Iran's Free Trade and Special Economic Zones: Challenges and Opportunities

Hassan Hakimian*
(H.Hakimian@city.ac.uk)

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* Senior Lecturer in Economics, Cass Business School, City University, London. (H.Hakimian@city.ac.uk). This paper draws from an earlier work produced for the Middle East and North Africa Region, Social and Economic Development Group (MNSED) of the World Bank. The views expressed here and any errors or shortcomings are the responsibility of the author and not of the Bank.

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1. INTRODUCTION

For over a century, governments around the world have sought to boost and exploit the economic power of their particular regions and zones by designating them as 'special' or 'free' economic zones. This trend has gained momentum in the last four or five decades with the number of zones proliferating in recent years. According to ILO estimates, by 2006 there were 3,500 zones in 123 countries accounting for 60 million direct jobs and in excess of $400 billion total trade (ILO, 2003 and 2007).

Iran's interest in free zones can be traced back to the 1970s when the potential development of Kish Island as a flagship free trade zone in the Persian Gulf was first advocated.

After the end of the war with Iraq and with economic reconstruction under way in the late 1980s, first concrete steps were taken – under the auspices of the First Five Year Development Plan – to realise this objective. In this first wave, three so-called 'Free Trade-Industrial Zones' (FTZS, hereafter) were announced in the two Gulf Islands of *Kish* and *Qeshm* in the south, with a third one in *Chahbahar* (also in the south but on the littoral of Sea of Oman). After about a decade and a half, another three FTZs have been established: two in the north (*Aras* and *Anzali*) in the proximity of the CIS states, with another (*Arvand*) in the south, bordering Iraq and Kuwait.

This initiative was followed up with the setting up of 15 'Special Economic Zones' (SEZ hereafter) dispersed throughout Iran. Whilst, the FTZs are more ambitious in their objective of acting as magnets for the attraction of Foreign Direct Investment (FDI) and ultimately for generating a diversified industrial base and promoting Iran's non-oil exports, the SEZ are conceived for goods transit and improving the supply and distribution networks in the country. A new generation of SEZs have indeed been introduced with 'special themes' (such as petrochemicals, shipping, minerals, gas, etc).

Given the relatively recent history of many of the zones in Iran – and serious lack of available information – it is probably too early to fully evaluate the performance and impact of these zones as yet. What evidence is available, however, highlights a mixed picture and a challenging start for many of the zones. For instance, even Kish Island – arguably the most successful of Iran's Zones – is better known for its success in developing as a centre of domestic trade and commerce rather than as an export platform. Attracting FDI and jobs creation on a significant scale no doubt remain the major challenges for all Iranian zones and only a critical and constructive reappraisal of the schemes can help identify some of these challenges in the years to come.

Some of these challenges apply at the micro level – i.e. the design, operation and management of the zones themselves. However, we argue that the macro picture is also critical to the ultimate success of these. With growing regional competition over attracting foreign capital, Iran's zones can be at a disadvantage if policies pursued there are largely decoupled from, and at odds with, those in the mainland. Streamlining both sets of policies – in the zones and the mainland – and giving a consistent signal to investors – domestic and foreign alike – will be critical to enabling Iran to exploit its undoubted strategic potential as a major regional economic powerhouse.

2. THE RISE OF FREE ZONES

The introduction of Free Trade Zones (FTZs) and Special Economic Zones (SEZs)[1] has featured as key components of many developing countries' outward-oriented policies in the last few decades. This trend has been justified in several ways. First, free zones are considered by host countries as magnets for attracting Foreign Direct Investment (FDI) and are considered as an essential plank of the strategy to promote manufactured exports and achieve long term economic diversification and growth. Second, for countries with high unemployment, free zones are seen as spearheads for job creation helping to reduce unemployment both in regional and national contexts. Third, another – albeit implicit – appeal of the zones has been that setting them up represents partial reform and a more acceptable substitute for complete liberalisation (Miyagiwa, 1993; Madani, 1999).

According to the ILO statistics, the number of countries with Export Processing Zones (EPZs) has risen steadily since the mid-1970s. By 2006, 130 countries were estimated to have set up a variety of different types of free zones (up from 27 only in 1975). The number of these zones likewise rose from a handful (79) to reach 3,500 in the same period. In the decade 1997-2006 alone, job creation in these zones trebled to reach a total of 66 million. Of these almost two-thirds (40 million) were accounted for by China (see Table 1).

Table 1: EPZs: Estimates of Countries, Numbers and Employment, 1975-2006

	1975	1986	1997	2002	2006
Number of countries with EPZs	25	47	93	116	130
Number of EPZs or similar types of zones	79	176	845	3,000	3,500
Employment (millions)	n.a.	n.a.	22.5	43	66
– of which China	n.a.	n.a.	18	30	40
– of which other countries with figures available	0.8	1.9	4.5	13	26

Source: ILO (2007), p. 1.

Table 2 shows that despite the heavy concentration of EPZs in Asia in general and China in particular (three-quarters of global EPZ employment is located in Asia with China taking a lion's share of 60% of the total), free zones are well-established globally and not just limited to the developing world. The US and European EPZs indeed account for about three-quarters of a million jobs in total (about 1% of the total). Elsewhere, EPZs are preponderant in Latin America & the Caribbean with 6.3 million jobs and the Transition economies with another 1.4 million jobs.

Such aggregate employment figures conceal a much greater significance of EPZs in job creation. First, their employment contribution goes well beyond the direct jobs they create as they create and support indirect jobs in a range of ancillary sectors. For instance,

[1] For a typology of different types of free zones, see Akinci and Crittle (2008), p. 10.

it is estimated that if taking into account the indirect employment effects, EPZ development globally could embrace from 9.6 million to 77 million additional jobs (Akinci and Crittle, 2008, p. 34). Second, in some small island economies (such as Mauritius) small absolute numbers conceal the disproportionate contribution of EPZs to total local employment generation. Moreover, in some countries (such as in the Caribbean and small Central American states) EPZs tend to be provide jobs mostly for the female workforce.[2]

Table 2: Geographical Distribution of Export Processing Zones, 2006

Geographical Area	Employment	%	Number of Zones
China	40,000,000	59.7	
Asia (excl. China)	15,741,147	23.5	900+
Latin America	6,258,554	9.3	448
Middle East & North Africa	1,686,749	2.5	115
Sub-Saharan Africa	860,474	1.3	90+
United States	340,000	0.5	713
Transition Economies	1,400,379	2.1	400
Europe	364,818	0.5	50
Others (Pacific & Indian Oceans)	328,642	0.5	15
Total (estimated)	**66,980,763**	100.0	**3500+**

Source: ILO (2007), p. 2.

Free zones have a long standing history in the Middle East and North Africa (MENA) region going back to the 1960s and 1970s.[3] The majority of the MENA region zones are, however, free trade zones and act as trading platforms rather than manufacturing zones for the host countries. This has severely limited the economic contribution of the MENA zones (with the exception of zones in Egypt and Jordan, which have developed a manufacturing focus). Another exception is Dubai, where the government-developed Jebel Ali Free Zone has been established as a major regional distribution and logistics hub[4] **(**Akinci and Crittle, 2008, pp. 28-29). Indeed, none of MENA's free zones feature in the top ten global zones ranked by employment size or export earnings.

[2] According to the ILO's free zone database, for instance, the following countries had the highest proportion of female employment in their EPZ operations in 2006: Jamaica 90%, Nicaragua 90%, Bangladesh 85%, El Salvador 85%; Sri Lanka78%, Honduras 75%, Philippines 74%; Madagascar 71%, Republic of Korea 70%; and so on (ILO, 2007).

[3] Egypt, Syria, Israel and Jordan, for instance, established government-run zones at about the same time that zones were first set up in the Philippines, the Dominican Republic, the Republic of Korea, and Taiwan (Akinci and Crittle (2008), pp. 28.

[4] Dubai has also pioneered the development of specialized zones, such as Internet City, Knowledge Village and Media City.

