Affairs, Geodesy, and Cartography	Ulaanbaatar
	D. Surenkhor	State Secretary	Ministry of Industry and Trade	Ulaanbaatar
12/2/04	U. Ulambayar	Vice Minister	Ministry of Infrastructure	Ulaanbaatar

Date	Name	Position	Organization	Location
	Baasankhuu Manduul	Director Policy and Coordination Department of Roads, Transport and Tourism	Ministry of Infrastructure	Ulaanbaatar
	Ayush Munkhtseteseg	Officer International Cooperation Division State Administration Department	Ministry of Infrastructure	Ulaanbaatar
	Zundui Tuul	Officer Department of Construction and Urban Development Policy Coordination	Ministry of Infrastructure	Ulaanbaatar
16/2/04	T. Dorjbal	Advisor to the Minister	Ministry of Industry and Trade	Ulaanbaatar

Meetings held with USAID/ Mongolia and U.S. Embassy officers:

Date	Name	Position	Organization	Location
2/2, 12/2/ & 13/2/04	Jonathan Addleton	Director	USAID Mission Location	Zamyn-Uud/Ulaanbaatar
	D. Sukhgerel	CTO Economic Policy Reform and Competitiveness Project	USAID	Zamyn-Uud/Ulaanbaatar
12/2/04 & 13/2/04	Michael J. Layne	Economic/Commercial Officer	United States Embassy to Mongolia	Ulaanbaatar
13/2/04	Hon. Pamela Slutz	Ambassador to Mongolia	United States of America	Ulaanbaatar

Meetings held with international donors:

Date	Name	Position	Organization	Location
2/2/04 & 9/2/04	Derrin Davis	Team Leader	PDP Australia PTY LTD/Asian Development Bank	Zamyn-Uud
12/2/04	Henning Tweten	Project Coordinator	German Technical Cooperation Ministry of Industry and Trade	Ulaanbaatar

Meetingsheld with EPRC team members:

Name	Position	Location
Fernando Bertoli	Chief of Party	Ulaanbaatar
Chris Broxholme	Deputy Chief of Party/Trade Advisor	Ulaanbaatar
Bruce Harris	Business Development Advisor	Ulaanbaatar
Horst Meinecke	Energy Advisor	Ulaanbaatar
Janusz Szyrmer	Policy Advisor	Ulaanbaatar

ANNEX B: STRENGTHS, WEAKNESSES, OPPORTUNITIES, AND THREATS ANALYSIS (SWOT) OF MONGOLIA'S FREE TRADE ZONES PROGRAM

ANNEX B: STRENGTHS, WEAKNESSES, OPPORTUNITIES, AND THREATS ANALYSIS (SWOT) OF MONGOLIA'S FREE TRADE ZONES PROGRAM

Strengths	Weaknesses	Opportunities	Threats
• Strong government support for program	• Public sector combines both regulatory and development functions • No private sector participation in development or decision-making instances • Considerable discretionary powers assigned to governor position without regulating • Lack of implementing regulations and SOPs makes for an unclear, surprise-laden program • Institutional framework not clearly defined within the context of other government agency roles and private sector participation • Does not provide realistic source of financing for infrastructure development • Enclave/tax holiday driven program • Lack of partnership approach with private sector • Lack of promotional support and coordination with the national promotional agency • Lack of thorough evaluation of an FTZ program in Mongolia, investment demand, feasibility and cost-benefits for all parties involved • Work force availability	• Evaluate program thoroughly based on demand study, cost-benefits for investors and country • Build strategic dialogue group that includes private sector to ensure support, participation and understanding of the program • Prepare a competitive program that serves as test bed for expected overall country reforms	• Precipitous international rollout of program in current status could affect Mongolia's image in other crucial local efforts that will require international market attention and credibility • International rollout of program as is could compound "negative brand" image as expressed in a recent article in *The Economist:* "A bridge to nowhere"[4]

[4] The Economist, Jan 29th 2004 Edition.

