

ORIGINAL ARTICLE

# The Pervasive Problem of Special Economic Zones for International Economic Law: Tax, Investment, and Trade Issues

Julien Chaisse<sup>1\*</sup>  and Xueliang Ji<sup>2\*\*</sup> 

<sup>1</sup>School of Law, City University of Hong Kong and Hong Kong Commercial and Maritime Law Centre and <sup>2</sup>Faculty of Law, Chinese University of Hong Kong and Asian Academy of International Law

\*Email: [julien.chaisse@cityu.edu.hk](mailto:julien.chaisse@cityu.edu.hk)

\*\*Email: [xueliang.ji@link.cuhk.edu.hk](mailto:xueliang.ji@link.cuhk.edu.hk)

(Received 15 May 2019; revised 22 October 2019; accepted 31 December 2019; first published online 29 May 2020)

## Abstract

Special Economic Zones (SEZs) have been a huge success and brought a great number of benefits to the whole world. With different kinds of incentives, SEZs have created favorable conditions in order to attract foreign investors. In this article, several specific issues are considered. First, whether SEZs are legal under international economic law (IEL). Second, what kind of specific issues they raise under IEL. Thirdly, what measures governments can take in order not to be challenged. The first section illustrates the definition of SEZs and their rapid development; the second section will consider the interaction between SEZs and international tax law, especially the base erosion and profit shifting (BEPS) Action 5; the third section focuses on the relationship between SEZs and investment agreements and the disputes raised as a consequence; the fourth section will talk about SEZs and the World Trade Organization (WTO), as some incentives used by SEZs may not be compatible with WTO regulations. The article shows that SEZs can be harmful. For one thing, tax incentives applied in SEZs may lead to tax evasion, and the competitive circumstances between states may be changed. For another thing, the frequent changes of policies in SEZs may result in indirect expropriation, and investor-state arbitration under investment treaties can be used by foreign investors to protect their SEZ-related benefits. In addition, although WTO rules do not explicitly regulate SEZs, a number of measures, such as subsidies, do fall under the ambit of WTO rules, and these measures cannot be discriminatory.

**Keywords:** SEZs; taxation; BEPS; BITs; expropriation; WTO; SCM Agreement; subsidies

## 1. Introduction

Special economic zones (SEZ) are specific areas within a nation with special treatment, generally in terms of customs, business law, and taxation. The free zone at Shannon Airport in Ireland, announced in 1959, was one of the first modern SEZs,<sup>1</sup> while in 2018, President Xi announced that Hainan province would be developed into a pilot free trade zone, making it one of the most major new SEZs.<sup>2</sup> There are many SEZs throughout the world. In fact, a comprehensive survey conducted by the World Bank (WB) in 2008 found out that ‘there are approximately 3,000 zones in 135 countries today, accounting for over 68 million direct jobs and over \$500 billion in direct trade-related value added within zones’.<sup>3</sup> In the last decade, the number of SEZs has

<sup>1</sup>Lotta Moberg, ‘The Political Economy of Special Economic Zones: Lessons for the United States’, *Chapman Law Review* 21 (2018): 408.

<sup>2</sup>China Plans to Build Hainan into Pilot Free Trade Zone’, *Xinhua Silk Road* (2018) 1, <http://big5.xinhuanet.com/gate/big5/m.silkroad.news.cn/article/51110> 1.

<sup>3</sup>World Bank, *Special Economic Zones: Performance, Lessons Learned, and Implications for Zone Development* (Washington, DC: World Bank Group, 2008).

rapidly further increased to more than 4,300 in 2017, making SEZs a defining feature of many countries' trade and investment policies.<sup>4</sup>

Despite being widespread and virtually always established through a 'top-down' method by the central government,<sup>5</sup> SEZs represent a complex regulatory phenomenon. In this respect, SEZs have different sizes, ranging from single factories to large cities.<sup>6</sup> Free ports, which can include entire economic regions, are the largest type of SEZ.<sup>7</sup> In sharp contrast, single factory zones, whose office buildings may be just one floor, are the smallest SEZs.<sup>8</sup> Moreover, Free Trade Zones (FTZs), where certain goods can enjoy tax exemptions, lie outside the host state's customs territory.<sup>9</sup>

Although SEZs are known to many and different jurisdictions, their legal definition remains a challenge. The geographic areas in which governments use different policy tools to attract foreign investment, such as tax holidays and other incentives aside from those generally available in the rest of the country, are generally treated as SEZs.<sup>10</sup> In fact, there is no single official definition.<sup>11</sup> In this respect, it is preferable to opt for a rather broad approach and use a frequent definition which presents SEZs as 'geographically delimited areas, frequently physically secured, that are usually, but not always, outside the customs territory of the host country'.<sup>12</sup> Different variations of concepts, including 'free trade zones, free ports, foreign trade zones, export processing zones (EPZ), free export zones, trade and economic cooperation zones, economic processing zones, and free zones' should all be included in the term SEZ.<sup>13</sup> These different terms are merely based on the type of zone and the country that they are located in.<sup>14</sup> For example, in developing countries, SEZs producing mainly for export are called (and marketed as) export-processing zones but they fundamentally remain SEZs.<sup>15</sup>

Countries establish SEZs with a variety of objectives and functions in mind. Among these aims, developing the economy of a specific region is the most common one.<sup>16</sup> While SEZs are

<sup>4</sup>World Bank Group, *Special Economic Zones: An Operational Review of Their Impacts* (Washington, DC 2017), <https://openknowledge.worldbank.org/handle/10986/29054> (accessed 13 February 2019).

<sup>5</sup>Douglas Zhihua Zeng, 'How Do Special Economic Zones and Industrial Clusters Drive China's Rapid Development?', World Bank Policy Research Working Paper No. 5583 (2016), 6.

<sup>6</sup>Stephen Creskoff and Peter Walkenhorst, 'Implications of WTO Disciplines for Special Economic Zones in Developing Countries', World Bank Policy Research Working Paper (2009), 7, <https://elibrary.worldbank.org/doi/abs/10.1596/1813-9450-4892>.

<sup>7</sup>UNIDO, *Industrial Development Report 2009: Breaking in and Moving in – New Industrial Challenges for the Bottom Billion and the Middle-Income Countries* (Vienna: United Nations Industrial Development Organization, 2009), 72.

<sup>8</sup>Gokhan Akinci and James Crittle, 'Special Economic Zones: Performance, Lessons Learned, and Implications for Zone Development', World Bank Foreign Investment Advisory Service, Working Paper No. 45869 (2008), 32.

<sup>9</sup>Sean Woolfrey, *Special Economic Zones and Regional Integration in Africa* (Trade Law Center, 2013), 3. For instance, in Pakistan, SEZs are within the customs territory based on major amendment of the SEZ Act. See 'FBR Agrees to Place SEZ within Customs Territory of Country', *Business Recorder*, 2014, <http://fp.brecorder.com/2014/12/201412021247573/> (accessed 13 February 2019).

<sup>10</sup>Connie Carter and Andrew Harding, *Special Economic Zones in Asian Market Economies* (Routledge, 2010).

<sup>11</sup>Teresa Cheng, 'Special Economic Zones: A Catalyst for International Trade and Investment in Unsettling Times?', *Journal of World Investment and Trade* 20 (2019): 34.

<sup>12</sup>Creskoff and Walkenhorst, 'Implications of WTO Disciplines'. See e.g. The *Special Economic Zones Act* ('SEZ Act') of Maldives, which provides for the designation, creation, and management of certain free zones in the Maldives to be known as 'special economic zones', *SEZ Acts* 1(a).

<sup>13</sup>Ame Rebecca Chimbombi, 'The Possibility of Base Erosion and Profit Shifting through Special Economic Zones: A Critique of the South African and Kenyan SEZ Regimes based on BEPS Action 5' (Doctoral dissertation, University of Cape Town, 2016).

<sup>14</sup>Stephen Creskoff and Peter Walkenhorst, 'Implications of WTO Disciplines for Special Economic Zones in Developing Countries', World Bank Policy Research Working Paper No. 4892 (Washington, DC, 2009), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1410477](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1410477) (accessed 13 February 2019).

<sup>15</sup>Ibid.

<sup>16</sup>Julien Chaisse and Jiaxiang Hu, 'International Economic Law and the Challenges of Economic Zones: An Introduction', in *International Economic Law and the Challenges of the Free Zones – Global Regulatory Issues and Trends*, eds., Julien Chaisse and Jiaxiang Hu (The Hague: Kluwer Law International, Global Trade Law Series, 2019), 2.

often used to attract foreign investment, fiscal policies and tax incentives are also targeted at domestic investors, and domestic suppliers are welcome in the SEZs.<sup>17</sup> Developing countries can utilize certain territories to test reforms' efficiency.<sup>18</sup> In other words, SEZs often function as 'regulatory sandboxes'.<sup>19</sup> For instance, China created SEZs to experiment with new economic policies and attract investment starting in the late 1970s.<sup>20</sup> Like with FTZs, China has tested ways to improve its trade and investment regulations before attempting to deploy such regulations at a larger scale.<sup>21</sup> Vietnam has learned from China and has extensively used SEZs to introduce new economic policies to attract investment.<sup>22</sup> India has made export processing zones a feature of its policy since the 1960s.<sup>23</sup> Poland utilizes SEZs to attract mostly manufacturing enterprises.<sup>24</sup> SEZs are also utilized by developed countries.<sup>25</sup> In 2008, the US had 257 FTZ areas,<sup>26</sup> and from 2001 to 2006, hundreds of SEZs were also established in Japan.<sup>27</sup> In the UK, local governments have established enterprise zones to support small and medium-sized enterprises (SMEs) with some discounts on local property taxes.<sup>28</sup>

The World Bank treats SEZs as an advanced policy tool.<sup>29</sup> First, tariff and non-tariff barriers still persist in a great number of states.<sup>30</sup> Exporters from developing countries have to compete with those whose business enjoys duty-free and tax-free treatment. Second, besides tariff barriers, there are some other obstacles affecting exports. Exporters face many kinds of distortions, such as procedural inefficiencies, which may be resolved only over a long period. As such, SEZs can be extremely useful, as a simplified regulatory environment promoting investment and exports.<sup>31</sup>

<sup>17</sup>Foreign Investment Advisory Service (FIAS), *Special Economic Zones: Performance, Lessons Learned, and Implications for Zone Development* (Washington, DC: World Bank, 2008), <http://documents.worldbank.org/curated/en/343901468330977533/pdf/458690WP0Box331s0April200801PUBLIC1.pdf> (accessed 13 February 2019).

<sup>18</sup>Michael R. Castle Miller, 'The Ciudades Modelo Project: Testing the Legality of Paul Romer's Charter Cities Concept by Analyzing the Constitutionality of the Honduran Zones for Employment and Economic Development', *Willamette Journal of International Law and Dispute Resolution* 22 (2014): 273.

<sup>19</sup>Lotta Moberg, *The Political Economy of Special Economic Zones: Concentrating Economic Development* (Routledge, 2017), 126.

<sup>20</sup>Guangwen Meng, 'The Theory and Practice of Free Economic Zones: A Case Study of Tianjin, People's Republic of China' (doctoral thesis, Ruprecht-Karls University of Heidelberg, Germany, 2003); Edward Graham, *Do Export Processing Zones Attract FDI and its Benefits? The Experience from China, International Economics and Economic Policy* (Springer-Verlag, 2004).

<sup>21</sup>Jie Huang, 'Challenges and Solutions for the China-US BIT Negotiations: Insights from the Recent Developments of FTZs in China', *Journal of International Economic Law* 18 (2015): 308.