Table 3: Zone Development Rankings

Employment (thousands)		Exports (US$ millions)	
1. China	50,000	1. China	$145,000
2. Indonesia	6,000	2. Malaysia	117,013
3. Mexico	1,300	3. Hong Kong	101,500
4. Vietnam	950	4. Ireland	82,500
5. Pakistan	888	5. Czech Republic	68,626
6. United Arab Emirates	552	6. India	49,000
7. Philippines	545	7. Algeria	39,423
8. South Africa	535	8. Argentina	36,478
9. Thailand	452	9. Philippines	32,030
10. Ukraine	387	10. Rep. of Korea	30,610

*Source***:** Akinci and Crittle (2008), p. 27.

The steady rise of the free zones since the mid-1960s has indeed reflected the developing countries' hopes of reaping lasting economic gains to generate employment, foster foreign exchange earnings and induce technology transfer. These hopes have generally fuelled perceptions of FTZs as 'engines of growth' deriving in turn from the belief that establishing an FTZ necessarily raises welfare in the host country.

Almost three decades on and with a deeper understanding of the theory and practice of the zones, some of these early expectations have, however, come to be moderated. Three factors, in particular, have contributed to this process.

First, from a theoretical stance, free-traders have questioned the zones' expected benefits contending that the welfare gains associated with preferential trade agreements in general and free trade zones in particular are second best compared to a policy of global free trade (Hamada, 1974).[5] Accordingly, the formation of these areas can have an adverse impact on the world economy if *trade diversion* outweighs *trade creation* even if external tariffs are left unchanged (see Krugman, 1991, for a useful exposition of this). Although establishing the potential for trade diversion may be a matter for empirical investigation,[6]

[5] See Jacob Viner (1950) for a classic demonstration of the theory of the second best, where he shows a move to free trade between two countries that maintain their respective external tariffs with the rest of the world can actually leave them worse off. This is because liberalizing trade with only a subset of trading partners can lead to a situation where countries switch from a relatively lower cost producer to a higher cost producer. Thus 'trade diversion' can potentially decrease welfare and result in a loss of world efficiency.

[6] Krugman (1991) suggests that in practice trade diversion caused by preferential trade arrangements is unlikely to be large due to the fact that most countries tend to trade with their neighbouring countries (their so-called natural trading partners).

the expected welfare gains are therefore far from unambiguous and should be subject to specific cost-benefit analysis (Warr, 1989, p. 77).[7]

A second contributory factor has been the realisation that some of the perceived benefits of the zones may not after all be lasting or sustainable in the long term. For instance, the ‘footloose’ nature of the FDI flows into EPZs means that foreign firms operating in free zones are highly mobile internationally with some leaving ‘an EPZ in one country often migrating to an EPZ in another, in which conditions are more favourable’ (Warr, 1989, p. 66).

Similarly, preferential arrangements in place to lure FDI into special zones may prove to have a short shelf life: the end of the Multifibre Arrangement (MFA) in 2004, for instance, is thought to have had a severe impact on the EPZs in Mauritius. Between 2004 and 2005, total employment in the EPZ sector fell by more than 10,000 workers (or 13.7 per cent). Given the predominance of women in this sector, this had a disproportionate impact on them (Otobe, 2008, pp. 16-17 and p. 36).[8]

In the same vein, if the host government extends preferential treatment it accords to EPZ firms to investors elsewhere in the country (such as extending the right to import intermediate goods free of duty to firms producing for export outside the free zones), this can undermine the advantages of EPZs operations, raising questions as to whether expensive special zones are ‘really necessary’ in the first place (Warr, 1989, p. 85, contends that this was the case with Philippines, Malaysia, and Korea). A similar experience is thought to have affected the EPZs in China in 1991 (Graham, 2004).[9]

A third factor mitigating the attractions of EPZs has to do with their ‘enclave’ nature, which can purportedly limit their local benefits such as backward linkages (local purchase of raw materials) and the extent and cost of technology transfer. Warr (1989, p. 71), for instance, finds that in reality, local sourcing makes up no more than a third of the total purchase of raw materials. As for the transfer of technology, many EPZ industries use technology that is universally available (e.g. labour intensive operations such as garment production). This contrasts with the high-tech industries (e.g. electronics), where technical know-how given to the locals is treated ‘like handing it to one’s competitors’. In other words, ‘know-how is not readily given away; it has to be purchased’ (Warr, 1989, p. 75).

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[7] See Akinci and Crittle (2008, pp. 32-4) and Madani (1999, pp. 22-55) for a cost-benefit framework for evaluating EPZs. Warr (1989) offers an applied analysis of benefits and costs of EPZs in four Asian countries of Indonesia, Korea, Malaysia, and the Philippines.

[8] This was an acceleration of a trend which had started since 2001. Between 2001 and 2005 male employment fell from over 30,000 to 24,000 (21%), while female employment declined more substantially, from 61,000 to just over 41,000 (33%) (Otobe 2008, pp. 16-17).

[9] In 1991 China largely lifted the restrictions limiting export-related privileges to firms located in the SEZs, and other measures were taken to liberalize China’s FDI policy. This increased dramatically the flow of FDI into China, leading to sceptics to ask whether the FDI benefits ‘could have been accelerated had the 1991 liberalization occurred earlier’ (Graham, 2004, p. 91).

In view of the above, it is perhaps not surprising that some of the earlier attractions of EPZs tend to wear off as economies mature. Nevertheless and despite the erosion of some of the initial optimism surrounding the establishment of EPZs, they continue to be popular to date as attested to by the rising trends seen above. For many developing countries, indeed, the zones are seen if not as spearheads for their globalisation strategy then as practical mechanism for their foray into the international arena. This perception seems to be summed up well by the World Bank that although ‘EPZs are a second-best solution compared with generalized country-wide reforms, but …where countrywide reforms are difficult to implement, they can be a useful weapon in the development arsenal’ (quoted in Graham, 2004, p. 100).

Iran’s experience with the development of free trade and special economic zones seems to fit well into this perception of the zones.

3. DEVELOPMENT OF FREE ZONES IN IRAN – AN OVERVIEW

Interest in setting up and operating SEZs in Iran may be traced back to the 1970s, when the potential of the Kish Island in the Persian Gulf was first mooted as a flagship trade zone in the south. However, uncertainties following the revolutionary upheaval after 1979 and war with Iraq in the 1980s meant it was not for another two decades before interest in the subject was revisited.

In the late 1980s, and with post-war reconstruction effort under way, the First Five-Year Development Plan (1989-93) laid down the foundation stones of the first 'Free Trade-Industrial Zones' (FTZs). Article 19, stipulated three such areas – all in Iran's southern shores: the two islands of Kish and Qeshm in the Persian Gulf, and Chahbahar at the far south eastern corner of the mainland bordering with the Sea of Oman (Table 4).

Table 4: Iran's FTZs

	Established	Area	Location	Nearby Countries	International Borders
1. Kish	1989	91 sq km	Persian Gulf	GCC states	Gulf waterways
2. Qeshm	1990	480 sq km	Strait of Hormuz	GCC states	Gulf waterways
3. Chahbahar	1991	140 ha	Southeast	Pakistan, Oman, GCC	Oman Sea waterways
4. Aras	2003	97 sq km	Northwest	Azerbaijan, Armenia	Nakhchivan
5. Arvand	2004	173 sq km	Southwest	GCC states	Iraq & Kuwait
6. Anzali	2003	3200 ha	North (Caspian Sea)	CIS, Caucasus	-

Source: Iran's Free Trade-Industrial Secretariat website, http://www.freezones.ir/

The momentum gathered pace after this with a number of other important steps following on. First, a High Council was set up in 1992 entrusted with regulatory oversight and management and operational responsibilities for these and future zones. One of the first priorities of the Council was to devise and ratify the laws and regulations that were to govern the operation of free zones. This task was completed by 1993/94. By the end of the Plan period, therefore, all three zones had been established, marking 1993 as a watershed in Iran's quest for FTZs. Another three zones have joined ranks in more recent years, raising the total number to six. Two of the newly established zones – Aras and Anzali – are located in the north (the former in the northwest bordering the Republic of Nakhchivan, in proximity of Azerbaijan and Armenia; the latter on the shores of the Caspian Sea with good access to CIS states). The third one, Arvand, is in the southwestern province of Khuzistan and shares international borders with Iraq and Kuwait (see Annex A for more detail).

