

**Zoran Čekerevac, Dr. Sc., Assoc. professor, Union University, Belgrade, Serbia**

**Dragan Radović, Dr. Sc., Assoc. Professor, Alfa University, Novi Sad, Serbia**

**Petar Čekerevac, dipl. pol., Faculty of Political Sciences, Belgrade, Serbia**

## **THE INFLUENCE OF BUSINESS IN FREE ZONES TO FDI, SME DEVELOPMENT AND EMPLOYMENT**

The paper pays attention to the analysis of operations of free zones and particularly free zones in Serbia. It shows the importance of development of business activities in free zones, some experiences in business development of free economic zones of developed economies, the contribution of newly established enterprises in the areas of new employment and problems of preserving the competitiveness of national economies in attracting foreign direct investment (FDI) in the free zones, as well as some of the risks which are exposed to SMEs doing business in the free zones. At the end of the paper, there are presented some dilemmas about the way of organizing free trade zones in countries in transition.

### **Introduction**

The objectives of free zones establishment and support of their business are attracting of foreign direct investment, creation of new jobs and provision of new employment opportunities, and stimulation of the export activities of the economy.

The free zones mainly trigger new production company. Key benefits for companies operating in free zones are the opportunity to establish and to develop company on the infrastructure arranged locally, not to pay customs duties on equipment and raw materials and not to pay tax (VAT) on imported goods. Doing business in free zones enables enterprises to achieve savings in the handling of imported resources (raw materials, technology, equipment, etc.), thereby directly affecting the reduction of operating costs, to create a real possibility to use the achieved savings to improve the business and processes in organization.

Because of the globalization of the world economy, traditional barriers that countries use to protect their own industries and production of goods and services have been broken. This new approach provides a competitive struggle of producers for predominance in the market, which is ultimately on the benefit of consumers. In

order to survive on the market, for the company it is necessary to fulfill at least one of the two most important factors: exclusivity and/or low cost

In both of these factors, free zones can provide a significant advantage to the company and a significant boost to its development. This is applicable on large multinational companies, but also on small and medium enterprises.

### **Free zones as a potential for economic development**

The first free zone appeared in the United States during the Great Depression. Free trade zones were defined by the act: Foreign-Trade Zones Act (1934).

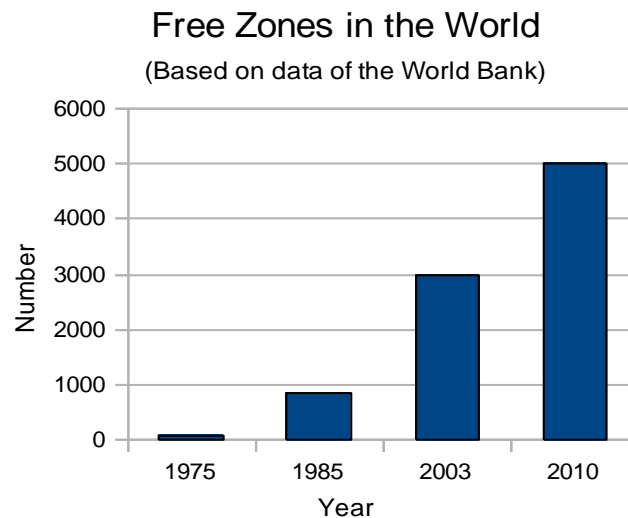


*Fig. 1 USA annual real GDP, with the years of the Great Depression highlighted [1]*

There is no doubt that the free zones contributed to the recovery of the American economy. Legislation was reformed 1950s, when production in free zones was allowed. They were additionally reinforced on the April 12<sup>th</sup>, 1980 when the U.S. Customs Service agreed to the request of the National Association of Foreign-Trade Zones (NAFTZ) that companies do not need pay customs duties for the goods and parts that are imported into free zones.

