

# POSSIBILITY OF PRIVATE SECTOR PARTICIPATION IN SPECIAL ECONOMIC ZONE DEVELOPMENT PROJECTS: A CASE OF MONGOLIA

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**ABSTRACT:** Special Economic Zone (SEZ) model is a commonly used method in developing countries to generate economic growth, to attract foreign direct investment, to increase employment and to improve living conditions. However, many developing countries are facing a number of problems to develop SEZs. Especially, the future of SEZ projects, which are highly dependent on government funding, is unpredictable whether they can be successful or not such as fully governmental projects in Mongolia. The SEZ project concept was implemented in Mongolia several years ago and there are 3 SEZ projects under the construction. The progress of Mongolian SEZ projects is far behind schedule due to lack of financial resources. It is clear that single government funding can not be sufficient to implement the SEZ projects. This paper analyses the possibility of private sector participation and gives some suggestions for finding an appropriate model of private sector participation on SEZ projects in Mongolia. Based on the world trend in SEZ development, private sector participation can be an essential method to accelerate the progress of the SEZ projects in Mongolia.

**KEYWORDS:** Public-Private Partnership, Special Economic Zone (SEZ)

## 1. INTRODUCTION

Most developing countries are trying to develop a various types of Special Economic Zones (SEZs) in their country for the last four decades. Mongolia, as a developing country, is also included the list of countries which are developing SEZs. But many developing countries are facing a number of problems to develop SEZs, Mongolia as well. Although the every project has its own problems, one of the predominant reasons for the problems is the lack of financial resources facing to SEZ development projects implemented by public sector. To prevent this problem, private sector participation model and its appropriate use are crucial. But attracting private sector participation in SEZ development needs preparation works related to the

laws, regulations and planning. Based on the lessons learned from SEZ development, a new planning system or feasibility study should be implemented to attract private sector participation. The new feasibility study method encourages implementation of not only existing SEZ projects but also new SEZ projects, which benefit both the host country and private investors.

## 2. SPECIAL ECONOMIC ZONE

Special Economic Zone (SEZ) model is a commonly used method in developing countries to generate economic growth, to attract foreign direct investment, to increase employment and to improve living conditions. There are several important reasons for establishing SEZs, as follows:

- Attract foreign direct investment
- Develop manufacturing
- Develop and diversify exports
- Job creation
- Develop infrastructure
- Regional development

Although SEZs were established a long time ago, modern era of SEZ was started together with the first industrial free zone in Shannon, Ireland in 1959. According to World Bank estimates, as of 2007 there are more than 3000 projects taking place in SEZs in 120 countries worldwide. There are many successful stories of SEZ projects, as well as many failed projects. Although the failed projects have their own reasons, one of the predominant reasons for failures of those projects is the lack of private sector participation or highly dependent on public sector financial resources (USAID 2004).

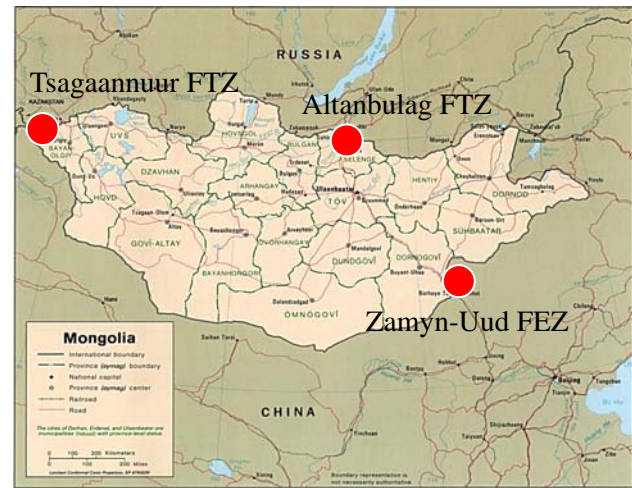
### 3. CONTEMPORARY SITUATION OF SEZs IN MONGOLIA

Mongolia entered a new era of market economy after the 70 years of a socialist economy by the help of the democratic revolution in the early 1990s. Nowadays implementing successful model of development is crucial for development of the country.