The economic context in which Iran's experience of FTZs originated deserves some attention. Given the isolationism of the post-revolutionary period as well as the ravages imposed by the war with Iraq during the harsh decade of the 1980s, these zones were clearly seen as attractive 'back doors' to the global economy, whilst the vexed and wider question of Iran's position in the international economy itself could be deferred – awaiting the test of the time. The war years had been particularly harsh for their impact on starving the economy of imported consumer goods and industrial inputs and intermediate products. Whilst the benefits of FTZs were officially articulated in terms of their potential contribution to addressing Iran's endemic economic problems (widespread capital shortages, low productivity, run-down public resources, highly limited non-oil exports, low level technology and management skills levels and practices; see Section 2 below), an unstated attraction of the zones was, no doubt, their potential contribution to alleviating Iran's appetite for imports at the time.

The early zones were selected principally for their proximity to Iran's international waters in the south and were hence seen as gateways for and potential links to the wider international economy.

The customs rules adopted for the zones, too, exacerbated the tendency for them to develop as import platforms for the mainland. These rules allowed domestic travellers to the zones to take back (import) goods with them onshore according to Iran's general customs and excise regulations (they were treated as imports from abroad). This practice had the inadvertent impact of encouraging their development as major centres of domestic tourism and leisure for the burgeoning domestic tourism. This was aided in turn by two factors. First, it became a major source of income as the Zone Authorities' revenues were limited to income from the sale of land and customs and excise duties they could charge on merchandise. Second, Iran's continued isolation limited possibilities for international tourism giving the zones an edge in attracting a growing number of domestic tourists. Thus, in early years the zones became major conduits for imports of consumer goods which sprang up on the back of growing domestic tourism (this was especially notable in the early growth of the Kish Island; more on this in Section 5 below). This practice was however, contrary to the spirit of setting up FTZs as *export* platforms and was subsequently abandoned in 2003 when the three new zones mentioned above were set up (Zakeri, 2006: 3-4).

Another important provision under the First Plan was the establishment of the so-called Special Economic Zones (SEZs) throughout the country. But if facilitating access to imported goods was only partially important for setting up Iran's FTZs, it was an even more explicit motivation behind the establishment of SEZs. Even before the Revolution and in the heyday of the 1970s' oil-boom, various industrial units had experienced costly delays in sourcing their industrial inputs and intermediate products from abroad. To address this, special facilities had been set up by Tehran's Customs Office to facilitate importation and storage of such goods. The need for these was heightened in the 1980s with the disruptions caused by the Iraq War.

Article 20 of the First Five-Year Development Plan recognised the need for the so-called '*protected customs areas*' but introduced a two-pronged approach whereby the zones on the mainland were managed by the Customs and those on the shorelines were under the supervision of the Ports and Shipping Organisation.

Under this Law, the first SEZ was established in Sirjan in 1992 (in the central province of Kerman to the north of Bandar Abbas) under the official title of 'protected customs area'. The status was later changed as Sirjan was officially designated as an SEZ. This was then followed by a second zone in Sarakhs on the old silk route connecting Iran's northeastern Khorasan province to the Central Asian states through a newly established railway line (Mashad-Sarakhs-Tajan). The number of SEZs in Iran steadily increased thereafter with a third one set up in the port of Anzali (which was later changed into an FTZ), and the fourth one was also in an existing FTZ area of Qeshm, embracing the non-FTZ areas of this island. The momentum gathered pace in 1997, when several new SEZs were added. Moreover, zones with a 'special theme' were introduced with a new petrochemicals free zone established in Bandare Imam, followed by an energy SEZ (oil and gas) in Pars (1998), mining zone in Lorestan (1999), electronics in Yazd (1997) and shipping in Bushehr.

There are currently a total of 15 SEZs in Iran (see Annex B for details).

3.1 The Objectives of Free Trade and Special Economic Zones

Free zones are generally set up with the following explicit or stated objectives:

- To attract foreign direct investment
- To contribute to job creation
- To promote and diversify exports
- To upgrade domestic technological capability, managerial skills and know-how
- To regenerate deprived and stressed areas and regions.

There may also be some implicit or unstated objectives such as:

- To reduce anti-export bias while keeping protective barriers elsewhere in the economy intact
- To act as experimental laboratories for trialling new policies and approaches (for instance, financial, legal and labour policies can be tested in these zones before considering their application elsewhere in the economy). (FIAS, 2006; Madani, 1999).

In Iran too, free zones have had both a policy and infrastructure rationale combining most of the above goals and objectives. As we shall see below (Section 3), the setting up of FTZs and SEZs involved packaging import and export duty exemptions, streamlined customs and administrative controls and procedures, a more liberal foreign exchange policy and income tax incentives to boost their competitiveness and to reduce entry and operating costs for investing firms.

For the Free Trade-Industrial Zones, in particular, the principal objective was to help reduce Iran's isolation from the international economy by attracting and promoting foreign direct and domestic investment to boost manufacturing exports. This is why they are carefully located in areas with good, strategic links with major waterways and key regional markets for Iran. This is seen as an important mechanism to enable Iran to develop its non-oil exports and to diversify the economy.

The Special Economic Zones, however, are dispersed throughout the country and are expected to play a more active role in regional policy, for their potential role in revitalising designated regions, as well as in improving the country's distribution system and supply network. Given the physical size of Iran and its well-known problems with the supply and distribution of imported inputs and intermediate products, it is not surprising that the SEZ have the added attraction of facilitating transit goods and the industrial inventory system, whilst simultaneously generating income and revenue for the SEZ authorities and creating local jobs.

3.2 Main Benefits and Attractions

There is little doubt that Iran commands much economic and geo-political significance in the Middle East and is of immense interest on the international arena, too. This contrasts its external perceptions, which may generally depict it as a risky choice for international investment.

Iran boasts a large land mass (three times the size of Spain), has a sizeable population (about 70 million) and is the fourth largest oil producer in the world (the second largest in OPEC). Its natural gas reserves account for 15% of the world's total – placing it second after Russia. It has a good education and health care system with abundant supplies of literate and technically trained personnel. Moreover, its rich culture and history as an ancient civilisation offer unique tourist attractions enhancing its potential as an important gateway between East and West.

In this context, Iranian special zones offer a wide range of attractions to draw new businesses and FDI into the designated areas. Broadly, three sets of advantages on offer:

(a) Streamlined business practices and special legal framework in the zones
(b) Economic incentives and material attraction to entice investment; and
(c) Geographic advantages associated with the choice of location where investment is channelled to.

The most common legal advantages of the zones are to do with streamlined bureaucracy and business friendly rules and regulations adopted (such as labour laws, investment protection, foreign exchange and banking regulations, etc). Examples of these in Iran's FTZs are:

- Joint ventures with no limit on investment and shareholding (100% foreign ownership is allowed)
- Full protection and guarantees offered to foreign investment
- No currency restrictions
- 100% repatriation of capital and profit to other Iranian Free Zones or to other countries
- Sale/lease of lands for Iranians and lease facilities for non-Iranians
- Streamlined bureaucracy including setting up business and company registration
- No entry visa requirement for foreign nationals
- Simplified employment and labour regulations in the zone.

A more detailed discussion of these and a comparison of rules for FTZs and SEZs is offered in Section 4 below.

The main policy incentives on offer in the zones are:

- 15 years' tax exemption for operators within the FTZ (this does not apply to SEZs)
- Duty exemption for raw materials and machinery imported for production and manufacturing in the Zone
- No taxes on re-exports and exported goods from the Zones to the mainland
- Provision of competitive infrastructure facilities and ancillary services.

With increased global competition and the proliferation of free zones around the world, however, special provisions and incentives of this type tend to weaken in a comparative context and lose their comparative edge. As similar packages and facilities become available elsewhere and given that investment is by nature a competitive process, locational and geographic considerations are of critical importance to the ultimate success of free zones.

As mentioned above, Iran's free zones are selected for their location within the country at large but also their links with other regions including neighbouring countries. This is especially true of the FTZs given their expected role in promoting exports.

As we have seen, all six Free Trade Zones have either direct access to Iran's international waterways or have common international borders. For instance, Kish and Qeshm Islands are strategically located in the Persian Gulf. Chahbahar is with direct access to the Sea of Oman and Anzali is on the Caspian Sea. Similarly, the Aras FTZ borders the Caucasus region and Arvand is neighbours to Iraq and Kuwait. Apart from their location, all FTZs have good access to major air, sea and land transportation routes at the local, regional, and international levels. This puts them in proximity to regional markets, which facilitates importation of raw materials and intermediate or manufactured goods and provides easy access to local and neighbouring markets – principally those of the CIS and Central Asia in the North and the Persian Gulf and the GCC states in the South (the so-called North South route). From an East-West perspective too, Iran is on the old Silk Road and various free zones can potentially play a role in this trade in this direction.