Today, the entire trade of the United States is based on the model of free trade. The model in theory knows only profit for all parties, but in practice there is, also, another side. Expenses that arise in this model are not negligible, but they are still smaller than the gain. It is normal that a model that is favorable for strong economies may not be suitable for all countries. Each country must make deep analysis about

advantages and disadvantages of the model in their own particular case. The same applies to the private companies that wish to operate within free zones.



*Fig. 2 The number of free zones in the world in the period 1975-2010 years*

*Table 1: Number of free zones in the world in the year 2008 [3]*

<b>FREE TRADE ZONES IN THE WORLD</b>	<b>Number of zones</b>
Europe	55
USA	713
Economies in transition (Central and Eastern Europe)	90
North Africa	23
Saharan Africa	64
Countries in the Indian Ocean	3
Middle East	37
Asia	749
Central America and Caribbean countries	3.387
Latin America	39
Pacific	14
<b>TOTAL</b>	<b>5.174</b>

The first free zones outside the U.S. were located at strategic points of interest (e.g. Singapore, Hong Kong, Hamburg ...) and were virtually international laboratories. Now, states in which free zones have been established constitute 70% of the world and 87% of world population. Table 1 shows the concentricity of the free zones around the world.

In **Slovenia**, there were two types of free zones: the two free economic zones and six free customs zones allocated in different cities. By amendments to legislation in the year 2001 there was changed the interpretation of the term "free zone", so the

number of free zones has declined dramatically as well as the number of potential locations for the establishment of free zones.

In **Hungary**, there were no free zones established by the territorial principle, but the eligible commercial companies have received authorization to operate under the principles of free zones. Before entering the EU under these conditions, there were 140 companies in 130 free zones. Since the end of 2005, these companies do not operate in the free zone anymore but the state has introduced a "Smart Hungary" program that gave special benefits to the operation of foreign companies.

In **Bulgaria** there are 6 free zones in which, under the law of the year 2006, investors can qualify for the exemption from the value added tax when they meet the criteria for opening new jobs and investment volume.

In **Romania**, there are six free zones with 159 companies. For the import of goods in free zone user does not pay the customs duties. For import of goods from free zone in the home country importer pays the tax.

In **Croatia**, there are 13 free zones. A user who has invested in the construction of free zone's building of more than € 125,000 is exempt from paying income tax in the year of investment and in the next five years.

In **Macedonia** there are three free trade zones where companies pay income taxes in the amount of 10%, but for reinvested profits they do not pay any taxes.

According to the Law on Free Zones [2] free zone is defined as a part of the territory of the **Republic of Serbia**, which was specially fenced and marked, where activities are performed under conditions established by that act. In Serbia, there are six free trade zones. Free zones in Serbia, offer to the users the following benefits:

- Free transfer of profit made in the activity zone.
- Import of goods and services in the zone and export in the area are free.
- On imported raw materials implemented into export's goods companies do not pay customs duties and other import duties.
- For imported equipment, machinery and building materials companies do not pay customs duties and other charges.



Fig. 3 Free zones in Serbia (<http://www.szns.rs/srbija.htm>)

- The foreign exchange resources realized from the operations in the zone are at disposal of the users of the zone
- Rights of zone's users established by the Law on free zones can not be reduced by other regulations.
- Goods from the zones can be placed on the domestic market with payment of customs duties and taxes. If the goods entering the customs territory of Serbia are produced in the zone with the participation of local components, customs duties will be paid only on the foreign component of the goods.
- Imports into the zone and exports from it are completely free, i.e. there are no applied contingents, import or export licenses or other restrictions on foreign trade operations;
- Zone users can rent, buy or build their own production, storage and business facilities. In the area of Zone expropriation is not allowed.

In Serbia, the free zones are used by global giants like FIAT, but also by small and medium enterprises. Table 2 shows the parameters of values of services, exports, investment and generated traffic in four zones in the year 2008.

