

**The Government Policy behind the performance
of free trade zones in Malaysia**Sissani Midoun ^{1♦}¹ University Ibn- Khaldoun-Tiaret, Algeria, sissanim@gmail.com**Received:** 08-10-2017**Accepted:** 20-04-2019**Published:** 31-05-2019**Abstract:**

Malaysia is one of the most innovative and successful economy in Southeast Asia and aims to become a high income country by 2020. IT has pursued a comparatively equitable development path. Free trade zones (FTZ) were one of the best choice and strategies adopted to fulfil the reforms and attract foreign firms and foreign direct investments.

This paper aims to illustrate the intensive competition between states on creating free zones because of their great impact on the country growth and as a mean of integration in the global economy. The second objective is to draw the Malaysian Authorities attention to invest heavily in free zones as modern form of economic diversification.

Key words: Export processing zones, diversification, of integration, attractiveness.

JEL classification : F20 ; F21 ; F23

1.Introduction

In 1960, the majority of Malays lived in rural areas cash cropping as fishermen or cash cropping. By 1970, industrial firms and multinational firms settled in Malaysia and attracted young Malaya work power. In the same year free trade zones were established by Americans, Europeans and Japanese corporations in Malaysia and seeking its lower cost workers especially in Singapore (Ong, Aihwa (1988)⁽¹⁾. The free trade zone have played a vital role in the boosting the industrial growth. The new Malaysian policy has succeeded to earmark the industrial sector. (Rasiah, R. (1993)⁽²⁾ Actually in 2016, Malaysia population is about 30.3 Million inhabitant and with its strategical location in the middle of the south east Asia is doubtfully a cost competitive area for offshore operations in the world and also has succeeded to make a great transformation step in its economy. It government and people fought to progress from an agriculture commodities to manufacturing based through export driven economy and strongly pushed the Malaysian a high technology and a the great capital intensive industries.

Free economic zones (FEZs) also called export processing zones, free trade zones and special economic zones almost refer to the same concept. However, the activities of the free zones vary according to the economic literature for each state. They are a gateway for a great, various number of investors seeking business opportunities. These zones are set up around seaports, international airports, and national frontiers. They represent areas with many geographic advantages for trade and According to the International Labour

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Organization's latest figures; the numbers of Free zones has grown from 79 in 25 countries in 1975 to 3000 in 116 in 2002. (ICFTU 2003);.

Generally speaking, free trade zones are created with a clear government policy which aims to take advantage of a country's comparative advantage in natural resources and labour. These zones are chosen by the government (1) (Krugman 1991) and focus on concentrated commercial, trade or industrial activity.

On other hand, (Johansson and Nilsson 1997);. (2) Free zones could be helpful while Take advantage of a country's comparative advantage in natural resources, existing infrastructure, or labour. They may also stimulate the local firms through learning and imitating the foreign firms on producing, exporting, how applying modern strategies in distributing manufactured good in any market.

2. Free trade zones definition :

According to (World Bank 1992) "Free Trade zones an industrial estate, usually a fenced in area of 10–300 hectares that specializes in manufacturing for export. Thus, some countries are offering foreign businesses attractive concessions and a number of investment incentives, including zero taxation and a great personage which may reach 100 percent ownership of a subsidiary.

However, OECD defines the free zone as "a government policy to promote exports of goods and/or services by offering a more competitive business environment through provision of special incentives including particular tariff exemptions to inputs in a geographically defined area" (Engman and Pinali 2007).

The Labour Organization (ILO), Defines export processing zones (EPZs) are industrial zones with special incentives set up to attract foreign investors, in which imported materials undergo some degree of processing before being exported again. Which means that The entire production of such zones is generally exported.

- The United Nations Industrial Development Organization (UNIDO) defines them as a relatively small, geographically area within a country established to attract export-oriented industries and offering them favourable facilities.

