



# THE CONCEPT BEHIND FREE ZONES AND GEORGIAN REALITY

# The Concept Behind Free Zones And Georgian Reality

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A Free Zone is set up in a part of a specific region or a geographical location where any legally permitted production of goods and services are exempt of taxation (fully or partially, depending on legislative framework) and other bureaucratic barriers. It is of high importance that such zones act as a one-stop shop, cutting excessive adherence to official rules and formalities, simplifying administrative procedures. This situation leads to reduced transactional costs for international companies.

Why do governments decide to set up Free Zones? The primary factors are:

- Attracting of Foreign Direct Investment (FDI);
- Incentivize economic activities in a specific region;
- Development of the new markets;
- Reduce unemployment rates;
- Boosting technological skills.

There are four main types of Free Zones:

- **Free Trade Zones** - typically located near seaports or airports, mainly offer exemptions from national import and export duties on goods that are re-exported. Local services gain, though there is little, if any, value added to the goods traded.
- **Export Processing Zones** - these go a step further by focusing on exports with a significant value added, rather than only on re-exports.
- **Special Economic Zones** – these apply a multispectral development approach and focus on both domestic and foreign markets. They offer an array of incentives including infrastructure, tax and custom exemptions, and simpler administrative procedures.
- **Industrial Zones** – these are targeted at specific economic activities, e.g. media or textiles, with infrastructure adapted accordingly.

It should be underlined that any kind of Free Zone operates with separate customs territories, creating fiction that it is a foreign territory (e.g. bringing Georgian goods in a local free industrial zone shall be considered an export of goods and taking goods out of a free industrial zone to other country shall be considered an import of goods).

Let's discuss what has got Georgia as a provider of Free Zones on a global market and what are the key advantages and disadvantages of operating throughout them. As we described above, there are four different kinds of free zones. In Georgia, what we call a Free Industrial Zone is a hybrid of all of them. It is regulated by the Law of Georgia on "Free Industrial Zones", enacted in 2007.

## Georgia's General Overview

According to Economic Freedom Index, which is published every year by Heritage Foundation, Georgia is 16th freest economy in the world (8th in Europe), which means that it classifies in the group of Mostly Free Economies. The Index covers 12 identified freedoms<sup>1</sup> – from property rights to financial freedom – in 186 countries. The ideals of economic freedom are associated with healthier societies, cleaner environments, greater per capita wealth, human development, democracy, and poverty elimination. Performing well in the complex and comprehensive Economic Freedom Index increases Georgia's attractiveness to investors and worldwide financial institutions.

In 2014 Georgia signed an Association Agreement with EU, resulting in Georgia becoming a Deep and Comprehensive Trade Area (DCFTA) for the EU. Also, Georgia gains benefits from the Generalized System of Preferences (GSP). It includes reductions in tariffs on a wide range of products which could be exported to the USA, Canada and Japan. Besides this, the country benefits from free trade with the European Free Trade Association (EFTA) member states: Iceland, Liechtenstein, Norway and Switzerland. Georgia also has a free trade regime with the Commonwealth of Independent States (CIS) and its neighbors: Turkey, Azerbaijan, Russia and Armenia. Of particular importance though is the Free Trade Agreement between Georgia and People's Republic of China, which came in force on January 1st 2018.

Beyond this, a stable financial sector, low utility costs and low crimes rates are attractive features of the country for foreign investors.

This means that countries from Central Asia as well as MENA countries and China could benefit significantly from using Georgia as a trade entry point to the EU - the second largest economy of the world with nominal GDP, consisting of almost USD 19 trillion in 2018.

## Fiscal Incentives in Georgian Free Industrial Zones

Now let's describe basic fiscal incentives that are available in Georgian Free Industrial Zones. Table 1 provides clarity regarding these incentives.

*Fiscal Incentives in Georgia*

Types of Taxes	Georgia Mainland Company	Free Zone Registered Company
VAT	18%	0%
Corporate Profit Tax	15%	0%
Tax on Dividend Withdrawal	5%	0%
Property Tax	Up to 1%	0%
Import Tax	12% / 5% / 0%	0%
Export Tax	0%	0%
Personal Income Tax	20% (payable by employees)	20% (payable by employees)

*Source: Law of Georgia on free industrial zones, Article 9*

<sup>1</sup> Property Rights, Judicial Effectiveness, Government Integrity, Tax Burden, Government Spending, Fiscal Health, Business Freedom, Labor Freedom, Monetary Freedom, Trade Freedom, Investment Freedom, Financial Freedom.