*Table 2 Indicators of investment and trade in free zones in Serbia (year 2008) [3]*

	<b>Zone</b>	<b>The value of services rendered in Euro</b>	<b>Exports of goods in Euro</b>	<b>Investments in Euro</b>	<b>Turnover in Euro</b>
<b>1</b>	<b>Pirot</b>	1.040.384	180.099.258	35.086.540	314.970.136
<b>2</b>	<b>Subotica</b>	371.364	112.916.867	2.189.111	254.866.901
<b>3</b>	<b>Zrenjanin</b>	16.813	9.485.007	104.625	25.485.358
<b>4</b>	<b>Novi Sad</b>	148.092	12.933.676	76.100	56.395.193
	<b>TOTAL</b>	<b>1.576.653</b>	<b>315.434.808</b>	<b>37.456.376</b>	<b>651.717.588</b>

According to data of the Authority for Free Zones, free zone's export in Serbia is about 2% of Serbia's exports, and it is far below the expected. Exports from free zones in the world are about 20% of world exports.

Despite to the general lack of results achieved in terms of exports (increase of 4.26% compared to 2007), value of turnover growth shows the significant increase. Value of supply of services in free zones amounted to 1,576,653 Euros in comparison to the year 2001 was increased 4.3 times. Compared to the year 2007 growth was 15.28% [3]. In comparison to the year 2007 supply of services was increased by 37.3%. The largest turnover was realized in the Free Zone "Pirot" and amounted to 314,970,136 Euros, or 48.33% of the total realized turnover in free zones [7].

### **Contribution of free zones to the resolving of the crisis in employment**

The companies that perform their activities in free zones are dedicated to the development of jobs, primarily for local residents. Needs for labor force varies from zone to zone but generating of new jobs is not related only to the direct engagement of workers in the zones. According to international statistics, each newly opened direct job in the free zones indirectly generates two vacancies.

If the free zones are intended for industrial production, the number of newly opened jobs is significant, but if the zone operates as a commercial free zone, the number of newly opened jobs is small. For example, on the Caribbean and in Central America, in the year 1995 in 53 free zones more than 250,000 jobs were open [6].

Table 3 shows the data on number of employees in free zones in the world. It is noticeable that the largest concentration of employees is just in the zones that have the largest share of exports in the world (Zones in Asia and Central America). Table

4 presents data about the companies that were operating in four free zones in Serbia in the year 2008.

*Table 3: Number of employees in free zones in the world from 1999-2002 [3]*

<b>FREE TRADE ZONES IN THE WORLD</b>	<b>Number of employees</b>
Europe	43,599
USA	315,000
Economies in transition (Central and Eastern Europe)	480,590
North Africa	440,515
Saharan Africa	414,460
Countries in the Indian Ocean	166,507
Middle East	328,932
Asia	36,285,033
Central America and Caribbean countries	4,755,635
Latin America	304,200
Pacific	13,590
<b>TOTAL</b>	<b>43,548,021</b>

*Table 4 Indicators of the zones Pirot, Subotica, Novi Sad and Zrenjanin (2008) [3]*

Number of companies	Domestic enterprises	Foreign investors	Investments in Euro	Turnover in Euro	Number of employees
<b>207</b>	<b>90</b>	<b>107</b>	<b>37,456,376</b>	<b>651,717,588</b>	<b>5,473</b>

Although the new jobs provide employment opportunities, they do not guarantee the satisfaction of workers on new jobs. Most often the jobs are manual or do not require high skills. Therefore, employers see them as easily replaceable, and often do not pay attention to their problems. Very often, the workers who work in free zones earn low wages. Also, employers often do not pay attention to long-term development and provision of human resources and human capital as one of the most important factors for gaining competitive advantage.

Employment is mostly reserved for female population, up to 90% of total employment. The situation is aggravated by the fact that many governments, in order to attract foreign investment, rarely make requests to investors about employment and education of local citizens and about transfer of technology to local firms.

Development of human resources and labor relations, beside technology, remain the main problematic aspects of doing business in free zones.