2.1. The Historical Background of Free Trade Zones :

Free zones are not a new model or a new invention but they existed in the deep past. So, while researching the history of Delos, some historians stopped thoroughly at this Greek island about 300 years BC and found out that this Island played the role of a commercial free zone which gathering Greeks, Italians, Phoenicians, Syrians, Egyptians, Palestinians, Jews and Persians who came and sail to trade in Delos without risk. The idea of the free trade zones return back to the Roman era, where the first (FTZs) were in this port «Delos» (1) and was also a weapon to face its competitors in the Greek island of Rhodes «Port of Rhodes».

Certainly, the first free zones which were known as ‘free trade zones’ without any customs tariffs or government organizing laws. They existed but just to trade goods internationally. However in 1959, the Irish government created Shannon Free Zone in order to attract some companies at that time with manufacturing facilities to develop the Irish trade. As a matter of fact, this zone became the first free zone and a model for other countries who established their free zones later.

3.Review of Literature

The existing literature on free zones tends to assume that foreign direct investment has played a great role in the growth of developed and developing countries. Most studies lay out overall economic impacts of free zones in developing countries. Among these studies :

- **(Alexandre and Laurent 2014);** ⁽¹⁾, have tried to bring a new vision and with draw writers to look at Free ports as international logistic interfaces that are free from border frictions besides This study brings out a modern definition of the free port concept and provides new understanding of these infrastructures and their key roles for company supply chains at the dawn of the 21st century.
- **(Rondinelli and Dennis 1987) ;** ⁽²⁾, Their study reviews the characteristics of free trade zones and export free zones and talk about their advantages in attracting foreign direct investments , generating employment and providing foreign exchange earnings for the economy. In their study they focused on Chinese free zones and some Asian countries including 80 free zones which were created by 1980 and 40 (FTZs) just after this date. This study also mentioned the adverse effect of these zones on some developing countries. The output showed weak results of free trade zones in these countries on labor ,technology transfer and export flows.
- **(Hakimian 2011);** ⁽³⁾ According to his analysis, first this study focused on the rise of free zones as a global phenomenon and examines the experience of these zones in Iran .The most of these trade zones aim to attract FDI and to promote manufacturing exports, to create new opportunity jobs, to transform domestic technological skills.
- **(Krugman1991);** ⁽⁴⁾ in his article entitled "The move toward free trade zones." He examined trade diversion and liberalization among countries effects and invite states to create free zones which are very important in increasing productivity efficiency and competitiveness .Besides, its strengthen the customs union and the integration in the global economy .He also warn countries to deal with the policy called ‘ beggar they neighbour ‘which is a an economic policy through which one country trend to worsen the economic problems of other countries.

4.Research Methodology

4.1. Free zones objectives :

The free zones are established to increase the exports and boost the country foreign direct investments. Moreover, these Zones can provide low cost supply and diminish

unemployment and gain more exchange earnings. Besides, they are developed to reach the following goals:

- ✓ Generate economic growth.
- ✓ Attract foreign direct Investment.
- ✓ Integrate the different regional economy of the country in the world economy.
- ✓ Develop the Investment environment.
- ✓ Promote innovations and creativity.
- ✓ Test new approaches to foreign direct investment and to policies related to law.
- ✓ Foster economic reform strategies by developing and diversifying exports.

4.2. The benefits of having a company in the free zone are as below:

- ✓ Zero per cent Tax
- ✓ 100% ownership
- ✓ No Currency restrictions
- ✓ Freedom to do business
- ✓ Competitive Rates

4.3. The law and the benefits of having a company in the free zone

The law on Free zones grants the following incentives to free zones operators and organizers:

- 100% Ownership.
- No Value-Added Tax (VAT) for delivering services and supplying goods in Free trade zones territory.
- Tax-free profit to legal entities and no income tax for sole proprietor acting as operators or organizers of free zones.
- No property taxes on public and industrial buildings and structures owned or leased within Free zones.
- No customs charges and non-tariff regulation measures applied to the export of goods released under the customs regime “Imports into Free Economic Zones”, or to other goods produced due to the use of such goods within the territory of free zones.
- Freely convertible currency is allowed as a medium of exchange while trading within FEZs, unlike the entire territory of the Republic of Armenia, where trade is allowed only through use of the national currency.⁽¹⁾