The Special Economic Zones are similarly interspersed throughout the country with a consideration for their linkages with major centres of economic activity within Iran or with neighbouring countries. For instance, Payam, Salafchegan, Shiraz, Yazd, Arg-e Jadid (they are near Tehran, Qom, Shiraz, Yazd, Kerman, respectively), and several others are at or near southern ports (Bushehr, Petrochemical SEZ, Bandar Rajaee, Keshti Sazi Khaleej, etc; see Annex B for more detail).

All these zones provide public investment in infrastructure and utilities and services. They boast good availability of skilled and semi- skilled manpower and highlight abundance of energy such as crude oil and natural gas. Several also have appropriate climates and drawing from Iran's fantastic historical heritage, can offer major tourist attractions, too.

Despite these advantages, as we shall see below, attracting FDI into these zones has proven a considerable challenge in the first decade or so since the inception of the free zones.

4. GOVERNANCE AND THE LEGAL FRAMEWORK

4.1 *Governance*

FTZs and SEZs in Iran have markedly different governance structures. Governance matters pertaining to the Free Trade Zones are defined by *"The Law on the Administration of Free Trade-Industrial Zones"*. As we saw above, this law was first passed in 1993 under the auspices of the First Five Year Development Plan and was subsequently amended in 1999. It comprises 28 Articles and 8 Notes, covering all aspects of the operation, management and governance in the zones.[10]

According to this law, all plans for the establishment of new zones and their boundaries will be subject to proposal by the government and have to be ratified by the Islamic Consultative Assembly. Moreover, under powers delegated by the Board of Ministers, each Zone is administered by an Authority organized as a company, with an autonomous legal status, whose capital shall belong to the government.[11] Management is through a Board of Directors, which consists of three to five persons appointed by the Board of Ministers. The Managing Director, who is also *ex officio* chairman of the Board, is appointed by the President from amongst the members of the Board of Directors and is the highest executive authority in the economic affairs and infrastructure in the Zone. Furthermore to facilitate the coordination of the zones' activities, a High Council was established. This Council is chaired by the President and its membership is made up of various Ministers and the Secretary of the High Council of Free Trade–Industrial Zones.[12]

10 Details available from: See http://pw3.freezones.ir/law02.html.

11 "The Authority and its affiliates and subsidiaries shall be exempt from the laws and regulations governing state-owned companies and from other general regulations decreed by the government… these companies shall be subject to the Commercial Code" (Article 5).

12 Membership is as follows: Ministers for Economic Affairs and Finance, Commerce, Interior, Labour and Social Affairs, Industries and Mines, Roads and Transportation, Petroleum, Energy, Housing and Urban development, Culture and Islamic Guidance, the Head of Management and Plan Organization, the Governor of the Central Bank of the Islamic Republic of Iran, head of the Environment Protection Organization and the Secretary of the High Council of Free Trade–Industrial Zones.

The Council in turn has a Secretariat, which is administered by the Secretary, who is appointed by President of the Republic.

Critically, perhaps, the Board of Ministers has under Article 138 of the Constitution, delegated all powers for the management of the zones to the Secretariat. This means that at least in the case of the FTZ, clear guidelines and legal powers exit which stipulate rules and regulations for their operations and management. Article 27 clearly enshrines the executive powers of relevant departments to the chairpersons and managing directors of the Free Zones. This means that both in principle and in practice the heads, chiefs and the acting directors of all government departments in the zone are appointed with the joint recommendation of the Chairperson and Managing Director of the Free Zone and ordinance of the highest official of the relevant government executive department. This is deemed necessary to avoid inconsistencies and conflicts between different departments and the management of the zones.

This is quite different from the operation of the Special Economic Zones, which were set up and are managed under different circumstances. Until 2005, these zones were governed according to Article 25 of the Second Five Year Development Plan (1994-99). In 2005, The Expediency Council intermediated between the Majlis and the Guardian Council to finalise the set of rules for these zones commonly known as *"The Law on the Establishment and Administration of Special Economic Zones in the Islamic Republic of Iran"*. This law comprises 25 Articles and 12 Notes and covers all aspects of the operation, management and governance in the zones.[13]

As we shall see, there are several similarities between these rules and those for the FTZs. However, one of the main differences relates to governance and administration rules. Whereas, the FTZ rules entrust clear executive powers to the High Council for the running and management of the zones, the establishment and operation of SEZs is not subject to a clear cut and universal template. First, Article 3 stipulates that – subject to the approval of the Board of Ministers – the administration of SEZs is open to both state and non-state entities (FTZs can only be administered by state bodies). In fact, the special zones in Sirjan and Arg-e Jadid fall in this category. Second, their administration is decentralised in the sense that (unless in cases where specified), each zone is subject to the constitution and rules pertaining to the (public or non-public) body which is in charge of the zone. In practice, this means executive powers are vested in the authority which in charge (for instance, for the Petrochemical SEZ, that would be with the parent organisation which is National Petrochemicals Company, and so on). In practice, of course this means the multiplicity of decision making bodies in charge and one corollary of this is that for each zone their budget is determined at the local level (i.e. within the resources set by the parent organisation) rather than centrally by the Secretariat Authority.

13 A Farsi version of the Law is available from; http://www.freezones.ir/docs/regulation/ftz4.pdf

4.2 The Legal Framework

The "Law on the Administration of Free Trade-Industrial Zones" mentioned above offers a raft of other business friendly rules and regulations for enterprises operating in the zones. These include full protection and guarantees offered to foreign investment. For instance, joint ventures are allowed with no limit on investment. Thus it possible to set up a wholly owned foreign enterprise in the zones, although in the SEZs, there is a limit to foreign ownership of 49%. Furthermore, in the FTZs:

- There are no currency restrictions
- It is possible to repatriate 100% of capital and profit to other Iranian Free Zones or to other countries
- Non-Iranians can lease land (Iranian can buy and sell or lease of land)
- Setting up business and company registration is streamlined and bureaucracy is simplified
- Foreign nationals do not require to obtain entry visa clearance (entry visas can be obtained at the point of entry)
- There are special employment and labour regulations (more of this below).

There are several *similarities* between the FTZs rules and those governing the special zones. Chief among them:

- Goods produced in both zones are exempt from customs duties when exported to the main land.
- Goods in transit are also exempt from customs duties in both zones.
- Both zones benefit from complete freedom of entry and exit for capital (including foreign capital).
- In both zones, land can only be leased to foreigners (Iranians can buy and/or lease).
- Special labour and employment laws apply in both zones (see below).
- Employing foreign labour is allowed in both zones (subject to a 10% limit of the workforce in the enterprise).

There are, however, a number of *differences* too. The main points being:

- There is a 15-year tax exemption for business in the FTZs. SEZ enterprises are, however, subject to Iran's general tax rules.
- In SEZs, foreign nationals are subject to the same visa entry requirements as in the mainland (there is no such entry visa requirement in FTZs).
- In FTZs, both Iranians and foreign nationals can engage in retail transactions; in SEZs, however, only foreigners are allowed this facility.
- There is no limit for foreign ownership in FTZs; in SEZs, a ceiling of 49% applies for joint ventures.
- Off-Shore banking facilities (including free exchange rates) are available in FTZs; in SEZs, only domestic banking services (including exchange regulations) of state banks apply.

- No retail selling is allowed in SEZs (these are allowed only in Kish, Qeshm and Chahbahar but forbidden in the new FTZs in Arvand, Aras and Anzali).

In general, FTZs have a longer history, are subject to clearer governance and administration rules and structures, and benefit from more business friendly legal and economic environments (see Annex C for more detail).

A good case in point is the employment and labour laws that are applied in the FTZs. The so-called *"Regulations of Employment of Human Resources, Insurance and Social Security in the Free Trade – Industrial Zone"* are generally more flexible and less detailed than Iran's Labour Code which is notoriously more prescriptive, especially with regards to its provision for suspension or termination of employment contract; remuneration; or working conditions for vulnerable groups, such as women and youth.