## Logistical Hub

Beyond the basic fiscal incentives, it is important to make note of Georgia’s strategic location. Being the shortest transportation route between Europe and Asia, with access to Black Sea, Georgia serves as the gateway for MENA, GCC and Central Asian countries to the EU and vice versa.

In addition, Black Sea ports (also projected deep-sea port in Anaklia), emerging rail systems and three airports in Batumi, Kutaisi and Tbilisi, together with three oil and gas pipelines create immense economic and trade possibilities. Georgia provides a high level of efficiency and flexibility to all the stakeholders from East to West.

Georgia – Regional Logistic Hub



Source: HUALING FIZ

## Challenges of Georgia Free Industrial Zones

Before moving to the challenging issues of local free zones, let’s quickly review those that exist in Georgia. There are four Free Industrial Zones in three different parts of the country. The first one was established in Poti, near the Poti sea-port. Two are located in Kutaisi, a historically industrial city, and the last is in Tbilisi, the capital of Georgia.

As previously mentioned, Free Industrial Zones in Georgia are regulated by the Law on Free Industrial Zones. This Law sets the procedure for establishing and liquidating Free Industrial Zones. It defines the procedures for managing Free Industrial Zones and for establishing and operating the governing bodies and service/supervisory agencies within them.

Some of the key highlights<sup>2</sup>:

<sup>2</sup> More details are available in the Law on Free Industrial Zones -[LINK TO MATSNE.GOV.GE](https://matsne.gov.ge)

- A Free Industrial Zone may be established: a) at the initiative of the Government of Georgia; b) at the request of a natural or legal person – called an organizer.
- A Free Industrial Zone shall be a type of a free zone under the Tax Code of Georgia with additional conditions and tax concessions effective within it.
- Powers of local self-government bodies shall not apply to a Free Industrial Zone.
- A Free Industrial Zone enterprise may be an enterprise of any legal structure and any form of ownership registered within a Free Industrial Zone.
- Accounts within a Free Industrial Zone shall be settled in any currency, also a free industrial zone enterprise and a Georgian enterprise shall settle accounts in any currency.

Prohibited operations within the Free Industrial Zone: Manufacturing arms and ammunition, trading in arms and ammunition; manufacturing nuclear and radioactive substances, trading in nuclear and radioactive substances; bringing in, storing, manufacturing and/or selling narcotic and psychotropic substances; bringing in, storing, manufacturing and/or selling tobacco products and/or tobacco raw materials.

**Now, about challenges.** According to the Georgian Tax Code, if a Free Zone company sells or purchases any kind of goods and services from the territory of Georgia, then it has to pay 4% of the invoice amount. This issue impacts companies when they want to purchase a capital asset or any raw materials needed for the production process. Because of this negative incentive, instead of stimulating local market, Free Zone companies are seeking solutions from outside Georgia (to not pay the 4% bill). This could reflect into considerable foreign currency outflow from the country for no good reason. It could worsen performance and diminish the attractiveness of Georgia for companies that produce some form of agricultural goods, as they do not, or will not, find it attractive to purchase local raw materials (seeds, plants, etc.). If it is not to be abolished completely, the existing tax could be lowered further, or simply not applied to companies that are adding value to raw materials to produce absolutely different product.

If a Free Zone is to help a country with high rates of unemployment, then it's a little unclear as to why all taxes are reduced to 0%, other than personal income tax.

Organizers are continually trying to maintain and upgrade the infrastructure inside the zones, but the current law does not allow them to execute this freely. The Law states, activities performed within a Free Industrial Zone must be undertaken by an enterprise registered within it, however, a Free Zone Organizer cannot be a Free Zone company. Enterprises registered outside of the free industrial zone (both Georgian and foreign) can conduct activities within the Free Industrial Zone through permanent establishments registered within that zone - except for Georgian enterprises distributing electricity, water, and natural gas, as well as providing communication and sewerage services and conducting related activities. Due to this constraint, an Organizer has to register an additional subsidiary company within a Free Zone and execute additional bureaucratic steps. For example, if an Organizer plans to renovate a building, firstly it has to sign an agreement with its subsidiary company on passing the asset to it and only after that will the subsidiary company be able to undertake the required processes.

We can assume that, there is still a lot room for improvement within the legal framework of Free Zones in Georgia.

Ultimately, I wonder why we cannot turn the entire country into a single Free Zone? Is this possible? Will it work? That is a subject for later debate.

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