### **Contribution of free zones to the development of SMEs**

At the end of the 1980s, small and medium-sized enterprises (SMEs) in countries belonging to OECD, in the industrial sector had a share of 90% and also had a share in the provision of employment of 30-70% depending on the state. [4] Their share in GDP was between 30 and 50%. For example, in Spain the companies with fewer than 200 employees participated in sale with 50% and in exports with 40%. In the United States, companies with 6 to 10 employees participated with 40% in high-tech jobs. [5]

The contribution of SMEs to export is of great importance, and in developed countries SMEs contribute at the level of 30% of total exports, while in developing countries this percentage goes up to 50% (China), and even up to 56% (Taiwan).

The establishment and operation of SMEs in free zones, is often accompanied by problems that have causes in:

- insufficient professional and under-developed managerial level of directors;
- lack of information on the necessary activities of their own companies, the state of the market and the activities of competing companies;
- lack of own know-how and lack of modern technology and equipment.

SMEs do not have the strength to overcome these problems alone. The interest of the zone is that companies do their business successfully within the zone. One of the main tasks of a free zone is that, in the common interest, zone provides services of this kind to their companies. Services may be in the form of "consultation" or "training-course" and might be provided by the administration of the zone directly, or, what is the current trend, the zone provides financial resources but some specialized organization carries out consultation and/or training.

For SMEs it is positive that free zones need to constantly work on looking for new businesses that could successfully operate in the zone, as well as on the promotion of companies that already operate in the zone. The conclusions of the UNCTAD Expert Meeting on Improving the Competitiveness of SMEs through



Enhancing Productive Capacity, held in Geneva, speak about the importance of these activities and give some recommendations for further work. [8]

### **Risks to which small and medium-sized enterprises are exposed**

Production processes in enterprises, especially SMEs, are daily exposed to the powerful influences of changes in the environment. They are under increasing pressure from the global production and global products with fewer chances for development, and even survival. Changes in business environment and incentives that would enhance the business and help companies to adapt their own business as response to threats and risks that come from the market and from the environment are preconditions for the survival of small and fragile economies. [4]

At the present time, time of intensive development of ITs, primarily the Internet, opportunities for SMEs are significantly closer to the opportunities of large companies. While these services are cheap today, there are still problems with their use, primarily because of the lack of professional staff. Therefore SMEs often need help in this area. If they do not get such assistance, SMEs can meet with significant limitations in the production and sale of goods and limitations in their development.

SMEs could be vulnerable because of the lack of specialists. Often the individual engagement of the right specialist is for a company unacceptably expensive. Often companies even do not know where to turn for advice and assistance. Therefore, the required profile involvement of experts from the free zones or of a specialized organization could be a positive solution.

Prediction and prevention of risks is one of the key tasks of strategic analysis of business operations. The choice of a type of business that carries minimal risk has great chances for success on market and the creation of profit that is based on the built or realistic potential competence of the company is one of the key demands of the strategic choice of companies. The company needs to verify each market segment in size, diversity, availability and compatibility to the company [5]. Built abilities of newly established companies are not at the required level to independently manage the level of business risk, which in practice is one of the reasons for their high "mortality". In such circumstances, the benefit of incentive measures could be

multiplied. At the same time incentives could certainly be far smaller than the assumed foreign exchange earnings and other benefits [9].

## Conclusions

Development and improvement of business in free zones is a tool for attracting investments in the service of regional development, one of the possible solutions for dynamic investment activity, especially to attract FDI and new technologies. Fiscal incentives for enterprises in free zones and savings in operations proved to be a powerful motivational tool for development and improvement of this type of business. Benefits are reflected also in the support that zone provides to the zone users in the areas of management, marketing, business and development planning, administration, training, etc.

Functioning of free zones is very important to encourage new employment, to reduce regional unemployment, the utilization of natural resources, and the potentials based on geographical location. Finally, analyzing the life cycle of free zones, it is evident that any economy at the moment is faced to the challenges of strategic decision making on the future of business in the zones: economic development strategies to strengthen, retain the current level, reduce or redirect the operations of free zones to the regular business' flows.

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