Table 5 offers a detailed comparison of the FTZ Labour Regulations with the provisions of the Labour Code in Iran. In general, the "Regulations" provide for more flexible work arrangements based on individualised labour contracts, and less generous entitlements, such as annual leave, overtime bonuses, or welfare benefits in the zones compared to the mainland. Moreover, these rules cover vaguely issues such as occupational safety and health; provision of training or employment of foreign citizens; and do not cover issues such as workers' and employers' organizations (but focusing largely on individual labour relationships); collective bargaining and agreements; or workers' welfare services.

Perhaps most characteristically is the FTZs' Labour Regulations' in respect of the flexibility they allow for termination of an employment contract. While such termination is only allowed under six highly specific conditions under the Labour Code (such as resignation, death, total incapacity, retirement, etc.), the Regulations additionally allow for the cancellation of a contract by 'the employer and the employee in cases stipulated in the employment contract in accordance with this decree' (Article 12). In practice, this allows employers to stipulate grounds for termination due to changes in economic, technological and organizational climate as long as these are clearly stipulated in the contract and agreed by the employee. In principle, therefore, the notion of labour market flexibility – judged by hire and fire – is more attainable in the zones than in the mainland. However, in practice, whether the dismissal of a worker is acceptable (if disputed) is subject to the judgment of the Board of Settlement of Disputes.[14]

14 In case it is not judged acceptable, the employer shall have an option of reinstatement of the worker and paying him/her the forgone salary and wages, or paying a compensation of 45 days of salary for each year of his/her service (Article 34). See http://www.freezones.ir/docs/regulation/ftz13.pdf for a Farsi version of the "Regulations of Employment of Human Resources, Insurance and Social Security in the Free Trade – Industrial Zone".

Table 5: Comparison of Iran's Labour Code with the Employment Regulations in the FTZs

Characteristic	Labour Code	Zone Regulations
Fixed term contracts	Allowed but the maximum duration determined by the Ministry of Labour and Social Affairs.	No such limit.
Resolution of labour disputes	Through a tripartite Board of Inquiry.	Through the Board of Settlement of Disputes in relevant Zones.
Termination of employment	Limited to six events: (i) the worker's death: (ii) the worker's retirement; (iii) the worker's total disability; (iv) the expiry of a fixed term contract; (v) the completion of work under a contract concluded for a specified assignment; and (vi) the worker's resignation.	Same list plus an additional conditionality: the cancellation of the employment contract by the employer and the employee in cases stipulated in the employment contract in accordance with the Decree.
Severance payment in case of contract termination	Quite generous (for example, in case of termination on grounds of total disability or retirement, as well as of the completion of a fixed term contract, the worker to be paid an amount equal to the last monthly wage for each year of completed service (and two monthly wages for each year of service if the disability is work related).	Negotiated individually. However, whenever the dismissal of the worker is judged acceptable by the Board of Settlement of Disputes, the Board shall confirm his/her dismissal and shall obligate the employer to pay (15) days of salary to the employee for each year of his/her service (e.g., not more than half of the severance in other parts of the country).
Probationary period	Not more than one month for unskilled and semi-skilled workers, and three months for skilled workers.	Same.
Hours of work	Limited to 8 hours per day but overtime is allowed so that total hours of work should not exceed 44 hours in any week.	Limited to 176 hours in four successive weeks (or 44 hours on average per week) but the parties are free to negotiate the actual working hours per each day or week within the total limits.
Overtime wage premium	40 percent of the standard hourly wage.	Up to the parties to agree on the premium.
Working hours	Daily: 6.00 am – 10 pm Night shift: 10 pm – 6.00 am.	Same.
Annual leave	One month including four Fridays.	A total of 20 days (including Fridays).

Characteristic	Labour Code	Zone Regulations
Minimum wage	Set centrally by the High Labour Council.	Shall not be less than the minimum legal wages in Iran.
Recruitment of foreign citizens	Allowed subject to work permit.	Same, but foreign workers not to exceed 10 percent of total employment population in each zone.
Welfare benefits	Relevant services and certain benefits and bonuses (such as annual bonus to workers) are established centrally.	The Authority of the Free Zone will establish funds independently or jointly with the Social Security Organization and/or insurance companies for relevant benefits and services.
Worker organisations	No independent unions recognised or allowed. However collective labour negotiations and contracts allowed under certain conditions. Moreover, provision for worker organisations in the form of 'Islamic Societies'. The by-laws, functions, powers and mode of operation of these must be formulated by the Ministries of Interior, and Labour and Social Affairs, and the Islamic Propagation Organization, and approved by the Council of Ministers	Workers' and Employers' organisations not covered (focusing largely on individual labour relationships).
General	Far more prescriptive and detailed as far as suspension or termination of employment contract; remuneration; or working conditions for vulnerable groups, such as women and youth.	Only vaguely covers occupational safety and health; provision of training or employment of foreign citizens; and does not cover issues such as collective bargaining and agreements; or workers' welfare services.

Source: Based on World Bank analysis.

5. TRACK RECORD

A full assessment of the net benefit of free zones in general requires a study of their main benefits and costs. It is customary to break down the former into static and dynamic benefits (FIAS, 2006: 17). These are:

Static benefits:

- Direct employment and income creation
- Export growth and diversification
- Foreign exchange earnings
- Foreign direct investment
- Government revenues.

Dynamic benefits:

- Indirect employment creation
- Skills upgrading
- Female employment
- Technology transfer
- 'Demonstration effect' due to application of best practice
- Regional development and regeneration.

In general, it is easier to measure the static benefits, although the dynamic benefits may be much more important in the long term.

On the costs side, we should also take into account the *incremental* financial and economic costs. These consist of:

- Salaries of government employees in the zone authority
- Other operating costs of the authority
- Infrastructure development outlays
- Tax income forgone from the domestic firms relocating from the domestic customs to the zone.

It has been observed that a government's costs associated with the development of the zone are those that are *incremental*, i.e. additional costs not otherwise entailed (and not recovered through service charges and assessments; FIAS, 2006: 17).

Evidence on Iran's FTZs and SEZs is very limited. In the case of the special zones, this is at least partly explained by the fact that they are relatively new creations and therefore their track record is still very limited. Although some of the early Free Trade Zones, as we have seen, have a relatively longer history, in their case too, unfortunately, there is serious paucity of data. Only Kish Free Zone Organisation publishes some (highly) selective quantitative information on certain aspects of the economics operation of the zone.

The analysis that follows is therefore highly selective in respect of some of the above benefits. We first look at some general indicators for Kish, Qeshm and Chahbahar for which there is some data available for the period 1993-2004 followed by a discussion of Kish as a case in point.

Tables 6-8 provide data on three key aspects associated with the static benefits of free zones mentioned above: trade and contribution to exports, FDI and employment creation.

Table 6 shows the total value of imports and exports from these three zones in the first seven years of their establishment (1993-2000) followed by the next four years to 2001. We can see a huge disparity between the zones' imports and exports volumes. During the early years, imports outstripped exports by a staggering imports/exports ratio of 44:1. Although the gap has declined to 10:1 in more recent years, it is clear that the zones have a long way to go to boost exports and foreign exchange earnings. Otherwise, their success will be limited to acting as platforms for meeting Iran's appetite for consumer goods imports rather than as export platforms.

Moreover, there is significant disparity in the experience of these three early zones, too. In the case of Chahbahar, exports are virtually non-existent. In the case of Qeshm Island, it is reported that in 1998, imports amounted to $480 million, whereas its exports earnings were a paltry $1 million only. Moreover, out of the 145 registered companies on the Island, only a handful could be considered as engaged in export business of any sort (Hedayati-Zadeh, 2007). Even if we combine the all exports from Kish and Qeshm Islands, the total falls short of 1% of Iran's non-oil exports altogether ($5.6 billion on average for 2000-04).