<sup>22</sup>Creskoof and Walkenhorst, 'Implications of WTO Disciplines', 8; Arisara Romyen et al., 'Assessing Regional Economic Performance in the Southern Thailand Special Economic Zone Using a Vine-COPAR Model', *Economies* 7 (2019): 1.

<sup>23</sup>Kasturi Bhagat, 'Implementation of Labor Laws Inside SEZs in India: A Perfect Example of Economic Development versus Social Security', *The IUP Law Review* 5 (2015): 32.

<sup>24</sup>Piotr Cizkowicz et al., 'The Effects of Special Economic Zones on Employment and Investment: Spatial Panel Modelling Perspective', National Bank of Poland Working Paper No. 208 (2016), 14.

<sup>25</sup>Marc Proksch, 'Success Factors and Required Policies for SEZs', in *International Economic Law and the Challenges of the Free Zones – Global Regulatory Issues and Trends*, eds., Julien Chaisse and Jiaxiang Hu (The Hague: Kluwer Law International, Global Trade Law Series, 2019), 17; Susanne A. Frick et al., 'Toward Economically Dynamic Special Economic Zones in Emerging Countries', *Economic Geography* 95 (2019): 3.

<sup>26</sup>Thomas Farole, *Special Economic Zones: Performance, Lessons Learned, and Implications for Zone Development* (The World Bank, Washington DC, 2008).

<sup>27</sup>Jürgen Basedow, 'Boosting the Economy – Special Economic Zone or Nationwide Deregulation?', Max Planck Private Law Research Paper 17/3 (2016), 4.

<sup>28</sup>UNCTAD, *World Investment Report 2019: Special Economic Zones* (2019), 135.

<sup>29</sup>Carter and Harding, *Special Economic Zones*.

<sup>30</sup>World Bank, *Special Economic Zones*.

<sup>31</sup>Stephen Kim Park, 'Special Economic Zones and the Perpetual Pluralism of Global Trade and Labor Migration', in *International Economic Law and the Challenges of the Free Zones – Global Regulatory Issues and Trends*, eds., Julien Chaisse and Jiaxiang Hu (The Hague: Kluwer Law International, Global Trade Law Series, 2019), 154; T. Yudo Wicaksono et al., 'Failure of an Export Promotion Policy? Evidence from Bonded Zones in Indonesia', ERIA Discussion Paper Series (2019), 1.

There are many benefits of SEZs (for host states and/or traders and investors) which this article does not intend to explore. Instead, this article provides a comprehensive analysis of the issues raised by SEZs under international economic law (IEL), and, in particular, whether SEZs are lawful under IEL, which is an issue largely ignored by the trade law literature. Three main types of rules have to be considered when assessing the legality of domestic SEZs under IEL: international taxation, international investment law, and multilateral trade rules. The Base Erosion and Profit Shifting (BEPS) project was launched by the OECD and G20 countries in 2013 in order to deal with the serious tax avoidance problems and a series of action steps were released in 2015.<sup>32</sup> Among the BEPS packages, Action 5 is the basis to ‘counter harmful tax practices’, and the competition conditions between countries can be changed by tax incentives.<sup>33</sup> Regarding investment conditions, investment agreements, mainly bilateral investment treaties (BITs), are functional, and tax-related disputes can be resolved under mandatory arbitration of BITs when some conditions are met and they are not within the ‘general exception provision’.<sup>34</sup> Although the WTO does not regulate SEZs explicitly, the Agreement on Subsidies and Countervailing Measures (SCM Agreement), which mainly focuses on improving GATT disciplines, has a strong relationship with the incentives the SEZs make use of.<sup>35</sup>

In this article, the question of SEZs’ legality is explored with respect to three dimensions. First is whether SEZs represent a lawful development under IEL or not. Second is what kind of specific issues SEZs may raise under IEL. Third is what measures governments can take in order not to be challenged before relevant tax, investment, or trade tribunals. In order to address these three issues and, fundamentally, answer the question as to whether SEZs are lawful under IEL, the article critically reviews the applicability of international tax law, international investment law, and international trade law to SEZs.

The article is structured as follows. The first section identifies and explains the main economic and regulatory drivers of SEZs’ rapid development; the second section considers the interaction between SEZs and international tax law, especially BEPS Action 5; the third section will focus on the relationship between SEZs and investment agreements and the disputes arising as a consequence; the fourth section will talk about SEZs and the WTO, as some incentives used by SEZs may not be compatible with WTO regulations. The last section is the conclusion.

## 2. The Phenomenon of Special Economic Zones: A Critical Overview

SEZs are now ubiquitous and a major instrument for many countries to attract foreign investors while boosting international trade. However, the omnipresence of SEZs does not equate to a harmonization (or standardization) of their design and operation. On the contrary, SEZs have become increasingly diverse. In this respect, Section 2 discusses the main commonalities and differences of SEZs (2.1). It then provides an explanation of the various factors which explain the proliferation of SEZs in very diverse economies (2.2). After that, the article reviews SEZs’ fundamental purposes, which should remain the benchmarks according to which SEZs’ success and failure should be evaluated (2.3). Finally, not all SEZs are successful, and some failed SEZs are considered (2.4).

<sup>32</sup>Reuven S. Avi-Yonah and Haiyan Xu, ‘Evaluating BEPS: A Reconsideration of the Benefits Principle and Proposal for UN Oversight’, *Harvard Business Law Review* 6 (2016): 188.

<sup>33</sup>OECD, ‘Action Plan on Base Erosion and Profit Shifting’ (2013): 18, [www.oecd.org/ctp/BEPSActionPlan.pdf](http://www.oecd.org/ctp/BEPSActionPlan.pdf) (accessed 2 January 2020); Alexander Klemm and Stefan Van Parys, ‘Empirical Evidence on the Effects of Tax Incentives’, International Monetary Fund Working Paper (Washington, DC, Fiscal Affairs Department, 2009), [www.imf.org/external/pubs/ft/wp/2009/wp09136.pdf](http://www.imf.org/external/pubs/ft/wp/2009/wp09136.pdf) (accessed 13 February 2019).

<sup>34</sup>Gonzalo Villalta Puig and Sabrina Leung Tsam Tai, ‘China (Shanghai) Pilot Free Trade Zone Investor-State Dispute Settlement: An Uncertain Experiment’, *Journal of World Investment and Trade* 18 (2017): 706.

<sup>35</sup>Julia Ya Qin, ‘WTO Regulation of Subsidies to State Owned Enterprises (SOEs). A Critical Appraisal of China Accession Protocol’, *Journal of International Economic Law* 7 (2004): 865.

## 2.1 Charting the Maze of Special Economic Zones

SEZs can be defined as ‘demarcated geographic areas contained within a country’s national boundaries where the rules of business are different from those that prevail in the national territory’.<sup>36</sup> According to United Nations Industrial Development Organization (UNIDO), ‘industrial parks, special economic zones, eco-industrial parks, technology parks and innovation districts are all comprised in the term of economic zones’.<sup>37</sup> ‘Free economic zones’ can extend across borders and may also include international growth zones.<sup>38</sup> Different countries have utilized various names for zones with these features.<sup>39</sup> In Ireland, they are called ‘industrial free zones’ and ‘export free zones’.<sup>40</sup> In China, they are named special economic zones, and in India, they are called foreign trade zones.<sup>41</sup> In Mexico, SEZs are named ‘maquiladoras’.<sup>42</sup> And in the Republic of Korea, the zones are called ‘duty-free export processing zones’ or ‘free export zones’.<sup>43</sup> Finally, some ‘development areas’ can be established in some jurisdictions and, without hesitation, they can also be included in the definition of SEZ.<sup>44</sup>

## 2.2 Explaining the Proliferation of Special Economic Zones

SEZs span the globe, with examples appearing in all regions, in a variety of shapes, sizes, and contexts. In Nigeria, an FTZ related to oil and gas was created in 1996.<sup>45</sup> In Dubai, the Airport Free Zone Authority (DAFZA) was established within Dubai International Airport.<sup>46</sup> In Russia, special industrial and innovative economic zones have been created to promote cooperation between Korea and Russia.<sup>47</sup> In Iran, Free Trade and Special Economic Zones have attracted foreign investors due to the state’s huge domestic market.<sup>48</sup> Even a small island, Mauritius, also established an EPZ in 1970.<sup>49</sup> In India, by 2016, 491 SEZs had been formally approved, the

<sup>36</sup>Foreign Investment Advisory Service (FIAS), *Special Economic Zones*; Thomas Farole, *Special Economic Zones in Africa: Comparing Performance and Learning from Global Experiences* (Washington, DC: World Bank 2011), <http://dx.doi.org/10.1596/978-0-8213-8638-5> (accessed 13 February 2019).

<sup>37</sup>United Nations Industrial Development Organization. *Economic Zones in the ASEAN: Industrial Parks, Special Economic Zones, Eco-industrial Parks, Innovation Districts as Strategies for Industrial Competitiveness* (UNIDO Country Office in Viet Nam 2015), [www.unido.org/fileadmin/user\\_media\\_upgrade/Worldwide/Offices/ASIA\\_and\\_PACIFIC/UCO\\_Viet\\_Nam\\_Working\\_Doc.pdf](http://www.unido.org/fileadmin/user_media_upgrade/Worldwide/Offices/ASIA_and_PACIFIC/UCO_Viet_Nam_Working_Doc.pdf) (accessed 13 February 2019).

<sup>38</sup>Xiangming Chen, ‘The Evolution of Free Economic Zones and the Recent Development of Cross-national Growth Zones’, *International Journal of Urban and Regional Research* 19 (2009): 593–621, doi 10.1111/j.1468-2427.1995.tb00530.x (accessed 13 February 2019).

<sup>39</sup>Creskoff and Walkenhorst, ‘Implications of WTO Disciplines’.

<sup>40</sup>Michael Engman et al., ‘Export Processing Zones: Past and Future Role in Trade and Development’, OECD Trade Policy Working Paper No. 53, TD//TC/WP(2006)39/FINAL (2006), 10.

<sup>41</sup>Creskoff and Walkenhorst, ‘Implications of WTO Disciplines’.

<sup>42</sup>Engman et al., ‘Export Processing Zones’, 10.

<sup>43</sup>Ibid.

<sup>44</sup>Creskoff and Walkenhorst, ‘Implications of WTO Disciplines’, 8.

<sup>45</sup>Nkiruka Chidia Maduekwe, ‘Legal Regime for Oil and Gas Free Trade Zone’ (Nigerian Institute of Advanced Legal Studies 2016), 5.

<sup>46</sup>Griffin Weaver, ‘Legal and Institutional Remedies for Middle East States Wishing to Develop and Increase Foreign Direct Investment’, *Florida Journal of International Law* 27 (2015): 77.

<sup>47</sup>Boogyun Kang et al., ‘Russia’s Economic Modernization Policy and Implications for Cooperation between Korea and Russia’, KIEP Research Paper No. World Economy Update (2016), 5.

<sup>48</sup>Ali Darzi-Naftchali, ‘Article 139 of Iranian Constitution and Foreign Investment Disputes Settlement’, *Journal of Poverty, Investment and Development* 32 (2017): 10, [www.iiste.org/Journals/index.php/JPID/article/viewFile/35629/36648](http://www.iiste.org/Journals/index.php/JPID/article/viewFile/35629/36648) (accessed 14 February 2019).