Table (1): Difference between free zones and non freezones :

Key Differentiators Free Zone Non-Free Zone	Free Zone	Non-Free Zone
- ForeignOwnership	100% Foreign Ownership	51% Local partner required
- Income&CorporateTax	100% Tax Free	100% Tax Free
- Business Horizon	Free to do business in Free Zones	Free to do business
- Customs Duties	100% duty exemption on all exports	Normal Customs duty will be applicable
- Capital & Profit repatriation	100% Allowed	100% Allowed
- Hiring of Expatriates	No restrictions	Local labor laws will apply

Source : www.fidfinvest.com**5. Types of free economic zones :**

- **Free trade zones (FTZs):** Known as commercial free zones with a great deal on products because no one is taxing and goods are traded without any barriers.

- **Export processing zones (EPZs):** These zones have been defined by the ILO as “Industrial zones with special incentives set up to attract foreign investors, in which imported materials undergo some degree of processing before being exported again”. Export zones Focus on manufacturing of exports only and allow investors to import and export goods free of duties and exchange controls.

- **Enterprise Zones (EZs):** A designated zones which aim to intended to revitalize distressed local areas and to promote job creation .Furthermore, they increase the capital investment in some poor, misfortunate areas of the country.

- **Free ports (FPs):** Encompass larger areas. They accommodate all types of activities, including tourism, retail sales and provide more incentives and benefits.

- **Specialized Zones (SZs):** Include science/technology parks, petrochemical zones, logistics parks, airport-based zones, and so on.

- **Special Economic Zones (SEZs) :** Special Economic Zones (SEZs), are geographically designated areas of a country set aside for specifically targeted economic activities, supported through special arrangements (that may include laws) and systems that are often different from those that apply in the rest of the world

5.1. Typical Free Zone incentives are:

- ✓ Foreign ownership of firms operating within the zone
- ✓ Duty free or reduced duty import of capital equipment
- ✓ Duty free or reduced duty import of raw material
- ✓ Duty free or reduced duty export of goods
- ✓ Processed within the free zone to areas outside the customs zone
- ✓ Free flow of currency
- ✓ Fixed term income tax holiday of company

5.2. Economic Impacts of Free Trade Zones: The Free Zones are quite efficient tools to boost the growth and integrates the different region in the country where they are settled with the global economy

by creating goods for export, attracting foreign currency, and create an economic bridge which may help the local companies outside the free zone.

5.3. The impacts of Free Zones on Employment: A Free Zone acts to stimulate growth and creates new job opportunities for local workers. There were around 3500 free trade zones across 116 countries in the year 2006, where nearly 66 million people were working. However, in China there were about 30 processing zones which generate about 40 million jobs.

Table(2) :Export processing zones and estimated employment from 1975 to 2006.

	1975	1986	1995	1997	2002	2006
Num. of countries with EPZs	25	47	73	93	116	130
Num. of EPZs	79	176	500	845	3000	3500
Employment (millions)	/	/	/	22.5	43	66
– of which China	/	/	/	18	30	40
– other countries for which figures available	/	/	/	4.5	13	26

Source: ILO calculations based on a variety of sources including zone administrations, national statistics, web sites, published articles, estimates and responses to ILO surveys, updated to Dec. 2002.

5.4. Impacts of Free Zones on Exports: Many counties create free trade zones to stimulate the economic growth for home consumption as well as Exports. From the table below we can see that the total export of free zones have increased from six million dollars in 1970 to six hundred million dollars. This huge development in export.

Table (3): The development of the total export of Free trade zones

1970s	Today
30 countries	More than 120 countries
80 zoneprojects	2000-5000 zoneprojects
No private zones	More than 1200 privatezones
Total exports \$6 billion	Total exports exceed more than \$600 billion
Direct jobs generated = 1 million	Direct jobs 50 million, of which 30 millions are in China

Sources: The 2003 ILO Survey & the World Bank

Free trade zones (FTZ) have become widespread and encouraging technology transfer and innovative industrial strategies. The contributions of (FTZs) to export seem to be great in the host country.