Table 6: Imports and Exports – Iran's FTZs, 1993-2004 (million $)

	Kish		**Qeshm**		**Chabahar**		**Total**	
	Imports	**Exports**	**Imports**	**Exports**	**Imports**	**Exports**	**Imports**	**Exports**
1993-2000							**2,494**	**56.9**
2001	136.6	4	247.8	9.5	100	0.06	484.4	13.6
2002	135.2	3	445.3	11.5	102.3	0.3	682.8	14.8
2003	82	4	194.5	114	73.8	0.2	350.3	118.2
2004	68.2	6.3	162.4	40.5	105.3	0.2	335.9	47.0
2001-04	**422**	**17.3**	**1050**	**175.5**	**381.4**	**0.76**	**1,853.4**	**193.6**

Source: Gozaresh-e Amalkard-e Manategh-e Azad (A Report on the Performance of the FTZs), Secretariat of the High Council of The Free Trade-Industrial Zones, Tehran, 1380 and 1383.

Table 7 gives the volumes and trends for domestic and foreign investment in these three zones. It can be seen that despite an increasing trend in recent years, overall foreign investment has remained very modest: amounting to a total of $2.8 billion only in all the three zones combined over more than a decade since their inception (1993-2004). The lion's share has gone to Kish (just under 60%), followed by Qeshm (just under 40%) with only 2% going to Chahbahar. Similarly, domestic investment has risen over these years with Kish accounting for more than four-fifth of all investment (81%), followed by Qeshm (14.3%) giving again a modest performance by Chahbahar (less than 5%).

Table 4: Domestic and Foreign Investment in Iran FTZs, 1993-2004

	Kish		Qeshm		Chahbahar				Total
	Foreign	Domestic	Foreign	Domestic	Foreign	Domestic		Foreign	Domestic
	(m $)	(Bn Rls)	(m $)	(Bn Rls)	(m $)	(Bn Rls)		(m $)	(Bn Rls)
1993		4.31		116.5				0	120.8
1994		26	0.33	109.6				0.3	135.6
1995		116	2.6	83.2		5.1		2.6	204.3
1996	29.3	305	43.75	57		68.7		73.1	430.7
1997	130	335	61.7	183.6		75.97		191.7	594.6
1998	118	172	100	276.6		134		218	582.6
1999	120	253	142	330.6	1	114		263	697.6
2000	115	312	125	478.75	1	10.7		241	801.5
2001	218	2553	160	585	0.3	5		378.3	3143.0
2002	315	3398	143	600	1.2	4		459.2	4002.0
2003	302	7649	217	649	1.2	109		520.2	8407.0
2004	300	8296	100	670	53.5	838		453.5	9804.0
Total	1647.3	23419.31	1095.38	4139.85	58.2	1364.47		2,800.9	28,923.6
(% of Total)	58.8	81.0	39.1	14.3	2.1	4.7		100	100

Source: 'Gozaresh-e Amalkard-e Manategh-e Azad' (A Report on the Performance of the FTZs), Secretariat of the High Council of the Free Trade-Industrial Zones, Tehran, 1380 and 1383.

Table 8: Annual Employment in Iran's FTZs, 1993-2001, ('000 persons)

	Kish		Qeshm		Chahbahar			Total	
		% Change		% Change		% Change			% Change
1993	1.2		1					2.2	
1994	3	150%	5.4	440%	0.5			8.9	305%
1995	5	67%	7.7	43%	1.7	240%		14.4	62%
1996	7.4	48%	14.2	84%	3	76%		24.6	71%
1997	7.6	3%	18.8	32%	4.5	50%		30.9	26%
1998	8.7	14%	21	12%	5.5	22%		35.2	14%
1999	9.1	5%	22	5%	7	27%		38.1	8%
2000	9.4	3%	24	9%	8	14%		41.4	9%
2001	10.5	12%	26.5	10%	8.5	6%		45.5	10%

Source: 'Gozaresh-e Amalkard-e Manategh-e Azad' (A Report on the Performance of the FTZs), Secretariat of the High Council of the Free Trade-Industrial Zones, Tehran, 1380 and 1383.

Table 8 sheds light on employment creation in these three zones during their first nine years of operation (1993-2001). It can be seen that starting from very low bases, all three zones have experienced rapid growth in employment with Qeshm accounting for the largest workforce (reflecting the size of the Island). However, in absolute terms, the contribution of any one zone, or their combined effect, is very modest.

Table 9 shows private sector companies operating in this zone as of March 2008 by type of activity and number of employees. It can be seen that total employment amounts to a 1,144 employees only. Most are concentrated in small scale consumer goods industries with an average employment size of fewer than 25 persons.

Table 9: Private Sector Employment in Chahbahar (as of March 2008)

Electrical and Electronic	95
Office Equipment and Computing	65
Health & hygiene	28
Pharmaceutical	44
Textiles	15
Packaging	229
Chemicals	13
Non-metallic minerals	32
Sugar and confectionary	247
Transport equipment	286
Home appliances	15
Pulp & paper	5
Agriculture	70
Total (persons)	**1,144**
Average size	**24.3**

Source: Chahbahar Free Zone,
http://www.cfzo.com/index.php?parent_id=71&sub_id=71

As stated above, unfortunately data limitations mean a more detailed assessment of the zones' track record is not possible at this stage. However, in the rest of this section we explore selective aspects of the development of the Kish Island for which there is relatively more data and information.

Table 10 shows the demographic growth and expansion of the Island in the last half century since Iran's first census was conducted in 1956. It is clear that despite a quick growth spurt in the oil-boom days of the mid-1970s, the Island's population remained small throughout the 1980s. It was not until after it was officially established as a free zone in the mid-1990s that its population began to increase. According to Iran's latest census, there were some 20,000 inhabitants in the island in 2006 (up from nearly 3,000 in 1986). This indicates that over the past decade, both population and the number of families living on the Island have trebled. Furthermore, the gender composition of the population is highly skewed with a 60:40 ratio males: females. This indicates the presence of a sizeable number of single, male internal migrants who are attracted to the zone in search of jobs (Table 10).

Table 10: The Population of Kish Island by Gender and No of Families (1956-2006)

Date	Population			No of families
	Men	Women	Total	
Nov 1956	377	383	760	*
Nov 1966	457	428	885	*
Nov 1976	3,916	1,676	5,592	*
Oct 1986	1,473	1,358	2,858	*
Oct 1996	5,148	2,274	7,422	1,818
Nov 1997	9,688	2,959	12,647	2,953
Dec 1998	11,087	4,139	15,226	3,883
March 2000	11,133	5,368	16,501	4,454
March 2004	13,767	7,998	21,765	6,316
2006	12,381	8,541	20,922	6,168

Source: Kish Free Zone Organisation, **http://www.kish.ir/HomePage.aspx?TabID=4489&Site=DouranPortal&Lang=en-US**

Table 11: Air Passengers - Kish Island, 1998-2006

Total No of Passengers (Arrivals and Departures)					
Year	**Internal**	**External**	**Total**	**% Change**	**% External**
1998	1,227,307	60,162	1,287,469		4.7
1999	1,089,182	81,340	1,170,522	-9.1	6.9
2000	1,106,059	100,466	1,206,525	3.1	8.3
2001	1,102,422	127,910	1,230,341	2.0	10.4
2002	1,027,561	164,369	1,191,930	-3.1	13.8
2003	1,094,084	174,904	1,268,988	6.5	13.8
2004	1,117,926	229,847	1,347,773	6.2	17.1
2005	1,273,048	338,513	1,611,561	19.6	21.0
2006	1,500,304	480,984	1,981,288	22.9	24.3

Source: Kish Free Zone Organisation, http://www.kish.ir/HomePage.aspx?TabID=4726&Site=DouranPortal&Lang=en-US

Table 11 reflects the growing importance of Kish as an emerging centre for domestic trade and tourism. Data on air passengers travelling into and out of Kish are provided since 1998 both for domestic and external passengers. It can be seen that the Island has recorded steady growth with the number of external passengers especially on the rise. By 2006, a quarter of all air passenger traffic was attributable to these (up from about 5% in 1998). Furthermore, a study of the origins and destination of passengers in 2006 shows that about two-thirds of all domestic passengers were attributed to Tehran (68%), followed by Shiraz, Isfahan and Mashad (each with 7-9% each). For external passengers, Dubai was in a commanding position with 80% of all, followed by Sharjah (18%) and Abu Dhabi (2%). The growing volume of air passengers from the UAE indicates of course bristling business with the neighbouring UAE but also a growing number of Iranians living and working in these Gulf emirates who maintain business and family ties with those living on the opposite side of the Gulf.