<sup>49</sup>Patrick Neveling, ‘Export Processing Zones and Global Class Formation’, in *Anthropologies of Class: Power, Practice, and Inequality*, eds., J. Carrier and D. Kalb (Cambridge: Cambridge University Press, 2015), 165.

majority from IT and IT-enabled-services sectors.<sup>50</sup> Almost all Indian SEZs are small.<sup>51</sup> Furthermore, regions where countries choose to locate their SEZs vary from high-growth regions to the poorest areas.<sup>52</sup> With the aim of attracting foreign investment or stimulating the economies of sub-national regions, SEZs offering many kinds of economic incentives are created.<sup>53</sup>

Despite their diversity, it is common for SEZs to create a favorable, liberal, and effective business climate which is not available in the other parts of the state. Governments apply friendly policies and packages of incentives to attract investors in SEZs.<sup>54</sup> Fiscal benefits, relaxed regulations, and export promotion services are often included.<sup>55</sup> Based on the type of investment project, various lengths of tax breaks are provided.<sup>56</sup> Since the conditions to induce multinational firms can change quickly,<sup>57</sup> some investors sign stability agreements in order to better protect their investment. This was the situation that arose in *Aguaytia Energy, LLC v. Republic of Peru* (ICSID Case No. ARB/06/13 case).<sup>58</sup> SEZs have greater autonomous power in developing these regulations, tax reductions, and exemptions in order to facilitate these reform experiments.<sup>59</sup> For example, in Shenzhen, the SEZ management enjoys significant autonomy under local regulations.<sup>60</sup> While the management of SEZs can be by either the government or private sector,<sup>61</sup> the establishment of SEZs has to be approved by the central government, as ruled in the *Gold Reserve Inc. v. Bolivarian Republic of Venezuela*.<sup>62</sup>

### 2.3 Rationalizing Special Economic Zones: Objects and Purposes

Although tax reductions and subsidies provided in SEZs may decrease government receipts initially, there are many long-term benefits of creating them and reasons to do so. A ‘greenhouse’ environment is created inside an SEZ which helps young companies to develop.<sup>63</sup> More productive firms can be attracted to the zone, resulting in productivity spillover to less established or smaller firms.<sup>64</sup> It should be noted that not only foreign investors but also local firms are attracted to SEZs.<sup>65</sup> Domestic companies can be connected with global value chains in

<sup>50</sup>Abdul Rahoof TK and PG Arul, ‘An Evaluation of Special Economic Zones (SEZs) Performance Post SEZs Act 2005’, *Universal Journal of Industrial and Business Management* 4 (2016): 44–524, [www.hrpub.org/download/20160530/UJIBM2-11605762.pdf](http://www.hrpub.org/download/20160530/UJIBM2-11605762.pdf) (accessed 14 February 2019).

<sup>51</sup>Partha Mukhopadhyay and Kanhu Charan Pradhan, ‘Location of SEZs and Policy Benefits: What Does the Data Say?’, CPR Occasional Paper Series No. 18 (2009), 70.

<sup>52</sup>Alexander D. Rothenberg et al., ‘When Regional Policies Fail: An Evaluation of Indonesia’s Integrated Economic Development Zones’, RAND Working Paper Series WR-1183 (2017), 2.

<sup>53</sup>Thomas J. Sigler, ‘Panama’s Special Economic Zones: Balancing Growth and Development’, *Bulletin of Latin American Research* 33 (2014): 2.

<sup>54</sup>For an overview of SEZs as a specific industrial policy tool, see Sherzod Shadikhodjaev, *Industrial Policy and the World Trade Organization: Between Legal Constraints and Flexibilities* (Cambridge University Press, 2018).

<sup>55</sup>Engman et al., ‘Export Processing Zones’, 17.

<sup>56</sup>Wei Ge, ‘Special Economic Zones and the Opening of the Chinese Economy: Some Lessons for Economic Liberalization’, *World Development* 27 (1999): 51.

<sup>57</sup>Peter G. Warr and Jayant Menon, ‘Cambodia’s Special Economic Zones’, Asian Development Bank Economics Working Paper Series No. 459 (2016), 2.

<sup>58</sup>*Aguaytia Energy, LLC v. Republic of Peru*, ICSID Case No. ARB/06/13.

<sup>59</sup>A. M. Moreno Romo, ‘China’s Special Economic Zones: Are They Still “Special” after China’s Accession to the WTO?’ (Doctoral dissertation 2009), 96.

<sup>60</sup>Moberg, *The Political Economy*, 124.

<sup>61</sup>Creskoof and Walkenhorst, ‘Implications of WTO Disciplines’, 7.

<sup>62</sup>*Gold Reserve Inc. v. Bolivarian Republic of Venezuela*, ICSID Case No. ARB(AF)/09/1.

<sup>63</sup>Edward M. Graham, ‘Do Export Processing Zones Attract FDI and its Benefits?’, *International Economics and Economic Policy* 1 (2004): 87–103, 94.

<sup>64</sup>Rothenberg et al., ‘When Regional Policies Fail’, 2.

<sup>65</sup>Foreign Investment Advisory Service (FIAS), *Special Economic Zones*.

SEZs.<sup>66</sup> Another reason for using SEZs is to catalyze economic development and facilitate trade, as was the case in China.<sup>67</sup> For example, the China (Shanghai) Pilot Free Trade Zone (SPFTZ) was founded to facilitate trade liberalization,<sup>68</sup> and currently, the benefits of the SPFTZ are already visible to foreign investors.<sup>69</sup>

SEZs also play an important role as regulatory test sites when it is difficult to implement countrywide reforms.<sup>70</sup> In 1980, four SEZs were created in China, including Shenzhen, Zhuhai, Shantou, and Xiamen, in order to attract investors, especially from Hong Kong, Macau, and Taiwan.<sup>71</sup> These zones were allowed by the central government in order to experiment with reforms in regulations.<sup>72</sup> The Chinese local policy makers can make use of different SEZ policies in order to find the ones which work best.<sup>73</sup> These EPZs then demonstrate the best path for country-wide reforms.<sup>74</sup>

The regulations utilized in SEZs are not only functional within the borders of the host states, but may have an effect on the host states' international legal obligations. If the regulations in SEZs are not stable and the incentives utilized by host states are prohibited by international regimes, the international legal obligations of host states might be violated. The possible situations will be analyzed in detail in the following sections.

#### 2.4 General Failures of SEZs

The history of SEZs has seen some failures; the Calabar zone in Nigeria is one example.<sup>75</sup> The location of this zone seemed perfect, as it was near the Calabar port.<sup>76</sup> Based on the development plan of the zone, after the port had been dredged, it could serve ships to export the goods produced in SEZs.<sup>77</sup> However, the related authorities failed to complete the dredging project.<sup>78</sup> Moreover, this zone had no connection with any highways in Nigeria.<sup>79</sup> What was worse, the power supply provided by the government was not reliable.<sup>80</sup> Consequently, few foreign investors

<sup>66</sup>Dorothea Ramizo, 'Special Economic Zones (SEZs): A Tool for Investment, Trade, and Development' (Asia Regional Integration Center, 2014), <https://aric.adb.org/blog/special-economic-zones-sezs-a-tool-for-investment-trade-and-development> (accessed 14 February 2019).

<sup>67</sup>Susan Tiefenbrun, 'US Foreign Trade Zones and Chinese Free Trade Zones: A Comparative Analysis', *Journal of International Business and Law* 14 (2015): 212.

<sup>68</sup>Daqing Yao and John Whalley, 'The China (Shanghai) Pilot Free Trade Zone: Background, Developments and Preliminary Assessment of Initial Impacts', *The World Economy* 39 (2016): 2.

<sup>69</sup>Xiaoyang Zhang, 'Further Disapplying Differentiated Treatment of Foreign Investment in China: Is This the Only Way Out for the Shanghai Free Trade Zone?', *International Business Law Journal* 2016 (2016): 53.

<sup>70</sup>World Bank, *Export Processing Zones in Sub-Saharan Africa (Economic and Social Policy Findings 193)* (The World Bank, Washington DC 2001).

<sup>71</sup>Ting Han and Andrew D. Mitchell, 'China's Free Trade Zones in Its Post-WTO Accession ERA: A Case Study of Shanghai FTZ', in *International Economic Law and the Challenges of the Free Zones – Global Regulatory Issues and Trends*, eds., Julien Chaisse and Jiaxiang Hu (The Hague: Kluwer Law International, Global Trade Law Series, 2019), 236.

<sup>72</sup>Provisional Regulations of the State Council of the People's Republic of China Regarding the Reduction of, and Exemption from, Enterprises Income Tax and Consolidated Industrial and Commercial Tax in the Special Economic Zones and the Fourteen Coastal Cities, issued by the State Council on November 15, 1984; Thomas Farole, 'Special Economic Zones: What Have We Learned?', *Economic Premise* (The World Bank, 2011), 1; Azam Pasha, 'Existence and Relevance of Economic Zones – A Strategic Development Perspective' (2019), 5, at SSRN: <https://ssrn.com/abstract=3337840> or <http://dx.doi.org/10.2139/ssrn.3337840> (accessed 11 April 2019).

<sup>73</sup>Moberg, *The Political Economy*, 125.

<sup>74</sup>Edward M. Graham, 'Do Export Processing Zones Attract FDI and its Benefits?', *International Economics and Economic Policy* 1 (2004); 87–103.

<sup>75</sup>Moberg, 'The Political Economy', *Chapman Law Review* 420.

<sup>76</sup>Farole, *Special Economic Zones in Africa*, 204.

<sup>77</sup>Ibid.

<sup>78</sup>Moberg, 'The Political Economy', *Chapman Law Review*, 420.

<sup>79</sup>Ibid.

<sup>80</sup>Farole, *Special Economic Zones in Africa*, 219.

chose to invest in this SEZ.<sup>81</sup> The Philippines' Bataan SEZ is another example of failure.<sup>82</sup> This zone was built on the site of a former US military field. The government spent a great amount of money in upgrading its bridges, roads, and other infrastructure.<sup>83</sup> Nevertheless, the zone had weak business potential, and few investors chose to establish in this zone.<sup>84</sup> In this case, even though the government spent a lot in supporting one SEZ, the outcome was not positive.

### 3. International Taxation Issues: Comparative Analysis of Tax Incentives

SEZs in Asia heavily rely on tax incentives, aiming to attract more foreign investment.<sup>85</sup> However, tax incentives are not always successful in attracting foreign investors, and SEZs are also not always successful.<sup>86</sup> BEPS Action 5 is utilized to test whether tax incentives and reductions provided in SEZs can be potentially harmful to the competition standards among states. This section explains that tax incentives are a key aspect of SEZs, but they are not the main issue.<sup>87</sup> Instead, an SEZ creates a wider preferential base than that envisioned by BEPS Action 5, which may render SEZs illegal under international taxation law (and in direct opposition to one of the latest much needed tax law global reforms). This section starts with a topography of SEZs' common tax advantages (3.1). It then discusses the adverse tax effects of SEZs (3.2) and the challenges raised by SEZs in the context of the ongoing BEPS implementation (3.3).

#### 3.1 Topography of Tax Advantages

With the strong support of central governments, companies can enjoy incentives, such as tax breaks in SEZs.<sup>88</sup> Tax exemption, lower tax rates, and tax concessions are the most common instruments of tax policy.<sup>89</sup> In 1934, federal customs duties and excise taxes were exempted in the US FTZs.<sup>90</sup> Tax incentives were introduced in SEZs aiming at facilitating foreign investment.<sup>91</sup> The incentives can be substantial, especially for foreign investors. For example, foreign investment enterprises which have already engaged in a service trade for more than 10 years and have total investment exceeding five million US dollars can get a one-year tax exemption and a two-year 50% tax rate reduction, which begins in their first profit-making year.<sup>92</sup> In 1994, the uniform tax rate for profits of all enterprises was 33%, while it could be as low as 15% in SEZs in order to attract foreign investment.<sup>93</sup> In China, foreign investors have enjoyed preferential treatment in SEZs for several years.<sup>94</sup> Foreign investors initially enjoyed 15%, while

<sup>81</sup>Ibid., 211–212.