5.5. The impacts of Free Zones on Government Budget : The free trade zones are an important tool Contributing to the trade balance because if these zones are well managed they can encourage export of goods and supply the local market .On other hands , Free trade zone reduce the importation of lot of manufactured productions and diminish the use of foreign currency in the home country .Thus, Free Trade Zones reduce the costs for

companies by granting them the same treatment as native-producers help in boosting technological skills.

5.6. Determinants affecting location decision of doing business: The MIGA FDI Trends Survey listed 20 factors affecting the decision making process for locating overseas and these factors are used in selecting location. However, we can also conclude that these factors are also a platform for firms location decision in any free trade zone. Most companies give a great value to the market access as main factor with 77% and then Socio-political factor with 64 % and in the third rank there is Ease of doing business.

Table (4): Determinants effecting location decision

Factor / Determinant	100% mostinfluential
1. Marketaccess	77
2. Stable socio-politicoenvironment	64
3. Ease of doing business	54
4. Reliability and quality of infrastructure and utilities	50
5. Ability to hire technical professionals	39
6. Ability to hire management staff	38
7. Level of corruption	36
8. Cost of labor	33
9. Crime and safety	33
10.Ability to hire skilled labor	32
11.National taxes	29
12.Cost of utilities	28
13.Roads	26
14.Access to rawmaterials	24
15.Availability and quality of university and technical training	24
16.Available land with all services in place	24
17.Local taxes	24
18.Access to suppliers	23
19.Labor relations	23
20.Air service	23

Source :The MEGA FDI Trends Survey 2003.

Many important geographical and non-geographical factors such as economic, political, historical , religious and social factors can influence the choice of location decisions and Free zones creation depends strongly on these factors .

Result and Discussion**7. Malaysian Economic Strengths:**

The Malaysian economy is expected to keep healthy since its GDP growth reached 5.1% for 2016 compared to 2011 and 2012. (Mansor, N., & Yeoh, K. K. (2016)⁽¹⁾ However, the inflation rate expected to be 2.8 and remains acceptable in general and the domestic demand will remain as a key driver of growth. Absolute poverty has been largely eliminated. Malaysia has undertaken important reforms to enhance the entrepreneurial environment too. Monetary and trade freedom are going straight. For example, Malaysia scored the 31st rank in the world according to the Economic Freedom Index in 2016 and pointed out that Malaysia has made a great success in the area of open markets measured by trade freedom, investment freedom, and financial freedom (Soon, S. V., Baharumshah, A. Z., & Chan, T. H. (2015)⁽¹⁾. But it has also noticed that the rule of law remains weak, the government has taken steps to tackle corruption more effectively.

Malaysia has really created its proper economic vision through a clear national target called the New Economic Model (NEM) which is a set of plan, Government policy, strategies and programs in order to achieve the emergence of Malaysia as a high developed country.

No doubt, that the supportive Malaysian policies have contributed to maintain an attractive business environment with opportunities for growth especially with its liberal equity policy which was applied since 2003 and permit all investor to hold 100 percent of the equity in all investments in new project or which contribute in the diversification of its economy.

7.1. Supportive Government strategies and advantages

Among the greatest economical advantage in Malaysia are as follows:

- Attractive tax incentives.
- GDP growth : 4.2 % IN 2016 and with \$350 billion GDP.
- \$26,211 GDP per capita, PPP
- Inflation CPI : 2.1 %
- Unemployment Rate : 3.4 %
- Engaged into modern technology.
- High developed infrastructure and high telecommunication
- Young, educated and productive manpower.
- High and developed Airports and seaports.

7.2. Malaysia rankings in International institutions: According to the Malaysia ranking in most known economic indexes, we can conclude that it remains an attractive business country for investors.