ANNEX C: STRENGTHS, WEAKNESSES, OPPORTUNITIES, AND THREATS ANALYSIS (SWOT) OF THE ZAMYN-UUD TENDER

ANNEX C: STRENGTHS, WEAKNESSES, OPPORTUNITIES, AND THREATS ANALYSIS (SWOT) OF THE ZAMYN-UUD TENDER

Strengths	Weaknesses	Opportunities	Threats
• Strong government support • Located close to Erlian City, China, which is experiencing fast economic growth • Possible niche market for Mongolia in special leisure-industry activity • Special leisure-industry activity legally allowed within site	• Lack of feasibility study to determine project viability • Lack of cost-benefit analysis for country to determine value of program • Off-site infrastructure not available • Poor overall planning of project • Shortage of labor in Zamyn-Uud may require Chinese workers • Quality of life in Zamyn-Uud below international standards • No apparent consultation process with the Zamyn-Uud community to gauge reaction to the project	• Ensure additional benefits from economic growth of Erlian City • Establish "twin" production facilities in close proximity to Erlian City to complement its industrial growth • Create a "production stop" in the trade between China and Russia that adds value to raw materials • Service a niche market in the leisure industry • Stimulate resort-type investment in Zamyn-Uud • Secure source of financing for infrastructure requirements of Zamyn-Uud site (if a feasible project) or use revenues for other key Mongolian socio-economic programs	• Failure of project due to lack of proper preparation that includes a full feasibility study with a clear cost-benefit study for investors and country • Premature tender of site as an FTZ site when in reality it is 900 hectares of non-serviced land • Risk of bidders taking advantage of GoM's lack of preparation and of GoM internalizing negative externalities of the project at a cost to society as a whole • Compounding of the negative brand image of Mongolia, already questioned by *The Economist* 's "Bridge to nowhere" article • Mongolia's loss of credibility could stimulate lack of interest or attention by international investors on other key programs currently under preparation

ANNEX D: AQABA INTERNATIONAL INDUSTRIAL ESTATE (AIIE): EXAMPLE OF A SUCCESSFUL TENDER PROCESS OF A “WELL-PREPARED PROJECT”

ANNEX D: AQABA INTERNATIONAL INDUSTRIAL ESTATE (AIIE): EXAMPLE OF A SUCCESSFUL TENDER PROCESS OF A "WELL-PREPARED PROJECT"

This annex is an overview of a successful tender process for the development of an industrial estate in Aqaba, Jordan. The Jordan Industrial Estate Corporation, an autonomous government organization is responsible for developing industrial estates in Jordan. The Jordanian program is approximately ten years old and includes privately developed projects.

Project description:

- Name: Aqaba International Industrial Estate
- Location: Aqaba Special Economic Zone, Hashemite Kingdom of Jordan
- Aqaba City population: 90,000
- Development concept:

  275 hectares total size
  Three phase development
  First phase-57 hectares tendered on a 30-year concession BOT basis

Exhibit D-1: Activities and their schedule for Jordan's AIIE tender process

Matrix/ Time Line AIIE International Tender Preparation Time line: 11 months	**Legal framework/enabling environment. Time line: Concurrent with preparation stage Seven**	**Detailed design/Off-site infrastructure full description and capacity availability. Time line: Sequential to feasibility study Five months**	**Creation of fully mandated tender technical group. Time line: Concurrent with preparation stage**	**Data room with supplemental documents available in case of inquiries. Time line: Concurrent with tender issue**	**Monitoring of all users Expressions of Interest to provide as information to prospective developer bidders: Concurrent with preparation stage**
• Financial and economic analysis (Included cost/benefit analysis for firm and country • Market demand study and comparative site analysis • Projected user mix • Physical and master plan • Complete environmental assessment • Legal framework of a concession agreement	• Located within the Aqaba Special Economic Zone • Business friendly and service ethos Zone Authority • Promotional support from Zone authority (Marketing in partnership) • Simple business licensing procedures; one-stop approach • Clear and flexible land transaction process • Attractive and clear incentive package	• On site urbanization • Two standard factory buildings • Electrical sub-station and distribution system • Waste water connection • Telecommunication system • Road access system • Administration and ancillary service area	• Technical group responsible for overseeing tender preparation • Answering inquiries • Inform management of tender status • Evaluate tenders	• Designs • Feasibility study findings • Laws and regulations • Maps • Other documentation	• Monitor and log all users' expressions of interest in a uniform format that included: • Company name • Contact name • Contact points (telephone, fax, email address) • Activity • Expected date of start-up • Size of facilities required