<sup>82</sup>Moberg, 'The Political Economy', *Chapman Law Review*, 420.

<sup>83</sup>Ibid., 420–421.

<sup>84</sup>Ibid., 421.

<sup>85</sup>Peter, G. Warr, 'Export Processing Zones: The Economics of Enclave Manufacturing', *The World Bank Research Observer* 4 (1989): 65–88; Beth Mitchneck, 'An Assessment of the Growing Local Economic Development Function of Local Authorities in Russia', *Economic Geography* 71 (1995): 150–151.

<sup>86</sup>Moberg, 'The Political Economy', *Chapman Law Review* 420.

<sup>87</sup>A. Laukkanen, 'The Development Aspects of Special Tax Zones', *Bulletin for International Taxation* 70 (2016): 152–162.

<sup>88</sup>Hyung-Gon Jeong and Douglas Zhihua Zeng, 'Promoting Dynamic & Innovative Growth in Asia: The Case of Special Economic Zones and Business Hub', Korea Institute for International Economic Policy Research Paper Policy Analysis-16-01 (2016); James Alan Brown, 'Territorial (In) Coherence: Labour and Special Economic Zones in Laos's Border Manufacturing', *Antipode* 51 (2019): 440.

<sup>89</sup>Olga A. Sinenko, 'Administrative and Managerial Issues of Tax Reforms', *Journal of Tax Reform* 2 (2016): 168–178.

<sup>90</sup>Tom W. Bell, 'Special Economic Zones in the United States: From Colonial Charters, to Foreign Trade Zones, toward USSEZs', *Buffalo Law Review* 64 (2016): 982.

<sup>91</sup>Mitchneck, *An Assessment*, 150–51.

<sup>92</sup>Ernst and Young, *Doing Business in China* (Ernst & Young International, Ltd. 1994), 27–28.

<sup>93</sup>Donald J. Swanz, 'Doing Business in China', *The CPA Journal* 65 (1995): 42.

<sup>94</sup>Olga Boltenko, 'Investment Protection in China's SEZs: Lee Jong Baek Case Study', *International Economic Law and the Challenges of the Free Zones – Global Regulatory Issues and Trends*, eds., Julien Chaisse and Jiaxiang Hu (The Hague: Kluwer Law International, Global Trade Law Series, 2019), 335.



local enterprises had to pay a 30% tax.<sup>95</sup> It should be pointed out that over time China tended to reduce its tax incentives for foreign investors, both quantitatively and substantively.<sup>96</sup> The establishment of special tax zones is also an illustration of the purpose of SEZs.<sup>97</sup> Different kinds of tax, including income tax, business tax, and value-added tax, are exempted or reduced.<sup>98</sup>

Zones located in Asia use many tax incentives, including exemption from normal income tax for a period of three to ten years, and exports without taxes.<sup>99</sup> For instance, the incentives in FTZs in Malaysia include ‘duty free imports of raw material and capital equipment, simplified custom formalities and income tax relief which included Pioneer status, Labour utilization relief, Investment tax credit, Export promotion deduction and local incentives instead of Pioneer status and Labour utilization relief if the firm is located in a designated locational incentives area’.<sup>100</sup> In India, three types of incentives are provided to enterprises in SEZs.<sup>101</sup> The first incentive is related to taxes and tariffs.<sup>102</sup> Industrial units in the zones can enjoy unlimited duty-free imports of raw materials and long-term tax holiday concessions.<sup>103</sup> The reason why Hong Kong can be a successful SEZ is because of its low, simple, and transparent taxation system.<sup>104</sup> A favorable business environment is created as a result of the uncomplicated, transparent, and low-tax regime.<sup>105</sup>

### 3.2 Adverse Tax Effects of SEZs

While a low-tax regime inside SEZs is beneficial for business, there are potentially detrimental effects resulting from these tax policies. In fact, SEZs, such as the former Turkish FTZs, which were free from value-added tax (VAT) and corporate and personal income tax, can be problematic, as they may lead to tax evasion and competitive disadvantages.<sup>106</sup> When officials abuse the tax-related provisions and give tax benefits to investments which are not eligible to get those benefits, tax evasion can occur.<sup>107</sup> Besides, regardless of the economic productivity, those which are given the tax benefits are more competitive than those that have got nothing.<sup>108</sup> Tax incentives and tax reductions have an effect on the competition standards between countries.<sup>109</sup> Tax incentives need to be carefully managed in order not to harm competition standards.<sup>110</sup> It is possible for tax competition to affect the fiscal systems worldwide negatively.<sup>111</sup> As a consequence, tax

<sup>95</sup>Jeffrey F. Fitzpatrick and Jian Zhang, ‘Using China’s Experience to Speculate upon the Future Possibility of Special Economic Zones (SEZs) within the Planned Development of Northern Australia’, *Flinders Law Journal* 18 (2016): 51.

<sup>96</sup>Carter and Harding, *Special Economic Zones*, 64.

<sup>97</sup>China Law No. 466, Arts. 1–3.

<sup>98</sup>Jeong and Zeng, ‘Promoting Dynamic’.

<sup>99</sup>Peter, G. Warr, ‘Export Processing Zones: The Economics of Enclave Manufacturing’, *The World Bank Research Observer* 4 (1989): 65–88.

<sup>100</sup>Peter, G. Warr, ‘Malaysia’s Industrial Enclaves: Benefits and Costs’, *The Developing Economies* 25 (1987): 30–55.

<sup>101</sup>Laura Bloodgood, *Competitive Conditions for Foreign Direct Investment in India* (ITC Publication No. 3931) (Washington, DC: Office of Industries, United States International Trade Commission, 2007), 60, [http://digitalcommons.ilr.cornell.edu/key\\_workplace/389/](http://digitalcommons.ilr.cornell.edu/key_workplace/389/) (accessed 14 February 2019).

<sup>102</sup>Ibid.

<sup>103</sup>Tarun Dhingra et al., ‘Location Strategy for Competitiveness of Special Economic Zones: A Generic Framework for India’, *Competitiveness Review: An International Business Journal* 19 (2009): 272–289.

<sup>104</sup>Jeong and Zeng, ‘Promoting Dynamic’.

<sup>105</sup>‘Hong Kong as an Offshore Financial Center’, *Fairbairn Catley Low & Kong Report* (2009), [www.fclklaw.com.hk/english/legal/update26.pdf](http://www.fclklaw.com.hk/english/legal/update26.pdf) (accessed 15 February 2019).

<sup>106</sup>Laukkanen, ‘The Development’, 152.

<sup>107</sup>Howell H. Zee et al., ‘Tax Incentives for Business Investment: A Primer for Policy Makers in Developing Countries’, *World Investment* 30 (2002): 1498.

<sup>108</sup>Ibid.

<sup>109</sup>Klemm and Parys, ‘Empirical Evidence’.

<sup>110</sup>Yotam Margalioth, ‘Tax Competition, Foreign Direct Investments and Growth: Using the Tax System to Promote Developing Countries’, *Virginia Tax Review* 23 (2003): 189.

<sup>111</sup>R. Altshuler and T. J. Goodspeed, ‘Follow the Leader? Evidence on European and US Tax Competition’, *Public Finance Review* 43 (2015): 486.

competition may result in a ‘race to the bottom’ situation, which means countries may decrease their tax rates to zero.<sup>112</sup> In this way, these countries want to improve their attractiveness for the foreign investors; however, growing pressure might be levied on them, as they cannot change their tax policies easily.<sup>113</sup> In Turkey, tax evasion increased because of the tax incentives issued in their FTZs.<sup>114</sup> When tax incentives are not utilized properly, such as when tax holidays are only available for foreign investors, the domestic investors may face a competitive disadvantage and the competition conditions are detrimental.<sup>115</sup> FDI and local firms are attracted to invest in SEZs because these zones have more liberal policies compared with other parts of the state.<sup>116</sup> Therefore, whether the tax measures in SEZs can be a kind of harmful tax practice should be considered.

### 3.3 SEZs and Base Erosion and Profit Shifting (BEPS)

In order to resolve the increasing base erosion and profit-shifting problems and establish a new international taxation regime, the OECD launched the ‘BEPS package’, comprising 15 actions.<sup>117</sup> The measures include minimum criteria and best practices.<sup>118</sup> As long as the participants, ranging from developed states to developing ones, commit to complying with the BEPS plan, they have to obey their commitments and also meet four minimum standards aiming to maintain the consistency of implementation.<sup>119</sup> Among those actions, BEPS Action 5 has been published with the intention:

[t]o counter harmful tax practices with respect to geographically mobile activities such as financial and other service activities, including the provision of intangibles... that unfairly erode the tax bases of other countries, potentially distorting the location of capital and services.<sup>120</sup>

BEPS Action 5 prescribes that in comparison with the relevant state’s general tax principles, ‘a regime is considered preferential if it offers some form of tax preference’.<sup>121</sup> Based on the definition of SEZs, the fiscal regimes are more liberal than those of the domestic economy.<sup>122</sup> An SEZ is accordingly a typical example of a preferential regime. In deciding whether a regime is harmful, BEPS Action 5 requires five key factors. However, not all the five factors have to be met at the same time to conclude that a regime is harmful. According to the OECD, the first

<sup>112</sup>C. Azémar and A. Delios, ‘Tax Competition and FDI: The Special Case of Developing Countries’, *Journal of the Japanese and International Economies* 22 (2008): 89.

<sup>113</sup>Ibid.

<sup>114</sup>R. Biçer, ‘An Assessment of Free Trade Zones from a Transfer Pricing Perspective’, *International Transfer Pricing Journal*. 15 (2008): 236.

<sup>115</sup>Margalioth, ‘Tax Competition’, 189; Ifeoma Betty Ezike et al., ‘Free Trade Zones: A Strategic Evaluation of Nigeria Success (Failure) Story’, *Journal of Management and Economic Studies* 1 (2019): 66.

<sup>116</sup>Lotta Moberg, ‘The Political Economy of Special Economic Zones’ (Lund University, Sweden, 2010), 7.

<sup>117</sup>Julien Chaisse and Xueliang Ji, ‘“Soft Law” in International Law-Making: How Soft International Taxation Law is Reshaping International Economic Governance’, *Asian Journal of WTO and International Health Law and Policy* 13 (2018): 469; Joint Comm. on Taxation, *Background, Summary, and Implications of the OECD/G20 Base Erosion and Profit Shifting Project* (2015), 9, [www.jct.gov/publications.html?func=startdown&id=4853](http://www.jct.gov/publications.html?func=startdown&id=4853) (accessed 17 February 2019); Michelle Andrea Markham, ‘Arbitration and tax treaty disputes’, *Arbitration and Tax Treaty Disputes* 35 (2019), 3.

<sup>118</sup>Organisation for Economic Co-operation Development [OECD], *Background Brief: Inclusive Framework on BEPS* (2017), 9, [www.oecd.org/ctp/background-brief-inclusive-framework-for-beps-implementation.pdf](http://www.oecd.org/ctp/background-brief-inclusive-framework-for-beps-implementation.pdf) (accessed 17 February 2019).

<sup>119</sup>Julien Chaisse and Xueliang Ji, ‘Soft Law in International Law-Making: How Soft International Taxation Law is Reshaping International Economic Governance’, *Asian Journal of WTO and International Health Law and Policy* 13(2) (2018): 493.

<sup>120</sup>OECD, ‘Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5-2015 Final Report’, *OECD/G20 Base Erosion and Profit Shifting* (OECD Publishing, Paris 2015), 11.

<sup>121</sup>OECD, ‘Countering Harmful Tax Practices’, 19.