6. CHALLENGES

As we have seen, for over a decade and a half now, Iran's free zones have sought to act as special havens for attracting capital investment and spearheading Iran's quest for economic diversification. Offering economic incentives and facilities – from infrastructure to special rules and a legal framework – the zones have aimed to entice domestic and foreign investors to create jobs and to promote Iran's non-oil exports. This has been in marked contrast to the approach in the mainland where the economy has continued to follow policies along an inward-looking, state-led track.

Yet, the experience of free trade zones around the world indicates that the hallmark of success lies in their ability to exploit geographic and locational advantages with business friendly environments to attract and promote inward investment. The latter in turn requires provision of economic incentives, a clear legal framework, streamlined bureaucracy and necessary infrastructure.

Two factors, however, hamper an evaluation of the performance and impact of Iran's zones: the relatively recent history of many of them, and paucity of information for others, which do have a longer history.

Some of the stated aims of the zones are clearly for the longer term and it is premature to assess these only on the basis of a few years' track record. This is especially true of the SEZs and the three more recent FTZs (Anzali, Arvand and Aras). However, the little data that is available for the earlier FTZs (Kish, Qeshm and Chahbahar) indicate limited ability to attract FDI, to promote exports and to contribute to job creation (see Section 6 above).

Challenges facing Iran's free zones so far can be broadly attributed to two sets of factors: those emanating from the design and operation of the zones themselves, and those relating to the broader macro picture, namely economic policies and the general business climate in the mainland, and growing regional competition. Below, we consider these briefly.

Among micro level challenges – i.e. those relating to the zones themselves – are: lack of sufficient focus on and clarity of objectives, governance matters, and resourcing issues.

As we have seen, even Kish Island, which is probably the most successful of Iran's FTZs, has strayed away from its original objectives of export promotion and jobs expansion as it came to emerge into more of a centre for domestic trade and tourism rather than as an export platform. One important reason behind this was early customs rules that – in a bid to draw in visitors and to increase the zone's attractiveness for business and commerce – allowed domestic travellers to the zones to take back (import) goods with them onshore according to Iran's general customs and excise regulations (these were treated as imports from abroad). Given that Iran had just emerged from the consumer goods 'hunger' of the war years in the late 1980s, and the higher costs of travelling abroad, the rule gave Kish an edge in its appeal to Iranian travellers keen to exploit commercial opportunities for purchasing foreign goods at competitive prices. Thus the Island encouraged mass tourism and trade, and was developed as a major conduit for imports of consumer goods. This practice was, however, contrary to the original spirit of setting up FTZs as *export* platforms and was subsequently banned in 2003 when three new zones were set up (see Section 1 above).

This example highlights the fact that although the choice of location for Iran's FTZs reflected their potential geographic value in terms of access to, and links with, larger markets beyond Iran's borders (CIS to the north and GCC in the south), they have some way to go to fully exploit their geographic advantages for promoting exports.

There is no doubt that there has been some learning from the experience of the early zones too. In the case of more recent SEZs, for instance, they are spread out more widely throughout the country and with a view to their value in proximity to mainly domestic centres of growth and business. Moreover, their operations and management follow a more modern approach of allowing non-state entities to set up and administer new zones in designated areas. Despite this flexibility, the proliferation of such bodies can be confusing in practice and may indicate lack of a uniform approach to management and governance matters. In practice, in fact, there can be as many zone authorities as zones themselves with each Ministry or organisation in charge setting, and following, its own objectives and priorities.

There are also resource implications. From a budgetary point of view, for instance, SEZs are subject to the budgetary considerations of their parent organisations or the authority which is in charge. Their own ability to raise revenue is limited to the sale of land and allocated budgets from those organisations. This can be a limiting factor during early development phases when the growth and expansion of infrastructure may necessitate a more strategic view of their development and a tighter timeline than may be feasible within the broader organisation they form part of.

It would be wrong to ascribe all of the challenges faced by the zones to their design and operation matters only as the wider macro context in which they are situated in is also critical to their ability to attract inward investment and to their ultimate success. This requires an examination of their relationship with the mainland and an understanding of how competitive international business perceives the business climate more widely. This may be indeed where Iran's most serious challenges may lie.

Despite Iran's undoubtedly promising potential as a major regional economy (see Section 3 above), its actual ability, or inclination, to attract inward foreign investment has been curtailed by two sets of factors in recent years – both working against the spirit with which free zones have been set up.

It is broadly agreed that most successful zones capitalise on their links with the mainland (Madani, 1999). This is, for instance, the case of successful free zones in China, Mauritius and the Philippines. On the contrary, in Iran free zones and mainland policies are mainly decoupled and pulling in different directions. Despite best efforts in the zones, therefore, their ability to attract investment is bound to be limited by adverse external perceptions of Iran as an investment destination and internal imperatives dispelling such investment.

First and foremost, with the state dominating key aspects of the economy and bureaucracy and red tape affecting most aspects of public life, the economic climate has been far less than business friendly for most of the period since 1979. Moreover, Iran has pursued a largely isolationist course in the international economic arena which has proven inimical to foreign private investment. This has resulted in an overall weak investment climate in which Iranian and foreign investors alike have been wary of engaging in long term productive investment.

Unfavourable domestic economic policies and business environment have been further aggravated by Iran's fraught international relations, which have meant the flow of FDI into Iran has been more of an uphill struggle during most of this period. Even before the recent nuclear stand off with the West, which has led to targeted sanctions against Iran's international interests, the US unilateral sanctions have, for over a decade since 1996, deterred foreign investors away from Iran. Although ostensibly levied against US companies and applicable to investments exceeding $40 million in Iran's energy sector, this has undoubtedly raised the bar for international investors in general who have shied away from entering the Iranian markets in any significant way.

Reflecting Iran's general difficulties with FDI, the free zones' task of appealing to foreign investors too has been challenging from the start. For instance, the government's pro-business policies in the zones risk lacking credibility given the glaring contradictions with policies in the mainland, which are beset by institutional ambiguities and are perceived as unwelcoming to foreign interests. The potential for flaring political and military conflict – even though lurching in the background – can further affect adversely the investment risk profile and pose an implicit cost in such investment decisions.

This is reflected in Iran's business rankings worldwide which tells a generally unfavourable story overall. Table 12 gives the results of such rankings for 183 countries based on 11 categories of business-related issues. It can be seen that Iran ranks 137 overall – well below its regional peers of Saudi Arabia (13), Bahrain (20), UAE (33), Qatar (39), Oman (65), Turkey (73), and Egypt (106), and not far from the West Bank and Gaza (139).

Table 12: Iran's International Business Rankings, 2010

Rank	**Doing Business June 2008-May 2009**
Ease of Doing Business	137
Starting a Business	48
Dealing with Licences	141
Employing Workers	137
Registering Property	153
Getting Credit	113
Protecting Investors	165
Paying Taxes	117
Trading Across Borders	134
Enforcing Contracts	53
Closing a Business	109

Source: *Doing Business, Iran* (2010).

Moreover, in seven of the 11 categories, Iran ranks in the bottom 40-50 (ease of doing business, dealing with licenses, employing workers, registering property, protecting investors, trading across borders, and closing a business). Only in two such aspects (starting a business, and enforcing contracts) does it make it into the top median.

This point highlights the competitive nature of international business and especially growing competition within the region that Iran will no doubt continue to face in increasing measure. The success of smaller, resource-rich Gulf states (such as Dubai) with a clearly established lead no doubt raises the bar for late followers such as Iran and its emulating experience in the Kish Island.

Overall, the growing importance of other regional economic powers such as Saudi Arabia, with a determination to initiate economic reforms and set up mega economic cities in recent years, as well as countries such as Turkey, with links to Europe and a longer track record of interaction with the international economy, pose tough competition for Iran.

Unless Iran's mainland policies in relation to FDI and general economic reform can be streamlined and brought into line with those it aims to promote in the free zones, the latter's ability to succeed will be curtailed and the next decade too will be as much of an uphill struggle as the first one has already proven to be.