Time line by stages:

- Feasibility study: March 2000-July 2000
- Preparation: Sept. 2000-Feb. 2001
- Legal framework/enabling environment: Sept. 2000-March, 2001
- Detailed design: March-July, 2001
- Tender issued: Aug. 2001
- Revisions to tender: end of 2001
- Off-site construction: 2002
- Contract assigned to winning bid: Aug. 2002
- Formal hand-over to winning developer: January 2003

Off-site infrastructure was not available at the time of tender issue. However, all capacities had been defined within the design stage and financing source was in place. Actual off-site infrastructure work was initiated after tender had been issued.

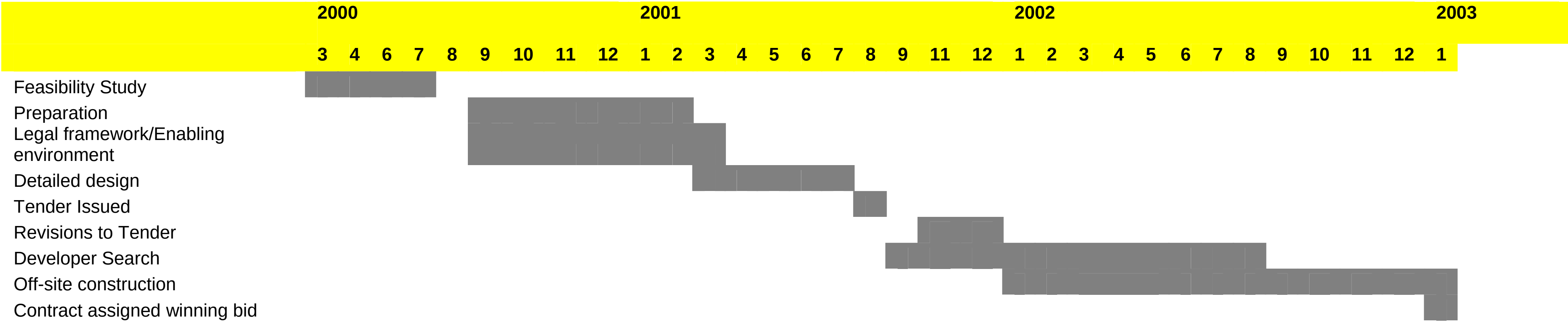
As can be observed from the matrix and time-line, the different stages of the AIIE tender spanned over a time period of approximately 17 months. The first step entailed the full feasibility study. Once that proved to be a “go”, all other stages moved simultaneously under a unified project management approach.

The result of this tender process was successful. A consortium led by Multinational Corporation Parsons Brickerhoff International (PBI) won the bidding process and took over the project in January of 2003. Results to date are considerably above initial projections. Investment inflow is 100% over the original projections with an investor “pipeline” that currently represents approximately 200,000 M2 of under-roof construction. Job creation is projected at over 2,000 over the next 24-month period.