<sup>122</sup>Farole, *Special Economic Zones in Africa*, 17.

factor is the gateway criterion. It considers ‘whether the regime imposes no or low effective tax rates on income from geographically mobile financial and other service activities’.<sup>123</sup> Consequently, referring to the tax incentives provided in SEZs, whether geographically mobile financial and other service activities enjoy no or low effective tax rates should be considered. The gateway criterion may be met if no or low effective tax rates are imposed in SEZs. Although tax incentives are one significant factor, they are not the main issue.<sup>124</sup> In reality, zero or low effective tax rates are not offered in every SEZ. For example, SEZs in South Africa provide no fiscal incentives.<sup>125</sup> Assuming the gateway criterion is met, the other key factors should be examined as detailed in the following paragraphs.

The second main factor is whether the SEZ regime exists in isolation from the domestic economy.<sup>126</sup> According to BEPS Action 5, ‘it is understood to mean where a regime implicitly or explicitly excludes resident taxpayers from taking advantage of its benefits or where an entity that benefits from the regime is prohibited from operating in the domestic market’.<sup>127</sup> SEZs ‘refer to spatially delimited areas within an economy that function with administrative, regulatory, and often fiscal regimes that are different (typically more liberal) than those of the domestic economy’.<sup>128</sup> As a result, SEZs are isolated from the domestic economy. Therefore, the characteristics of SEZs meet the second factor. The third factor is a lack of transparency.<sup>129</sup> This is a subjective factor, and it has to be considered in relation to a specific SEZ. Although it is hard to decide whether typical SEZs are transparent or not, as they are used to attract foreign investment, it is more likely for them to be transparent, as it may be more attractive for the foreign investors. The fourth factor related to the regime is a lack of effective exchange of information. This means that the host state should have an elaborate tax treaty network with other states, and it would be better if the host state has signed tax information exchange agreements. It has to be considered in relation to the specific country’s tax treaty network. To cite South Africa as an example, it not only created a comprehensive tax treaty network with other African states, but also signed a tax information exchange agreement with Liberia.<sup>130</sup> Consequently, South Africa has an effective tax information exchange regime.

In BEPS Action 5, the 5th requirement is the substantial activity requirement. It requires that taxation should be realigned with the substantial activities generating them.<sup>131</sup> The goal of the substantial activity requirement is to make sure that any benefit given to a taxpayer in a preferential regime is directly related to the activities which generate the main income. A direct link between a company’s expenditure and the tax benefits it is thereby entitled to should be maintained.<sup>132</sup> Although both IP regimes and non-IP regimes are available in the current SEZs, in analyzing this requirement, the IP (Intellectual Property) regimes are mainly considered. Compared with the traditional labor-intensive SEZs, IP assets are substantial for the technology-intensive manufacturing and especially for high-technology firms in SEZs, and they must be owned in the place where the expenditure is incurred for tax purposes.<sup>133</sup> The expenses of the actual research activity creating the IP should be related to the taxpayer’s expenditure. The qualifying taxpayers are defined as ‘those taxpayers that undertook the core income generating activities

<sup>123</sup>OECD, ‘Countering Harmful Tax Practices’, 20.

<sup>124</sup>Laukkanen, ‘The Development’, 162.

<sup>125</sup>‘The Geographical Designation of Special Economic Zones’, TIPS Working Paper (2014), 3.

<sup>126</sup>OECD, ‘Countering Harmful Tax Practices’, 20.

<sup>127</sup>Ibid.

<sup>128</sup>Farole, *Special Economic Zones in Africa*, 17.

<sup>129</sup>OECD, ‘Countering Harmful Tax Practices’, 20.

<sup>130</sup>SARS Home, [www.sars.gov.za/Pages/Find-a-Publ.aspx?k=TIEA](http://www.sars.gov.za/Pages/Find-a-Publ.aspx?k=TIEA) (accessed 17 February 2019).

<sup>131</sup>R. Fisman and E. Werker, ‘Innovations in Governance’ (2011), 84, [www.nber.org/chapters/c12045](http://www.nber.org/chapters/c12045) (accessed 18 February 2019).

<sup>132</sup>OECD, ‘Countering Harmful Tax Practices’, 71.

<sup>133</sup>Farole, *Special Economic Zones in Africa*, 199.

required to produce the type of business income covered by the preferential tax regime'.<sup>134</sup> As a result, in order to meet the substantial activity requirement, the favorable tax condition provided in SEZs must directly relate to core income-generating activities.

With tax incentives, special tax zones (STZs), a type of SEZ, traditionally focus on attracting substantial economic activities.<sup>135</sup> Distortions can be created when the taxes are used to finance subsidy programs.<sup>136</sup> In short, the SEZ regimes have the potential to be harmful if the substantial activity requirement is not met. Tax incentives are one significant factor in the decision-making processes for MNEs when they consider new business locations, but they are not the main issue.<sup>137</sup> An SEZ creates a wider preferential base than that envisioned by BEPS Action 5, because of the liberal and favorable climate provided by it.

#### 4. The International Investment Issues: Special Economic Zones before ISDS

Virtually all BITs include rules considering expropriation and dispute resolution mechanisms, while their main goal is to protect the property rights of foreign investors.<sup>138</sup> More specifically, in the world of investment law, expropriation<sup>139</sup> of property can take two forms. It can be either direct or indirect.<sup>140</sup> In addition, binding and independent arbitration under BITs is more favorable than local remedies from the perspective of foreign investors.<sup>141</sup> It should be noted that other BIT standards could be violated by SEZs, such as fair and equitable treatment (FET) and national treatment (NT).<sup>142</sup> As domestic investors within SEZs are treated differently compared with those outside, NT standards can be triggered in this situation. However, there are two reasons why in this article the expropriation is mainly considered. For one thing, there are a representative number of investment disputes which relate to SEZs and which involve expropriation claims. For another, the expropriation standard is relatively hard to meet, so if there is a breach of an expropriation clause, it is also very likely that the fair and equitable treatment clause is violated (while the reverse is not true). In order for the article to test the relevance of investment treaties to review the legality of SEZs, it is preferable to focus on the most challenging investment standard. Expropriation, which is the most basic type of protection, is the main form considered in this

<sup>134</sup>Ibid.

<sup>135</sup>Reuven S. Avi-Yonah and Martin Vallespinos, 'Special Tax Zones and the WTO', University of Michigan Public Law Research Paper No. 545 (2017), 3; Pasquale Pistone, Jan de Goede, and Antti Laukkanen (eds.), *Special Tax Zones in the Era of International Tax Coordination* (2019), 5.

<sup>136</sup>Alan O. Sykes, 'The Economics of WTO Rules on Subsidies and Countervailing Measures', John M. Olin Law and Economics Working Paper No. 186 (2003), 10.

<sup>137</sup>Laukkanen, 'The Development', 162.

<sup>138</sup>Mary Hallward-Driemeier, *Do Bilateral Investment Treaties Attract Foreign Direct Investment? Only a Bit ... and They Could Bite* (The World Bank, 2003), 4.

<sup>139</sup>Also termed 'taking', 'wealth deprivation', 'dispossession', 'deprivation' or 'privation'.

<sup>140</sup>When the investment is directly taken through a formal seizure, it can be treated as direct expropriation. Direct expropriation is used to describe 'the targeting of individual businesses for interference for specific economic or other reasons' (see M. Sonarajah, *The International Law on Foreign Investment* (3rd edn, Cambridge University Press, 2010) 365). If the investor cannot utilize the investment successfully, the measure which results in this outcome may still amount to an expropriation. This is what is called indirect expropriation. The meaning of indirect expropriation was defined by the tribunal in the *Metalclad v. Mexico* case: '[E]xpropriation ... includes not only open, deliberate and acknowledged takings of property, such as outright seizure or formal or obligatory transfer of title in favour of the host State, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be expected economic benefit of property even if not necessarily to the obvious benefit of the host State'. *Metalclad Corp v. United Mexican States*, ICSID (Additional Facility) Case No. ARB(AF)/97/1, Award, 30 August 2000, para. 103.

<sup>141</sup>Ibid., 6.

<sup>142</sup>For instance, the government may issue regulatory measures to protect the environment in SEZs, and foreign investors might argue that they have not received FET when the related measures hinder their investment. Valentina Vadi, 'Balancing Human Rights, Climate Change and Foreign Investment Protection', in *Climate Change and Human Rights: An International and Comparative Law Perspective*, eds., Ottavio Quirico and Mouloud Boumghar (2016), 194.

article (4.1). Some old BITs might only allow expropriation to be presented in international arbitration.<sup>143</sup> In the second section, a group of cases which deal with SEZs and the expropriation clause will be considered (4.2).

#### 4.1 SEZs in the Context of Expropriation

The concept of indirect expropriation is generally recognized today – that is, the acceptance or recognition that there are measures that, apart from outright takings, constitute expropriation – both in decisions made by international tribunals<sup>144</sup> and in legal instruments and the writings of scholars.<sup>145</sup> However, there is no clear line drawn between non-compensable governmental measures and measures amounting to indirect, compensable expropriation. Based as it is on competing interests, the relationship between a foreign investor and the host state is a delicate one. On the one hand, by making an investment in a foreign country, a foreign investor is subjecting its investment to the jurisdiction of the host state and therefore has the right to expect certain protections from that state. On the other hand, the state, owing to its territorial sovereignty, has the right to regulate within its territory. It is well recognized in international law that ‘states are not liable to pay compensation when, in the normal exercise of their police powers, they adopt non-discriminatory, *bona fide* regulations aimed at the general welfare’.<sup>146</sup> According to the commentary to the oft-quoted *Restatement of Foreign Relations Law of the United States*:

[A] state is not responsible for loss of property or for other economic disadvantage resulting from *bona fide* general taxation, regulation, forfeiture for crime, or other action of the kind that is commonly accepted as within the police powers of the states, if it is not discriminatory ... and is not designed to cause the alien to abandon the property to the state or sell it at a distress price.<sup>147</sup>

The *Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens* of 1961<sup>148</sup> also identifies as non-compensatory measures ‘measures executing tax laws, general changes in the value of currency, actions of competent authorities of the State in the maintenance of public order, health or morality; or from the valid exercise of belligerent rights or otherwise incidental to the normal operation of the laws of the State’.<sup>149</sup> While, as noted by Professor Sonarajah, these types of measures have long been recognized as non-compensable measures, new developments show that many takings that would have been characterized as legitimate non-compensable regulation may now be subjected to compensation.<sup>150</sup> While the right to regulate

<sup>143</sup>The Agreement Between the Government of the Republic of Korea and the Government of the People’s Republic of Bangladesh for the Promotion and Protection of Investments, 1986 BITREAT BDKR (6 October, 1988), states: ‘The national or company affected shall have a right, under the law of the Contracting Party making the expropriation, to prompt review, by a judicial or other independent authority of that Contracting Party, of his or its case and of the valuation of his or its investment in accordance with the principles set out in this paragraph.’ Therefore, only expropriation cases can be presented in the domestic courts of the contracting party.

<sup>144</sup>See e.g. *Metalclad Corp v. United Mexican States*, ICSID (Additional Facility) Case No. ARB(AF)/97/1, Award, 30 August 2000.

<sup>145</sup>Nowadays, it is essential to draw a clear line between legitimate non-compensable regulations, and legitimate regulatory expropriation, which carries with it an obligation to compensate. George C. Christie, ‘What Constitutes a Taking of Property Under International Law?’, *British Year Book of International Law* (1962), 38; Rudolf Dolzer, ‘Indirect Expropriation of Alien Property’, ICSID Review-FILJ (1986): 41.

<sup>146</sup>*Telenor Mobile Communications AS v. Hungary*, ICSID Case No ARB/04/15, Award, 13 September 2006, para. 64; *Marvin Feldman v. Mexico*, ICSID Reports 7 (2002): 318, 103.