Table 5 : Most important Malaysia rankings in International institutions

Economic	
Baseline Profitability Index 2015	ranked 6th out of 110 countries
World Competitiveness Yearbook 2016	ranked 19th out of 58 countries
Doing business index Report 2017	ranked 23rd out of 190 countries
2016 Global Enabling Trade Report	ranked 37th out of 136 countries
Social	
Sustainable Development Solutions Network's World Happiness Report 2017	ranked 42nd out of 155 countries
Index of Ignorance 2016	ranked 36th out of 40 countries
Technological	
Global Connectivity Index : Huawei 2017 (GCI)	ranked 24th out of 50 countries
: International Telecommunication Union 2017 Global Cybersecurity Index (GCI)	ranked 3rd out of 165 countries
Political	
Corruption : Transparency International 2016 Perceptions Index	ranked 55th out of 176 countries
Rule of Law : World Justice Project Index 2016	ranked 56th out of 113 countries
Democracy : Economist Intelligence Unit 2016 Index	ranked 65th out of 167 countries

Source : https://en.wikipedia.org/wiki/International_rankings_of_Malaysia

7.3. Free Zones in Malaysia

A free zone is a designated, secured area in which commercial and industrial activities are carried out and released by the Minister of Finance as stated under section 3(1) Free Zones Act 1990 (Act 438). There are almost many types of free zone in Malaysia, such as the free zone for commercial activities (FCZ) and free zone for industrial activities (FIZ) and the most recent one is the world's first Digital Free Trade Zone (DFTZ) which was launched on 22 March 2017 by Dato' Sri Mohd Najib Tun Abdul Razak, the Prime Minister of Malaysia. This DFTZ was established to enhance the Malaysia's eCommerce in 2016, and to boost and double the nation's eCommerce growth through increasing the GDP contribution about US\$47.68 billion by year 2020. The first FTZ was established in Penang in January 1972 in the Bayan. It was absolutely a real open gate towards electronics industry in Malaysia (Nesadurai, Helen ES (1991) ⁽²⁾).

7.4 Free industrial and trade zone in Malaysia

- 1) Bayan Lepas Free Trade Zone, Penang : is a high-tech industrial zone on the southern part of Penang Island and The earliest phase of the industrial zone was developed in the early 1970.

- 2) Kulim Hi-Tech Park, Kedah : It is a high technology science park in the northern of Peninsular Malaysia and only 36km away from Penang island. It is famous for its high quality infrastructure in term of reliable power supply, high capacity fibre optic network and abundant water supply.
- 3) Melaka Batu Berendam FTZ (Texas Instrument, Dominant Semiconductor, Panasonic)
- 4) Pasir Gudang Free Trade Zone, Johor.
- 5) Port Klang Free Zone, Klang, Selangor : Port Klang Free Zone (PKFZ) in Port Klang, Malaysia, one of the most ideal investment for companies intending to set up or expand their business in South East Asia.
Port Klang Free Zone , an integrated 1000 acre. It represents an ideal investment for companies intending to set up or expand their business operations in South East Asia.

8. Conclusion

The Malaysia's economy grew faster and free trade zones have played key role in economic globalization and the diversification of economies of many countries. This form of zones helped and could help more and more the Malaysian authorities to activate the National economy and enter in the sphere of the economic diversification and high income countries..

It become necessary to Malaysian Authorities to deal carefully with the creation of free trade zones in the different region of Malaysian especially near Airports and seaports or next to specific inner region with the most modern infrastructure in order to assure their success and make them work.

It is time for the Malaysian Authorities to modify its policy and create an appropriate investment climate to attract foreign capital flows as well as Attracting national immigrant capitals.

Free zones also help to customize and exploit optimally economic resources .The free trade zones are important means in reducing the deficit in the trade balance. These trade zones require the availability of fundamental factors and clear vision to achieve the goals. However, the unavailability of geographic and non-geographic factors may cause the failure of these trade zones. "Malaysia economic performance is expected to reach the goals due to the private consumption which may give more flexibility in terms of policy for the government.

Although ,Malaysian belongs a lot of determinants for the success ,a lot of work must be done to moderate the investment law and incentives and make them more attractive.

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