Exhibit D-2: Time-line matrix for Jordan's AIIE tender process

ANNEX 4

AIIE Tender Process Time Lines



ANNEX E: SAMPLE DRAFT TERMS OF REFERENCE FOR A MARKET DEMAND STUDY FOR THE ZAMYN-UUD FREE TRADE ZONE OF MONGOLIA

ANNEX E: SAMPLE DRAFT TERMS OF REFERENCE FOR A MARKET DEMAND STUDY FOR THE ZAMYN-UUD FREE TRADE ZONE OF MONGOLIA

BACKGROUND AND PURPOSE

The GoM wishes to conduct a market demand study as a first step in a due diligence process for the proposed establishment of a free trade zone (FTZ) in Zamyn-Uud. The purpose of this consultancy is to identify the main potential users of the zone.

OBJECTIVES

Objectives of the market demand study include, *inter alia*, the following:

1. Identification of specific potential markets and users of the zone
2. Quantification of potential demand based on targeted users identified under 1, above
3. Analysis of the potential identified demand and its implications for the potential development of a Zamyn-Uud FTZ.

INDICATIVE TASKS

Principal tasks to be undertaken include, but are not necessarily limited to the following:

*Identify potential market audience***.** Identify potential range of prospective market and investment targets based upon: i) investor interest registered with the GoM, ii) national and regional investment trends/patterns; and iii) from global benchmarking. The results will be grouped according to nationality, size of enterprise and industry/activity sub-sectors. The consultant will concentrate on the main sectors existing in the region and potential new sectors. The analysis of this work will identify competitive advantages or concerns for the Zamyn-Uud site.

Develop standardized demand study instrument. Develop a simple questionnaire that will evaluate potential demand. This will be done by preparing a questionnaire that looks at:

- Industry/activity sub-sector, export orientation and geographic origin of investment
- Requirements for Standard Factory Buildings (SFB), serviced land and other facilities
- Transport modes and requirements
- Sensitivity to differences in lease versus purchase options—assuming the later is possible—rental rates, and terms
- Preferences for joint venture direct foreign investment, or subcontracting relationships
- Average demand in terms of amount of under-roof SFB space or serviced land under different scenarios regarding political and economic conditions
- Estimated job creation level at start-up and at maximum levels of production.

The survey instrument should provide first-hand data regarding the origin, composition, and character of demand for space in the proposed FTZ, taking into account political and economic conditions, and competing sites and prospects.

Conduct survey of targeted firms. Using a standardized questionnaire, conduct interviews with a representative sample of targeted enterprises. It is expected that a variety of techniques will be employed to conduct the survey: personal interviews, direct mailings, telephone surveys, etc. Some questions posed to target firms may be in regard to:

- Fast tracking movement of goods and products
- Streamlining customs procedures
- Simplifying the registration procedures
- Implementing special leasing and property tax regimes
- Utilities and infrastructure needs
- Costs for doing business.

Prepare demand absorption forecasts. Drawing upon survey results, and analyzing the space demand absorption patterns of comparable FTZs within the region, the consultant will prepare a national demand forecast of space in terms of serviced land and SFBs for the Zamyn-Uud site. The analysis will fully consider the impact of the many variables affecting investors demand including political issues; bilateral agreements, trade regimes, incentive packages, and other factors to arrive at a realistic determination of anticipated demand. The analysis should include a review of absorption rates, occupancy levels, and growth patterns. Annual demand absorption levels should be developed under different site development scenarios, such as optimistic, moderate, and pessimistic.

Prepare summary report and hold public presentation. The final task will be the preparation of a report summarizing the demand study analysis and the implications it holds for the development of the Zamyn-Uud FTZ. The report should both quantify and qualify the projected demand and propose specific recommendations as to how to market the Zamyn-Uud Free trade zone. The public presentation will disseminate the findings of the consultancy.

EXPECTED PRODUCTS OR DELIVERABLES

The consultancy shall produce two products or deliverables:

1. A final report that shall quantify the specific potential demand and market for the proposed FTZ in Zamyn-Uud and analysis of its implications for site development under different scenarios
2. A public presentation of the findings of the consultancy.