<sup>147</sup>*Restatement (Third) of Foreign Relations Law of the United States*, s 712, Comment (g) p. 201.

<sup>148</sup>Louis B. Sohn and Richard Baxter, ‘Draft Convention on the International Responsibility of States for Injuries to the Economic Interests of Aliens’, *The American Journal of International Law* 55 (1961): 545.

<sup>149</sup>*Ibid.* 553.

<sup>150</sup>Sonarajah, *The International Law*, 365.

was never absolute, the development of the law on indirect expropriation is continuing to place further restrictions on the right of the state to regulate. It is therefore all the more necessary to agree on criteria that distinguish between non-compensable regulations that are legitimate and *bona fide*, and regulatory expropriation, which, while legitimate, carries with it an obligation to compensate. That task is currently left to investment and other arbitral tribunals.

#### 4.2 ISDS Case Law on SEZs

There are already a significant number of investment awards dealing with SEZs and the clauses on expropriation. In fact, a number of states have lost cases after having modified the regime of SEZs, which demonstrates the link between domestic law and practice on SEZs and international investment law.

For example, in the *Lee John Beck v. Kyrgyz Republic* case, the termination of foreign investors' lease agreements has been challenged as an expropriation.<sup>151</sup> *Middle East Cement v. Egypt* is another example in which the revocation of the claimants' license has been found to amount to expropriation.<sup>152</sup> Furthermore, in *Empresas Lucchetti v. Peru*, the claims occurred because of the revocation of permits previously granted to the claimants, which could amount to expropriation.<sup>153</sup> Consequently, it is challenging to maintain the balance between the rights of a foreign investor and the interests of host states. SEZs have both risks and opportunities at the same time.<sup>154</sup>

As explained above, in SEZs market restrictions are suspended and investors invariably enjoy a lot of benefits.<sup>155</sup> However, within SEZs, the states can change and interpret regulations at will.<sup>156</sup> In the *Yury Bogdanov v. Moldova* case, the disputes arose because of the wrongdoings of the host state.<sup>157</sup> The changes of policies in SEZs may give rise to disputes which can be resolved under bilateral investment agreements.<sup>158</sup> In *Bawabet v. Egypt*, the government cancelled the claimant's free zone status, resulting in a claim brought by the foreign investor.<sup>159</sup> Disputes may also arise because of different interpretations. In the *Albacora S.A. v. Ecuador* case, the claims were caused by different views towards the claimant's company status.<sup>160</sup> When disputes arise, foreign investors in SEZs can sue the host state based on the related BIT, as the claimant in *Gennady Mykhailenko v. Belarus* did.<sup>161</sup> And, in *Southern Pacific Properties (Middle East) Limited v. Arab Republic of Egypt*, regulations concerning foreign investment and free zones were applied.<sup>162</sup> Stakeholders must take actions collectively to create a proper system of regulations based on the limited successful experience of SEZs.<sup>163</sup>

<sup>151</sup>*Lee John Beck and Central Asian Development Corporation v. Kyrgyz Republic*.

<sup>152</sup>*Middle East Cement Shipping and Handling Co. S.A. v. Arab Republic of Egypt*, ICSID Case No. ARB/99/6.

<sup>153</sup>*Empresas Lucchetti, S.A. and Lucchetti Peru, S.A. v. The Republic of Peru*, ICSID Case No. ARB/03/4 (also known as: *Industria Nacional de Alimentos, A.S. and Indalsa Perú S.A. v. The Republic of Peru*).

<sup>154</sup>In November 2017, the Department of Trade and Industry of the African Union Commission organized the 1st African Union Symposium on Special Economic Zones (SEZs) and Industrial Development from 7 to 10 November 2017, <https://au.int/en/pressreleases/20171107/african-union-commission-organized-1st-african-union-symposium-special> (accessed 18 February 2019).

<sup>155</sup>Yao and Whalley, 'The China (Shanghai) Pilot Free Trade Zone', 14.

<sup>156</sup>Krishna Chaitanya Vadlamannati and Haider Ali Khan, 'Race to the Top or Race to the Bottom? Competing for Investment Proposals in Special Economic Zones? Evidence from Indian States, 1998–2009', in *Invisible India: Hidden Risks within an Emerging Superpower*, eds., Jason Miklian and Åshild Kolås (Routledge, 2017), 19.

<sup>157</sup>*Yury Bogdanov v. Republic of Moldova (III)* (SCC Case No. 114/2009).

<sup>158</sup>Prabhash Ranjan, 'Free-Zone Company, Investment Standards and the Arab Spring: A Case Study of Ampal-American and Others v. Egypt', in *International Economic Law and the Challenges of the Free Zones – Global Regulatory Issues and Trends*, eds., Julien Chaisse and Jiaxiang Hu (The Hague: Kluwer Law International, Global Trade Law Series, 2019), 347.

<sup>159</sup>*Bawabet Al Kuwait Holding Company v. Arab Republic of Egypt*, ICSID Case No. ARB/11/6.

<sup>160</sup>*Albacora S.A. v. Republic of Ecuador* (PCA Case No. 2016-11).

<sup>161</sup>*Mr Gennady Mykhailenko & United Pipe Export Company Trading Ag v. The Republic of Belarus*, [www.italaw.com/cases/2307](http://www.italaw.com/cases/2307).

<sup>162</sup>*Southern Pacific Properties (Middle East) Limited v. Arab Republic of Egypt*, ICSID Case No. ARB/84/3.

<sup>163</sup>See UNCTAD, *ASEAN Investment Report 2017: Foreign Direct Investment and Economic Zones in ASEAN* (UNCTAD 2017).

In *Ampal-American and others v. Egypt*, the claimants were an American company and the East Mediterranean Gas company (EMG) – an Egyptian company which was owned by the American company.<sup>164</sup> EMG made profits by purchasing natural gas from Egypt and exporting it to Israel through a pipeline. As a free-zone company, Egyptian law provided EMG special benefits. The Egyptian General Petroleum Corporation (EGPC) was approached by EMG to purchase gas in Egypt, and a Preliminary Agreement was concluded between them in 2000, which was a long-term upstream supply agreement confirmed by the Prime Minister of Egypt. In 2001, the State-owned Egyptian Natural Gas Holding Corporation (EGAS) was created by Egypt to implement policies related to the gas sector. The Egyptian government authorized the EGPC and the EGAS as representatives of the Egyptian Ministry of Petroleum to execute a source gas supply agreement (GSPA) in 2004. EGPC, EGAS, and EMG created a tripartite agreement in 2005.<sup>165</sup>

The main allegations advanced by the claimants were in five parts. Firstly, the free-zone status of EMG and its tax exemptions were revoked by the Egyptian government, which led to an increase in the expenses and tax burdens of the claimants.<sup>166</sup> Secondly, in order to coerce the claimants into making great concessions in signing an amendment to the Source GSPA ('First Amendment'), during the negotiation process, the gas was withheld by Egypt.<sup>167</sup> Thirdly, because of Egypt's failure to meet its supply obligations based on the Source GSPA, EMG faced the growing possibility of contractual violations. Fourthly, the Egyptian pipelines were attacked several times, and Egypt failed to protect the security of EMG's pipelines. What is worse, the damage was not repaired by Egypt in a reasonable period. Lastly, the Source GSPA was unlawfully terminated by EGPC/EGAS, and claimants believed this termination was politically motivated. These measures were treated as a violation of the US–Egypt BIT by the claimants.

The tribunal considered whether the revocation of the tax exemption enjoyed by EMG or the termination of the Source GSPA could be treated as expropriation.<sup>168</sup> The tribunal found that the tax incentives in SEZs can be protected under the BITs if the measures are connected to the term of expropriation. According to Article III of the US–Egypt BIT, only tax measures which are equivalent to unlawful expropriation can be included in the treaty.<sup>169</sup> In this case, the tribunal considered whether the revocation of EMG's tax exemption amounted to expropriation. From the perspective of the claimants, the revocation of the license could be treated as expropriation, as the license was an important protected investment itself.<sup>170</sup> The tribunal agreed that it constituted a direct and total taking, which had the same effect as expropriation,<sup>171</sup> as it was a '*defined and valuable interest that had been validly conferred according to Egyptian law*' and the claimants made their decisions based on it because it was '*guaranteed by the State for a defined period*'.<sup>172</sup> The tax-free status was a significant factor when the claimants made their investment decisions.<sup>173</sup> Although the Tribunal was convinced that the decisions made by the Respondent were for public interest reasons, prompt and adequate compensation was required based on Article III of the BIT.<sup>174</sup> The tribunal opined that compensation was essential no matter whether

<sup>164</sup>*Ampal-American Israel Corporation and others v. Arab Republic of Egypt*, ICSID Case No. ARB/12/11, para. 1, Decision on Jurisdiction.

<sup>165</sup>*Ibid.*, para. 40.

<sup>166</sup>*Ampal-American Israel Corporation and others v. Arab Republic of Egypt*, ICSID Case No. ARB/12/11, para. 44, Decision on Jurisdiction.

<sup>167</sup>*Ibid.*, paras. 49–52.

<sup>168</sup>*Ibid.*, para. 70.

<sup>169</sup>*Ibid.*, para. 151.

<sup>170</sup>The Tribunal cited *Gami Investment Inc. v. The Government of the United Mexican States* (UNCITRAL, Final Award, 15 November 2004, paras. 126–127) as an authority to support its position.

<sup>171</sup>*Ibid.*

<sup>172</sup>*Ampal-American Israel Corporation and others v. Arab Republic of Egypt*, ICSID Case No. ARB/12/11, para. 183.

<sup>173</sup>*Ibid.*, para. 182.

<sup>174</sup>*Ibid.*, para. 184–185.

the expropriation was lawful or not.<sup>175</sup> Therefore, based on Article III of the BIT, the tribunal concluded that the revocation of the license was an expropriation. Investors should expect that governments will make legislative and policy changes, and it is an inherent risk they should consider in advance.<sup>176</sup>

*Antoine Goetz and Others v. The Republic of Burundi (I)* is another case illustrating the relationship between policy changes in SEZs and BITs.<sup>177</sup> A free zone regime was created in 1992 by the Republic of Burundi, and companies could enjoy benefits like tax exemptions.<sup>178</sup> Based on the advice of a consultative commission, the business in some non-traditional sectors could enjoy a free-zone certificate.<sup>179</sup> In 1992, Affinage Des Metaux (AFFIMET) was formed under Burundian law and was owned by the Belgian-based Goetz family.<sup>180</sup> It was a mining enterprise, and its object was to produce, refine, and market precious metals.<sup>181</sup> A free-zone certificate was given to AFFIMET on 3 February 1993, but five months later it was informed that different opinions had arisen related to the proper scope of the free zone system. It was informed that if it wanted to enjoy the free zone status, a sum equivalent to the duties had to be deposited in advance during the investigation procedure. Following completion of investigations, on 20 August 1993 AFFIMET was told that its free-zone certificate had been suspended. However, in 1994, the certificate was handed back, while in 1995, it was withdrawn again. In 1995, based on the Belgium–Luxembourg Economic Union–Burundi BIT, the claimants filed a claim before ICSID.<sup>182</sup> The political instability of the Burundian authorities had to be responsible for the frequent changes.<sup>183</sup>

One more case, *Link-Trading Joint Stock Company v. Moldova*, can also be considered. The company protested that the tax treatment change taken by Moldova violated the tax stability which was promised by the host state.<sup>184</sup> Additionally, the measures could be treated as an expropriation, and the lack of compensation violated the US–Moldova BIT. Moldova asserted that the changes related to the tax treatment were a proper government exercise. Based on Article X(2) of the BIT, the respondent should respect the claimant’s investment according to the State’s tax policy.<sup>185</sup> When tax measures are found to constitute a direct or indirect taking of the investor’s

<sup>175</sup>Ibid., para. 186.