Based on the successful stories of SEZs in other developing countries around the world, demand of SEZs were sought in Mongolia, and accordingly the proposal titled “The Concept of Establishing Free Economic Zone” was approved by the Parliament upon 87th resolution in 1995. Then “Law on Free Zones” was approved by parliament in 2002. After the approval of laws, currently there are 3 projects (1 Free Economic Zone and 2 Free Trade Zones) are established in Mongolia (Figure 1). But the future of these fully governmental SEZ projects,

which are highly dependent on government funding, is unpredictable whether they can be successful or not.

Figure 1. Location of Special Economic Zones in Mongolia



#### 3.1 Altanbulag Free Trade Zone

The Law on the Legal Status of the Altanbulag Free Trade Zone, the first free trade zone of Mongolia, was approved by parliament in 2002. The Altanbulag FTZ is located in the northern part of Mongolia with a planned area of 500 hectares. It is adjacent to Khiagt border port of Russia, 335 km away from the capital city of Ulaanbaatar. The construction of on-site infrastructure of the zone development is in progress but it is getting big delay on the schedule depending on the government funding. The zone development has been limited by iron fence since the zone development started in 2004.

The Government of Mongolia (GoM) suggested to the governor’s office of Altanbulag FTZ to invite domestic and foreign investors, who shall implement investment projects in the zone area. According to the suggestion of the GoM, over 60 domestic and foreign investors have signed segmental investment agreement and started to lease total area of 400 hectares since September 2006. But

the investors are waiting for the on-site infrastructure complete.

### 3.2 Zamyn-Uud Free Economic Zone

The development of Mongolia's first free economic zone is in its initial stage and governed by the law of the Zamyn-Uud Free Economic Zone issued in 2003. The zone is located next to the biggest border port town of Zamyn-Uud, Dornogobi province. It is situated 670 km from Ulaanbaatar and 8 km from Erlian town of China. A planned area of Zamyn-Uud FEZ is 900 hectares. The Law on the Legal Status of the Zamyn-Uud FEZ envisages developing the zone with three major sections: industrial, commercial, and tourism-entertainment.

Based on the experience of Altanbulag FTZ, GoM has sought a strategic investor for Zamyn-Uud FEZ. Therefore GoM had announced international open tenders for selection of the strategic investor of Zamyn-Uud FEZ project in 2004 and 2007 twice. Although "West Paradise" Co. Ltd from British Virgin Islands and "Winwheel Bullion" corporation from US were selected the tender winners, the GoM revoked the both contracts in the evidence of they had not completed their responsibilities.

The GoM had decided to use its own capacity to complete the project by government funding and included the expenditure of the project into the government budget from 2007 to 2009. Currently there has been built only a fence and guard places around the zone, which started to build in 2007.

### 3.3 Tsagaannuur Free Trade Zone

The latest free trade zone to be established is situated on the western border of Mongolia with a planned area of 708.4 hectares. It is located 1720 km from Ulaanbaatar city, 28 km away from Russian border and 190 km from Kazakhstan border through Russia.

Parliament has approved the law of Tsagaannuur Free Trade Zone in 2003, and the governor's office of Tsagaannuur FTZ was established in 2005. Currently progress of this zone is almost stopped due to lack of financial resources.

Author's field visits in Altanbulag FTZ, Zamyn-Uud FEZ and interviews with project personals identified that the main problem is the lack of financial resources.

## 4. PRIVATE SECTOR PARTICIPATION

Recently private sector participation in SEZ development has become a highly visible tendency around the world. According to FIAS (2008), "62 percent of 2301 zones in developing and transition countries are private sector developed and operated (Table 1). This contrasts greatly with the 1980s, when less than 25 percent of zones worldwide were in private hands."