Products of the consultancy shall be made available in printed and electronic form. Format of the printed report shall be as per standards to be provided to the consultant in advance. Eligible electronic format for the report and files to be produced by the consultancy shall be in Microsoft Office Suite (Word, Excel, PowerPoint, etc.) unless agreed upon and in advance with he supervisor.

PROJECTED LEVEL OF EFFORT AND COST

The projected level of effort of the main consultant is projected not to exceed to thirty-five working days, exclusive of international travel. Cost of the consultancy is expected not to exceed the equivalent of US$ xxxxxxx.

In-country transportation, office space, logistical support, translation and interpreting services will be made available to the consultancy.

PROJECTED SCHEDULE AND PLACE(S) OF ASSIGNMENT

The consultancy shall take place in Ulaanbaatar, with travel to Zamyn-Uud and other sites as required and agreed upon with he supervisor of the assignment.

SUPERVISION ANDCOORDINATION OF ASSIGNMENT

To be determined.

TECHNICAL AREA OF EXPERTISE AND EXPERIENCE REQUIREMENTS FOR THE CONSULTANCY

The consultant will have demonstrable experience in the preparation and tendering of feasibility studies for FTZs. Experience in establishing and/or managing FTZs is also highly desirable.

ANNEX F: A CASE STUDY: THE DOMINICAN REPUBLIC FREE TRADE ZONE REGIME

ANNEX F: A CASE STUDY: THE DOMINICAN REPUBLIC FREE TRADE ZONE REGIME

The Dominican Republic is a good example of a country with a successful Free Trade Program containing most of the international best practices. In spite of the success of the FTZ program, the country has not fared so well economically.

The country is located in the center of the Caribbean on the island of Hispaniola, borders with Haiti in the West and is within close proximity to the United States of America to the north. Exhibit F-1 presents basic data for the country for the year 2002

Exhibit F-1

Size	Population	Work force	Total exports	Total imports
48,000 Km2	8.8 Million	3 Million	US$5.3 Billion	US$8.7 Billion

The FTZ program was launched in 1969 without consideration to cost-benefits for the country and had, and maintains as objectives: job creation, foreign exchange generation and stimulation of non-traditional exports.

The Dominican FTZ program currently boasts of 53 FTZs housing 520 operating enterprises, 171,000 direct jobs, and a total investment level of US$1.3 Billion. Total foreign exchange earnings for 2002 represented US$1Billion. Investment sources for enterprises under the program is split between the United States (50%), the Dominican Republic (34%) and other nationalities (Korea, Taiwan, Spain, Italy making-up the bulk of the remaining 16%). The enterprise mix is comprised of garment assembly (50%), services (17%), electronics/electrical assembly (5%), tobacco and derivatives (5%), jewelry (5%), pharmaceutical products (3%), footwear (3%), and 12% in diverse productions such as label cutting, printing, etc. The United States is by far the primary recipient market of FTZ exports, representing over 90% of the total[5].

GDP for 2002 was US$7.1 Billion, FTZ program participation being 2.5%[6].

The Dominican FTZ program can be divided into two distinct periods, reflecting results directly attributable to the program's enabling environment.

A. Period 1: 1969-1980

During this period the program was rolled out based on the following elements:

- Heavy emphasis on tax holidays that created a fiscal paradise: open-ended tax exemptions, duty-free movement of goods), etc.
- Weak legal framework; the law creating the FTZs simply identified eligibility based on 100% export of production
- No backward or forward linkages with the local economy
- Fixed exchange rate policy
- Non-existence of a clearly empowered institutional framework, except for a heavy customs role based on control to avoid contraband into the local market
- Designation of FTZ was based on a policy of creating growth poles to mitigate immigration into the capital city from other provinces

[5] Dominican National Duty Free trade zone Council 2002 Statistics Report
[6] Central Bank of the Dominican Republic 2002 Statistics Report

- Lack of promotional support

The results of this period were not very encouraging: three FTZs in operation, 71 firms, and 16,000 jobs. The source of investment during this period was predominantly from the USA, with over 95% of the total. Enterprises in the zones concentrated primarily in garment assembly for re-export to the USA. The major attraction of the program during this period was basically the country's quota free status for garments until 1980.