<sup>176</sup>*Vigotop Limited v. Hungary*, ICSID Case No. ARB/11/22, Award (1 October 2014) para. 625.

<sup>177</sup>Olaoye Kehinde Folake, ‘Goetz v. the Republic of Burundi I & II: How Foreign Investors Challenge “Free-Zone Regimes”’, in *International Economic Law and the Challenges of the Free Zones – Global Regulatory Issues and Trends*, eds., Julien Chaisse and Jiaxiang Hu (The Hague: Kluwer Law International, Global Trade Law Series, 2019), 317.

<sup>178</sup>*Antoine Goetz and Others v. The Republic of Burundi (I)*, ICSID Case No. ARB/95/3, Decision on Liability (2 September 1998), para. 1.

<sup>179</sup>The main criteria for eligibility are export of all production; creation of substantial added value; compliance with environmental, health, and safety regulations; and importation or re-export after further processing or packaging of imported products based on a list established by the Minister responsible for the free zones. Advantages of free zone status are: exemption from taxes for 10 years at 15%; minimum tax of 1% for business commercial free; tax reduction of 0.8% for companies that have created more than 30 permanent jobs; dividends are exempt from taxation for an indefinite period; right to repatriate capital and income; permission to have foreign currency bank deposits; flexible labour regulations; and exemptions from import duties and taxes. Businesses are not required to have import licenses.

<sup>180</sup>*Antoine Goetz and Others v. The Republic of Burundi (I)*, ICSID Case No. ARB/95/3, Decision on Liability (2 September 1998), para. 5.

<sup>181</sup>Ibid., para. 3.

<sup>182</sup>Agreement between the Belgo-Luxemburg Economic Union and the Republic of Burundi on the Encouragement and Reciprocal Protection of Investments (signed 13 April 1989, entered into force 12 September 1993) (BLEU (Belgium–Luxembourg Economic Union)–Burundi BIT (1989); *ibid.*, para. 18.

<sup>183</sup>Akin to what is described as roller-coaster-effect legislative changes. See *PSEG Global Inc. and Konya Ilgin Elektrik Üretim ve Ticaret Limited Sirketi v. Republic of Turkey*, ICSID Case No ARB/02/5, Award (19 January 2007), para. 250.

<sup>184</sup>*Link-Trading Joint Stock Company v. Moldova*, Final Award, IIC 154 (2002), 18 April 2002, Ad Hoc Tribunal (UNCITRAL), para. 7.

<sup>185</sup>Ibid., para. 63.



lawful investment, Article X of the Treaty permits the claims of such measures related to the expropriation clause. Article X states that '[w]ith respect to its tax policies, each Party should strive to accord fairness and equity in the treatment of investment of nationals and companies of the other Party. Nevertheless, the provisions of this Treaty, and in particular Articles VI and VII, shall apply to matters of taxation only with respect to the following: expropriation, pursuant to Article IIP.<sup>186</sup>

If the application of tax measures violates a specific government commitment, such measures can also amount to expropriation.<sup>187</sup> Article II(3)(c) stipulates that a state is required to '*Observe any obligation it may have entered into with regard to investments*'.<sup>188</sup> The lack of prompt and adequate compensation is a common claim related to expropriation.<sup>189</sup> If measures interfere with investments substantially, they can be treated as indirect expropriation. The burden to prove the causal link between the measures and the negative effect on its business is on the claimant. The tribunal found that the elimination of the customers' tax exemption did not interfere with the claimant's business substantially. As it is normal for tax measures to have a cost influence on taxpayers, the tax measures themselves were not enough.

Based on above cases, two main lessons can be learned. On one hand, although the government has rights to regulate in SEZs, it should be careful in designing, implementing, modifying, and revoking the regulations in SEZs to avoid committing the expropriation clause. On the other, if a specific commitment is violated by the application of tax measures, prompt and adequate compensation is required.

## 5. The International Trade Issues: Are Special Economic Zones Compliant with WTO Law?

With reference to WTO agreements, SEZs have not been explicitly regulated.<sup>190</sup> But SEZs within the territory of WTO members will be bound by WTO law, unless otherwise specified.<sup>191</sup> The WTO's goal is to reach a balance between helping exporters and importers conduct their business and allowing governments to maintain their social and environmental objectives.<sup>192</sup> The states in the WTO have various economic development conditions.<sup>193</sup> In order to maintain the liberal nature of the WTO trading system, government restrictions on trade should be reduced.<sup>194</sup>

The interactions between the incentives of SEZs and the WTO agreements will be considered in the following; first is how to maintain a balance between the NT standard and SEZs' incentives. It has to be noted that SEZs contravene the notion of NT which is found in GATT, GATS, and TRIPs to some extent (5.1).<sup>195</sup> Besides, the incentives of SEZs may trigger the SCM agreement, and countries should learn how to use the related measures properly (5.2). Lastly, the TRIMs agreement is also very significant, and governments should take actions to avoid possible challenges from other members (5.3).

<sup>186</sup>Ibid.

<sup>187</sup>Ibid., para. 73.

<sup>188</sup>Ibid.

<sup>189</sup>Ibid., para. 87.

<sup>190</sup>Arpita Mukherjee et al., *Special Economic Zones in India: Status, Issues and Potential* (Springer 2016), 183.

<sup>191</sup>Sherzod Shadikhodjaev, 'SEZs under the WTO's Scrutiny: Defining the Scope of Trade Issues', in *International Economic Law and the Challenges of the Free Zones – Global Regulatory Issues and Trends*, eds., Julien Chaisse and Jiaxiang Hu (The Hague: Kluwer Law International, Global Trade Law Series, 2019), 216.

<sup>192</sup>Romo, *China's Special Economic Zones*, 40.

<sup>193</sup>Gulnara Ruchkina and Evgeny Vengerovsky, 'Investment Activities within the Legal Framework of the World Trade Organization', *Russian Law Journal* 3 (2015): 128.

<sup>194</sup>World Trade Organization 2001a, 'WTO Successfully Concludes Negotiations on China's Entry', *WTO News* (2008), [www.wto.org/english/news\\_e/pres01\\_e/pr243\\_e.htm](http://www.wto.org/english/news_e/pres01_e/pr243_e.htm) (accessed 18 February 2019).

<sup>195</sup>Romo, *China's Special Economic Zones*.

### 5.1 The Problem of National Treatment

National treatment, which is found in GATT, GATS, and TRIPs, is the universal principle of WTO, but this presents a challenge to the ‘particularistic contracting’ feature of SEZs,<sup>196</sup> because based on the definition of NT standard, it prohibits discrimination and requires that ‘a WTO member may not discriminate on the basis of the national origin of the product’.<sup>197</sup> However, the ‘particularistic contracting’ characteristic of SEZs can be treated as a kind of ‘discrimination’, as different treatment does exist. To cite China as an example, ‘one of the most important characteristics of Chinese reform at both domestic and foreign levels was *‘particularistic contracting’*, which means that the arrangements for foreign trade and investment were negotiated for each unit, namely province, locality, or firm’.<sup>198</sup> For example, the SPFTZ was founded to change China’s low-value-added trade pattern with the development of technology, brands, quality, and service.<sup>199</sup> Offshore business is supported in SPFTZ, and headquarters and/or operation centers of multinational firms are encouraged to be set up.<sup>200</sup>

### 5.2 The Problem of Subsidies

Although the policies of SEZs might be challenged, WTO members can (and do) establish SEZs. Referring to Article 1 of the SCM Agreement, a subsidy is regulated as ‘a financial contribution by a government or any public body within the territory of a Member’.<sup>201</sup> Footnote 1 of the SCM Agreement states that ‘the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption ... shall not be deemed to be a subsidy’.<sup>202</sup> To exempt products whose production is for domestic purchase and which are imported into the SEZs from import duties or taxes levied on like products is the most common SEZ incentive, and it is not included in the definition of subsidy.<sup>203</sup> According to Article 1 of the agreement on Trade-Related Investment Measures (TRIMs), it ‘applies to investment measures related to trade in goods only’.<sup>204</sup> In order to meet TRIMs requirements, China, for instance, promised to modify or abandon the existing provisions which are inconsistent with its commitments to TRIMs.<sup>205</sup> Besides, transparency is a basic WTO value, and it requires rules and procedures to be transparent. In order to fulfill its commitments, China has provided its trade-related regulations through different channels, such as ministry websites, newspapers, and some journals.<sup>206</sup>

Developing states are concerned about WTO disciplines regarding subsidies for their SEZ programs.<sup>207</sup> There are two main components relating to WTO disciplines regarding subsidies. On the one hand, the use of subsidies in domestic markets is limited.<sup>208</sup> On the other, the use of countervailing measures is regulated in order to prevent trade barriers.<sup>209</sup> The SCM

<sup>196</sup>Ibid.

<sup>197</sup>Gerhart, Peter M. and Michael S. Baron, ‘Understanding National Treatment: The Participatory Vision of the WTO’, *Indiana International and Comparative Law Review* 14 (2003): 505.

<sup>198</sup>Susan. L. Shirk, ‘Internationalization and China’s Economic Reforms’, in *Internationalization and Domestic Politics*, eds., R. Keohane and H. Milner (3rd edn, Cambridge University Press, Cambridge 1999), 198.

<sup>199</sup>Yao and Whalley, ‘The China (Shanghai) Pilot Free Trade Zone’, 14.

<sup>200</sup>Ibid., 15.

<sup>201</sup>*Marrakesh Agreement*, Annex 1A, Agreement on Subsidies and Countervailing Measures (*SCM Agreement*), Article 1.

<sup>202</sup>Ibid.

<sup>203</sup>Creskoof and Walkenhorst, ‘Implications of WTO Disciplines’, 24.

<sup>204</sup>*TRIMs*, Article 1.

<sup>205</sup>Ibid.; For example, China promised to change its long-time ‘technology transfer’ requirement, which is inconsistent with TRIMs commitments.

<sup>206</sup>United States Trade Representative, ‘2017 Report to Congress On China’s WTO Compliance’ (2018), 137, <https://ustr.gov/sites/default/files/Press/Reports/China%202017%20WTO%20Report.pdf> (accessed 3 November 2018).

<sup>207</sup>Creskoof and Walkenhorst, ‘Implications of WTO Disciplines’, 12.

<sup>208</sup>Romo, *China’s Special Economic Zones*, 54.

<sup>209</sup>Ibid.

Agreement is aimed to improve GATT disciplines with respect to the use of both, subsidies and countervailing measures, while allowing members to make use of these two measures under certain conditions.<sup>210</sup> Based on both GATT Article XVI and Article 1 of the SCM agreement, the duty-free importation of intermediate goods for products destined for export is not treated as benefiting from subsidies in WTO rules.<sup>211</sup> According to the WTO, ‘the SCM Agreement requires that a subsidy must be specifically targeted to a certain enterprise or industry, to fall into the WTO and SCM Agreement regulatory regimes’.<sup>212</sup> Export subsidies and subsidies contingent on the use of domestic over imported goods are completely prohibited, as they amount to being ‘specific’ regardless of their details, and the allocation of resources has been distorted.<sup>213</sup> Export subsidies can be tax benefits for exportation.<sup>214</sup> If the subsidy is prohibited, a dispute settlement procedure can be requested by any WTO member to obtain a ruling in order to make the offending subsidies ‘be withdrawn without delay’.<sup>215</sup> India’s export subsidy measures for SEZs were challenged by US in 2018 and WTO dispute resolution panel required India to withdraw these measures within 90 days in 2019.<sup>216</sup> Appropriate countermeasures can be taken if the violating party does not obey the recommendation.<sup>217</sup>

To cite China as an example, it faced a growing number of trade-related disputes within the SCM area.<sup>218</sup> A number of measures taken by China, such as the exemptions from taxes on benefits available in the SEZs, were challenged by the US in 2007.<sup>219</sup> And refunds and deductions provided by China were also challenged.<sup>220</sup> From 2006 to 2008, there were five cases submitted by the US against China. The disputed measures included those ‘affecting imports of automobile parts; granting refunds, reductions or exemptions from taxes and other payments; affecting the protection and enforcement of intellectual property rights; affecting trading rights and distribution services for certain publications and audio-visual entertainment products; and affecting financial information services and foreign financial information suppliers’.<sup>221</sup> And it should be pointed out that specific tax exemptions are also among the main concerns as regards the countervailing investigations against China.<sup>222</sup> When China withdrew the related measures, the dispute was settled.<sup>223</sup> Based on the WTO regulations, subsidies can be actionable.<sup>224</sup> Some subsidies can be challenged under certain conditions, while they are normally not challenged

<sup>210</sup>Julia Ya Qin, ‘WTO Regulation of Subsidies’, 865.