Table 1. Public and Private Sector Zones in Developing and Transition Economies

Region	Public Zones	Private Zones	Total
Americas	146	394	540
Asia and the Pacific	435	556	991
Sub-Saharan Africa	49	65	114
Middle East and North Africa	173	40	213
Central and Eastern Europe and Central Asia	69	374	443
<b>Total</b>	<b>872</b>	<b>1429</b>	<b>2301</b>

Source: FIAS, 2008

### 4.1 Reasons of decrease in SEZs, developed by public sector

Private sector SEZ projects are considered more successful than public sector SEZ projects. There are

several reasons for the failure of public sector initiated SEZ projects, as follows:

- Government monopoly on SEZ development

The situation of SEZ projects in Mongolia can be put down to this reason. Mongolian Law on Free Zones encourages fully governmental SEZ projects. In accordance with this law, all of the existing SEZ development projects are being developed by government agencies.

- Selecting rural areas for the SEZ site

Government oriented SEZ projects usually select rural areas for SEZ sites, which requires a huge amount of infrastructure expenditure.

All of the SEZ projects in Mongolia are located in rural areas, along the border of the country lacking basic infrastructure.

- Lack of financial resources

The governments of developing countries always lack financial resources, and big development projects such as SEZ projects place pressure on the government budget. The lack of financial resources is the main reason for prolonged projects.

#### 4.2 Types of private sector participation in zone development

Several types of private sector participation models are used in SEZ development. Public-Private Partnership (PPP) is becoming a way to develop SEZ projects. The PPP is effective funding method to attract financial resources and benefit of private sector.

Table 2. Types of PPP

Types of PPP	
Build-Own-Operate (BOO)	The private
Build-Develop-Operate (BDO)	sector designs,
Design-Construct-Manage-Finance (DCMF)	builds, owns,
Design-Build-Finance-Operate (DBFO)	develops,
	operates and
	manages an asset

Design-Build-Operate-Manage (DBOM)	with no ownership transfer obligation to the government.
Buy-Build-Operate (BBO) Lease-Develop-Operate (LDO)	The private sector buys or leases an existing asset from the government, operates the asset with no ownership transfer obligation to the government
Build-Operate-Transfer (BOT) Build-Own-Operate-Transfer (BOOT)	The private sector designs and builds an asset, operates it, and then transfers it to the government upon completion of the operating contract or within some other agreed time period.

Source: Gbeleyi, 2009

Some examples, used in SEZ development are:

- Built-Operate-Transfer and Built-Own Operate methods of on-site and off-site infrastructure and facilities
- Public financing for off-site infrastructure and facilities as incentive for private funding of on-site infrastructure

This example can be implemented in Mongolian case. But according to attract private sector interest to the site, off-infrastructure should be developed in effective way. Also the site location is important.

- Contracting private management for government-owned zones

This example had already tried in Zamyn-Uud FEZ's

case twice. Unfortunately both attempts were failed. If government can select a potential management group, this method can be very successful.

## 5. CONCLUSION AND RECOMMENDATION

Mongolian SEZ projects should follow the world trend of private sector participation in SEZ project development so as to avoid reliance on government funding. Attracting private sector participation in SEZ development needs preparation work related to laws, regulations and planning.

The following steps should be taken.

- The Law on Free Zones should be amended to determine the private sector role in SEZ project development.
- Other laws and regulations related to private sector participation should be improved and amended.
- The policy on Public-Private-Partnership should be approved quickly (the policy on Public-Private Partnership is now under discussion, by 2009).
- Public-Private Partnership approaches should be indicated in the amended Law on Free Zones.
- New SEZ projects should be approved on a cost-recovery basis so as not to repeat the same story as seen in existing SEZ projects.
- Cost of off-site infrastructure should be carefully considered when choosing new SEZ site locations
- Change the thinking way of the “SEZ is growth pole in rural area”

- A phasing method which does not burden the government budget should be implemented in SEZ project development

Based on the lessons learned from SEZ development, a new planning system or feasibility study should be implemented to attract private sector participation. The new feasibility study method encourages implementation of not only existing SEZ projects but also new SEZ projects, which benefit both the host country and private investors.

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