B. Period 2: 1980-2002

During this period the program reported spectacular results responding to key economic reforms applied nation-wide; chief among these was the implementation of a liberalized exchange rate. Other key steps taken during this period included:

- Creation of a competitive legal framework and clear regulations
- Creation and consolidation of a specialized free trade zone authority
- Designation of FTZs based on market demands
- Proactive promotional effort.

Adjustments of the enabling environment yielded quite different results during the second period. There are now 50 new free trade zone parks, 449 enterprises, and 155,000 new jobs.

The generous tax incentive scheme—the "fiscal paradise" approach—has been a constant throughout both periods and cannot help explain the rapid growth during the second period. Nor was the application of quotas on garment exports a constraint to further growth of this activity within the FTZs, as they actually grew from about 65 in 1980—when quotas were introduced—to an additional 225 operations during the second period. In the first case, it is evident that the fiscal paradise offer was not sufficient as the driving force of the program during the first period. Successful growth during the second period was due to the country's implementation of a transparent quota assignment process, with private sector participation, based on historic production and installed capacity.

The Dominican FTZ program has effectively addressed the chronic unemployment of the country and it is doubtful that other alternatives would have performed as well. Technology transfer has been successful as reflected in the number of Dominican-owned operating enterprises. A new and sophisticated national entrepreneur class has been created, well-versed in the export activity. Foreign exchange reported to the national treasury in the amount of US$1 billion makes a significant contribution to foreign exchange reserves. Tax collection on salaries is minimal since about 90% of workers earning level are below the national income tax threshold. Although there has been no clear evaluation of the actual downstream impact of the FTZs on local commerce, it is assumed that workers' increase in purchasing power does create indirect benefits to government revenues and SMEs have developed around FTZs for the purpose of providing services to workers and enterprises.

The country is not performing very well recently. Production in the FTZ program has actually reported a downturn due to the economic difficulties of the USA immediately after the September 11 tragedy. Figures for 2002 show a five percent decrease in jobs compared to 2001, while foreign exchange fell by 3.1% in the same period.

The government has experienced a serious short-fall in revenues and foreign exchange reserves while seeing its external debt grow considerably over the past four years due to investments needed in infrastructure and socially-oriented programs.

The electrical sector, privatized based on concessions to IPPs is in a continuous state of crisis as the government arrears grow. Generating plants are turned off because of lack of payment and the public suffers blackouts lasting 10 to 15 hours on average. Local currency has devalued by over 200% during the past 12-month period, while inflation is estimated at over 40% by the Dominican Central Bank.

The IMF has recently signed a stand-by memorandum of understanding with the government, stipulating among other requirements the need for government to widen its fiscal base by implementing a fiscal reform that would include a revision of tax levels and elimination of subsidies.

The obvious conclusion is that the FTZ program in the Dominican Republic indeed represents a success at the micro level. However, since it was launched without any clearly defined economic reform strategy or any kind of cost-benefit analysis and more as a politically expedient measure; its actual contribution to the country as a whole—the macro level—is subject to criticism. Currently, the Dominican FTZ program is not WTO compliant as its regime is clearly based on exceptional conditions vis-à-vis the rest of the economy. The “fiscal paradise” and enclave-type environment is a subsidy to exports as set out in the WTO conditions and will require adjustment.

One consequence of “fiscal paradise” approach of the FTZ program of the Dominican Republic is the difficulties it presents in the country’s efforts to secure free trade agreements with countries in Central America and the Caribbean Region.

ANNEX G: SUMMARY SLIDE PRESENTATION GIVEN TO GOM OFFICIALS AND USAID

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