Annex A: Iran's Free Trade-Industrial Zones

	Area	Location in Iran	International Proximity	Managing Director	Phone	Fax	Website	Email
1 Kish	91 sq km	Persian Gulf	GCC states and Gulf waterways	Majid Shayesteh	+98 764 4222841	+98 764 422581	http://kish.ir/HomePage.aspx?TabID=0&Site=DouranPortal&Lang=en-US	info@kish.ir
2 Qeshm	480 sq km	Strait of Hormuz	GCC states and Gulf waterways	Mohammad Asghari	+98 763 5227007	+98 763 5225595	http://www.qeshm.ir/?Lang=en&Page=00	info@qeshm.ir
3 Chahbahar	140 ha	Southeast	GCC states and Oman Sea	Mohammad Reza Bagherizadeh	+98 545 4442237	+98 545 444 2229	www.cfzo.com	director@cfzo.com
4 Arvand	173 sq km	Southwest	Iraq & Kuwait	Ramazan Ahmadi	+98 631 333 4017	+98 631 333 1120	http://arvandfreezone.ir/HomePage.aspx?TabID=0&Site=DouranPortal&Lang=en-US	info@arvandfreezone.ir
5 Aras	97 sq ha	Northwest	Azerbaijan, Armenia, Nakhchivan	Abbas Ranjbar	+98 492 302 4949	+98 492 302 4766	www.arasfz.ir	info@arasfz.ir
6 Anzali	3200 ha	North (Caspian Sea)	Central Asian states, Caucasus and east Europe	Kamal Firouzabadi	+98 132 4423004	+98 132 4423006	http://www.anzali-fz.org/	firouzabadi@anzali-fz.org

Source: Iran's Free Trade-Industrial Secretariat website, http://www.freezones.ir/

Annex B: Iran's Special Economic Zones

SEZ (Year established)	Area	Location in Iran	International Links	Special Theme	Phone	Fax	Website
1 Sirjan (1991)	1380 ha.	North of city of Sirjan	300 km North of Bandar Abbas	Multi-purpose	+98 (0) 345 347 3000	+98 (0) 345 347 2222	www.sirjan.org
2 Salafchegan (1997)	2000 Acres	Near Qom (185 km from Tehran)	No direct link	Multi-purpose	+98 (0) 252 367 7001-5	+98 (0) 252 367 7011	www.qssez.com
3 Sarakhs (1996)	5200 ha	Northeast (165 km from Mashad)	Turkmenistan	Multi-purpose	+98 (0) 51 1761 5065	+98 (0) 51 1761 5067	www.sarakhsfz.org
4 Petrochemical Special Economic Zone	2000 ha	Southwest, (Mahshar a district of Bandar Khomeini)	Persian Gulf shores	Petro-chemical	+98 21 881 0851-4	+98 21 881 0857	www.nipc.net http://arvandfreezone.ir/HomePage.aspx?TabID=0&Site=DouranPortal&Lang=en-US
5 Bandar Bushehr	9700 ha	Southwest (Bushehr port)	Persian Gulf shores	Shipping and Port facilities	+98 771 2522051-7	+98 771 2522051-7	http://www.pso.ir/Portal/HomePage.aspx?TabID=0&Site=Bushehr&Lang=en-US
6 Arg-e Jadid (1997)	1100 ha	10 km from Bam	No direct link	Multi-purpose	+98 (0) 346 346 2291-5	+98 (0) 346 346 2944	http://www.argejadid.ir/index.php?id=-1

7 Iran Shipbuilding & Offshore Industries Complex CO (1999)	2000 ha	South (near Bandar Abbass)	Persian Gulf shores	Energy intensive mining industries	+98 (0) 763 2223208	+98 (0) 763 2223220	www.isoico.com
8 Shaheed Rajaee Port (1999)	20 sq km	South	Persian Gulf shores	Shipping	+98 (0) 761 5564025	+98 (0) 761 5564063	http://www.shahidrajaeeport.ir
9 Bushehr (1998)	10,000 ha	South	Persian Gulf shores	Energy (gas, oil and petrochemicals)	+98 (0) 771 5551611	+98 (0) 761 3549894	www.bushehrfz.org
10 Shiraz (2000)	300 ha	Central (near Shiraz)	-	Electrical and electronic	+98 (0) 3 227 3821	+98 (0) 3 227 3826	http://www.seez.ir/indexEN.aspx
11 AmirAbad Port (1997)	60 ha	North (Mazandaran)	North-South (Sari-Bandar Abbas	Port and shipping services	+98 (0) 152 546 2001	+98 (0) 152 546 2006	http://www.pso.ir/Portal/HomePage.aspx?TabID=3838&Site=Amirabad&Lang=en-US
12 Payam (1992)	3600 ha	50 km west of Tehran	-	Air cargo, postal transportation, storage and time sensitive goods	+98 (0) 21 886 8018	+98 (0)21 886 4900	ww.payamaviation.com
13 Yazd Textile SEZ (2000)	570 ha	Central Iran	-	Textile	+98 (0) 351 623 9701-4	+98 (0) 351 623 9700	www.yazdtsez.com

14 Keshti Sazi Khaleej Fars				Shipbuilding	+98 (0) 21 880 89901	+98 (0) 21 880 85511	www.isoico.com
15 Lorestan	71 ha	Western Iran	-	Stones and quarry	+98 (0661) 322 9007	+98 (0661) 320 7758	www.lorestaniec.com

Source: Iran’s Free Trade-Industrial Secretariat website, http://www.freezones.ir/

Annex C: Comparison of Rules & Regulations in FTZs and SEZs

	Description	FTZ	SEZ
Similarities			
1	Import of goods from abroad into the Zone to be sold in the zone or re-exported abroad, but not re-imported to the mainland	Free from all kinds of taxes and duties, but local levies and fees are collected according to the services rendered by the executive departments.	Same.
2	Re-exporting imported goods to the zone	Free from all kinds of taxes and duties.	Same.
3	Warehousing in the Zone	Available with no grace period for clearance of goods	Same.
4	Unloading, loading, transit and Transhipment of merchandises abroad	Free from all kinds of taxes and duties, only warehousing and local charges shall be collected.	Free from all kinds of taxes and duties, only warehousing and local charges shall be collected.
5	Certificate of Origin	Issued by the Zone Authority for the goods to be re-exported partially, and or for value-added in the Zone.	Issued by the S.E. Zone Authority for the goods to be re-exported partially, and or for value-added in the Zone.
6	Utilization of land and natural reserves	Land is sold and/or leased to the Iranian nationals, but only leased to the foreigners.	Land is sold and/or leased to the Iranian nationals, but only leased to the foreigners.
7	Protection of foreign capital investment	Accepted, protected and guaranteed.	Accepted, protected and guaranteed.
8	Social security, social insurance	The mainland social security regulations enforced.	The mainland social security regulations enforced.
9	Labour law, labour and industrial relations	Subject to the regulations enforced in the Free Zones.	Subject to the regulations enforced in the Free Zones.

	Description	FTZ	SEZ
10	Employment of foreign personnel	Up to the 10 % of the workforce employed in the enterprise.	Up to the 10 % of the workforce employed in the enterprise.
Differences			
1	Entry to the Zones	No entry visa needed for the Zones (visa issued at the point of entry)	Subject to the law concerning alien's entrance into the mainland.
2	Registration of a company	Application must be submitted to the Free Zone authority.	Application must be submitted to the S.E.Z. Authority.
3	Foreign ownership	Up to 100% of foreign capital investment.	Up to 49% of foreign capital investment (subject to the law and regulations on foreign capital investment enforced in the mainland).
4	Foreign Exchange rates	Free market exchange rates in the Zone.	Domestic banking exchange rates in the mainland.
5	Certificate of Origin	Issued by the Zone Authority for the goods to be re-exported partially, and or for value-added in the Zone.	Issued by the S.E. Zone Authority for the goods to be re-exported partially, and or for value-added in the Zone.
6	Retail selling	Allowed, except in the Arvand, Aras and Anzali Free Zones.	Not allowed at all.
7	Offshore banking services and operations by private sector	Available in the free zones.	Only domestic banking services operation by the state banks.
8	Guaranteeing of foreign investments against nationalization and confiscation	Shall be guaranteed by the Zone Authority, or the government, and approved by the Board of Ministers (depending on the sums involved).	Subject to the "Law on the attraction and protection of foreign investments".

Source: Based on information provided by the FTZ Authority; see website: http://pw3.freezones.ir/law00.html

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