<sup>211</sup>Mukherjee et al., *Special Economic Zones*, 183.

<sup>212</sup>World Trade Organization, *Agreement on Subsidies and Countervailing Measures* (World Trade Organization, Geneva 2009).

<sup>213</sup>Ibid.

<sup>214</sup>Sykes, ‘The Economics’, 9.

<sup>215</sup>Raul Torres, ‘Free Zones and the World Trade Organization Agreement on Subsidies and Countervailing Measures’, *Global Trade and Customs Journal* 2 (2007): 219.

<sup>216</sup>‘WTO rules against India’s export subsidies: All you need to know’, *India Today* (New Delhi, 1 November 2019), <https://www.indiatoday.in/business/story/wto-rules-against-india-s-export-subsidies-all-you-need-to-know-1614635-2019-11-01> (accessed 3 January 2020); Asit Ranjan Mishra, ‘Commerce ministry sets up panel to make SEZ policy compatible with WTO rules’, *Live mint* (7 June 2018), [www.livemint.com/Politics/LWcLXS4l3aQpEhCp8cdahJ/Commerce-ministry-sets-up-panel-to-make-SEZ-policy-compatibl.html](http://www.livemint.com/Politics/LWcLXS4l3aQpEhCp8cdahJ/Commerce-ministry-sets-up-panel-to-make-SEZ-policy-compatibl.html) (accessed 3 January 2020).

<sup>217</sup>Ibid.

<sup>218</sup>Diheng Xu, ‘Prospects on the Relationship between Chinese Direct Tax Incentives and Subsidy Rules of the World Trade Organization’, *Intertax* 44 (2016): 538.

<sup>219</sup>World Trade Organization, *Trade Policy Review: China*, Report by the Secretariat, WTO WT/TPR.S/199 (World Trade Organization, Geneva 2008).

<sup>220</sup>Ibid.

<sup>221</sup>Ibid.

<sup>222</sup>Xu, ‘Prospects on the Relationship’, 538.

<sup>223</sup>World Trade Organization, *Trade Policy Review*.

<sup>224</sup>Sherzod Shadikhodjaev, ‘International Regulation of Free Zones: An Analysis of Multilateral Customs and Trade Rules’, *World Trade Review* 10 (2011): 205.

altogether.<sup>225</sup> Based on the WTO regulations, ‘a subsidy is actionable if it is specific and if it causes one of three kinds of damage to another member: a) injury to a domestic industry; b) impairment of the benefits of a tariff concession, or c) serious prejudice to the interest of other members’.<sup>226</sup> As long as nations comply with the WTO restrictions, they do not need to worry about their measures being challenged.<sup>227</sup> For instance, when companies in SEZs purchase domestically made goods, the value-added tax is refunded to them and the refund is not prohibited by WTO, since such a refund is not regarded as a specific subsidy.<sup>228</sup>

### 5.3 The Problem of Trade-Related Investment Measures

In the WTO Agreement, the Trade-Related Investment Measures (TRIMs) covers foreign investment.<sup>229</sup> TRIMs are government measures, and private foreign investors are encouraged to follow some specific behaviors.<sup>230</sup> This agreement lists the measures that members of WTO should not apply.<sup>231</sup> The goal of the TRIMs Agreement is to facilitate investment while ensuring the liberalization of world trade.<sup>232</sup> Amit and Tarum point out that ‘in general, the TRIMs Agreement merely reaffirms GATT disciplines and reapplies them to TRIMs, such as transparency requirements (Article 6), general exceptions (Articles 3 and 4), and dispute settlement procedures (Article 8)’.<sup>233</sup> If a TRIM is inconsistent with the regulations of Article 3 or Article 11 of GATT 1994, it will be prohibited by the Agreement.<sup>234</sup> The prohibited TRIMs must be abolished, and the time periods are various based on the different levels of development. Developed countries are required to eliminate prohibited TRIMs within two years; the grace time for developing countries is five years; and for least-developed countries, it is seven years.<sup>235</sup> For example, a ‘local content’ requirement, which requires the investor to purchase a minimum percentage of domestic resources, may be required by the government of the host state.<sup>236</sup> A subsidy can also be granted if the investors comply with the so called ‘local content’ requirements.<sup>237</sup> These measures aim to benefit the host country by altering the investment condition in SEZs.<sup>238</sup>

There are four types of TRIMs inconsistent with GATT: (1) Performance Requirements: these require investors to do certain actions such as purchasing certain goods.<sup>239</sup> These requirements have been utilized by many countries.<sup>240</sup> (2) Local Content Requirements: these impose a mandatory condition, whereby a certain amount of domestic goods have to be purchased for the foreign investor to establish his enterprise.<sup>241</sup> (3) Export Restrictions: host states require the foreign investors to export a certain amount of their products.<sup>242</sup> (4) Local Equity Requirements: these

<sup>225</sup>World Trade Organization, *Agreement on Subsidies*.

<sup>226</sup>Ibid.

<sup>227</sup>Sykes, ‘The Economics’, 31.

<sup>228</sup>Romo, *China’s Special Economic Zones*, 91.

<sup>229</sup>Ibid., 65.

<sup>230</sup>Ibid., 67.

<sup>231</sup>Amit Banerji and Tarum Jain, ‘WTO Rules on Investment: Futility Manifold’, *Journal of International Business Research* 6 (2007): 1–24.

<sup>232</sup>Romo, *China’s Special Economic Zones*, 65.

<sup>233</sup>Banerji and Jain, ‘WTO Rules’, 4.

<sup>234</sup>Romo, *China’s Special Economic Zones*, 65.

<sup>235</sup>Ibid.

<sup>236</sup>Kevin C. Kennedy, ‘WTO Agreement on Investment: A Solution in Search of a Problem?’, *Journal of International Economic Law* 24 (2003): 97.

<sup>237</sup>Romo, *China’s Special Economic Zones*, 67.

<sup>238</sup>Kennedy, ‘WTO Agreement on Investment’, 97.

<sup>239</sup>UNCTAD, *World Investment Report 1998: Trends and Determinants* (1998), 180.

<sup>240</sup>David Collins, *Performance Requirements and Investment Incentives under International Economic Law* (Edward Elgar Publishing, 2015), 10.

<sup>241</sup>WTO Council for Trade in Goods, Joint Study by the WTO and UNCTAD Secretariats, *Trade-Related Investment Measures and Other Performance Requirements* 21–26, G/C/W/307/Add.1 (8 February 2002).

<sup>242</sup>Ibid.

allow foreign investors to invest in the host state only when the locals of the host country have a certain percentage of the ownership rights.<sup>243</sup> Based on some surveys, removing the export share requirements helps attract FDIs towards SEZs.<sup>244</sup> In the case of the SEZs in China, these types of TRIMs can be found in the initial laws issued by China to attract foreign investment, including the Foreign Equity Joint Ventures Law of 1979 and the Foreign Contractual Joint Venture Law of 1988.<sup>245</sup>

In order to avoid possible challenges from other members, governments can provide non-discriminatory treatment for all investors, no matter whether they are in or out of the zone.<sup>246</sup> The measures do not have to be the same, and as long as all eligible enterprises can access the zones fairly without any discriminatory regulations, challenges can be avoided.<sup>247</sup>

## 6. Conclusion

After analyzing the different aspects of SEZs, including their various names, their rapid proliferation, and their objectives, this article shows that the aims of SEZs are to create a favorable, liberal, and effective business climate which is not available in other parts of the state.<sup>248</sup> However, despite the states' intentions in establishing SEZs, the article also demonstrates that SEZs can lead to a number of challenges and violations of international economic rules, which is a finding of systemic importance. As a matter of fact, SEZs have the potential to undermine a number of well-established rules of international law.

The emerging tension between SEZs and IEL is problematic for all stakeholders, whether host states, traders, and international organizations. For instance, political stability is one factor that is considered by investors in accessing SEZs.<sup>249</sup> Despite their unilateral character, SEZs have already come under the scrutiny of investment tribunals. This is a tangible warning, especially as a series of decisions suggest that investment treaties, by default rather than by design, lead to SEZs incentives not being easily modified or withdrawn.<sup>250</sup> When policies in SEZs change frequently, the foreign investors' expectations may be affected and disputes arise.<sup>251</sup> The emerging tension between IEL and SEZs is also palpable in the context of trade and tax rules.

By considering the effect that the three main branches of IEL (namely international taxation, international investment law, and multilateral trade rules) can have on SEZs, this article discusses and assesses the legality of SEZs. The article demonstrates that SEZs have the potential to be harmful under international taxation law. In particular, if tax incentives are used to finance subsidy programs (while MNEs which enjoy tax benefits have no substantial activities in SEZs), the SEZ regimes can be considered harmful. In relation to international investment law, changes to policies in SEZs may amount to indirect expropriation. In such a situation, no matter whether the expropriation is lawful or not, prompt and adequate compensation by the host state is required. As regards WTO law, the measures provided in SEZs are also likely to constitute violations of international rules. In fact, it is only when governments can provide non-discriminatory treatment for all investors that possible challenges can be avoided before the WTO DSB.

Lawyers and policy-makers should carefully take into account IEL rules when designing and establishing SEZs. Not doing so could soon result in disputes and tribunals' findings which are

<sup>243</sup>Investment, Trade and International Policy Arrangements (1996), 176–179.

<sup>244</sup>Fabrice Defever et al., 'Does the Elimination of Export Requirements in Special Economic Zones Affect Export Performance? Evidence from the Dominican Republic', World Bank Policy Research Working Paper No. 7874 (2016), 3.

<sup>245</sup>Romo, *China's Special Economic Zones*, 68.

<sup>246</sup>See Shadikhodjaev, *Industrial Policy*, 198–202.

<sup>247</sup>Ibid.

<sup>248</sup>Carter and Harding, *Special Economic Zones*.

<sup>249</sup>Ibid., 106.

<sup>250</sup>Fernando Dias Simoes, 'When Green Incentives Go Pale: Investment Arbitration and Renewable Energy Policymaking', *Denver Journal of International Law and Policy* 45 (2017): 263.

<sup>251</sup>Ibid., 264.

unfavorable to many states. In addition, not meeting the requirements and standards set by IEL could simply defeat the very reasons that drive the establishment of SEZ, which is to provide a stable and open environment to local and foreign companies engaged in international trade.

**Acknowledgements.** The authors thank Jacopo Dettoni, Georgios Dimitropoulos, Jędrzej Górski, Jiaxiang Hu, Yulia Levashova, Arpita Mukherjee, Sherzod Shadikhodjaev, and Elisabeth Tuerk for indispensable feedback and comments. The opinions expressed herewith are the authors' own.