

## FREE ZONE – THE SOURCE OF SOCIO-ECONOMIC BENEFITS \*

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### ABSTRACT

Practice in developed and developing countries indicates the existence of numerous and heterogeneous free zones as well as the different role which they have in the economic development of countries that have implemented them. The main objective for start-up of a modern free zone with industrial characteristics is to attract those investors who will build the industrial infrastructure for the production of goods aimed for exports. Consequently, free zone will contribute, *inter alia*, to the increase in national exports and decrease in deficit of the country's current account, to the creation of new jobs and new added value, to the increase in the dynamics of economic activities and generation of new entrepreneurial opportunities, to the transfer of new technologies, knowledge, skills, good organizational and managerial business practice, as well as to the reduction of regional imbalance.

Experiences of former transition countries indicate that a free zone represents an important policy instrument for the attraction of foreign direct investment, especially the greenfield ones. Furthermore, experiences of developed countries indicate that free zone can act as a policy instrument for promoting regional development and development of a country as a whole. The main purpose of this paper is to consider the benefits that free zones can have on economic and social development of the area where they are located. The Osijek free zone is in the centre of this consideration.

**Key words:** free zone, benefits, costs, Osijek free zone

### 1. INTRODUCTION

Croatia has been faced with many macroeconomic problems. Especially noticeable are unemployment, twin deficit, foreign debt and insufficiently fast economic growth. One should note that sufficiently fast and sustain economic growth is a precondition for solving

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most of the above mentioned problems. Furthermore, numerous indicators show regional imbalance as the additional Croatian problem although more balanced development of each part of Croatia has been stated in many strategic materials.

According to the Croatian employment bureau (CEB, 2006), the lowest unemployment rate among Croatian counties was in 2005 in the Zagreb city (7.8%), while at the same time the highest rate was in the Vukovar-Srijem county (32.1%). Standard of living, measured by gross domestic product (GDP) per capita, in the Vukovar-Srijem county was also the lowest (2,070 USD), while the highest one had the Zagreb city (23,361 USD).<sup>2</sup> Furthermore, the share of people with tertiary education aged 15 and over was the biggest in the Zagreb city (22.6%), while at the same time the lowest one was in Virovitica-Podravina county (5.73).<sup>3</sup> Regional imbalance is also evident when the value added, entrepreneurial level of activity, intellectual capital efficiency, capital employed efficiency and the other indices come into question (see Borožan and Penavin, 2006).

Free zones and foreign direct investment (FDI) can be used as a tool for solving these problems. Croatia was unattractive for FDI, especially for greenfield investment, till 1998, i.e. peaceful reintegration of East Slavonia, Baranja and West Srijem in Croatia, primarily because of the Homeland war and political instability not only in a country, but also in the South-East Europe. Official statistics recorded FDI in that period, but they were very small in their volume and in most cases they took the form of overtaking or buying a share in state enterprises in the privatization process. Although the situation has been turning to better since 1998, many problems remain unsolved and continuing to hinder inward foreign investment. According to the Croatian National Bank, FDI accounted approximately 11,620 million EUR from 1993 to the second half of 2006 in Croatia. When the Croatian FDI inflows are compared with the same in the Central and Eastern European (CEE) countries, one should conclude that this amount is very small. But, when relative term comes into question, i.e. FDI inflows per capita, situation is more favorable for Croatia. However, considering that most of these investments were made in service sector (communication, trade and banking), and not in production (for export), as well as that most of them are of brownfield and not greenfield character, the need for formulation of the consistent and attractive FDI government policy and programs is obvious.

Croatia has not offered a lot of initiatives for attracting foreign investors. The practice in numerous developed and developing countries indicates that a free zone represents an important instrument for FDI attraction, especially the greenfield ones, as well as for boosting the export orientation of a country. A free zone refers to dedicated and fenced geographical area within the territory of a country in which business activities, which have been performed, are encouraged by the set of policy instruments and incentives in order to achieve certain economic objectives (see Madani, 1999). Because these instruments are not

<sup>2</sup> Source of data: Centre for intellectual capital (2005)

<sup>3</sup> Source of data: Census 2001, Croatian Central Bureau of Statistics

used in the rest of the country, business activities are performed under favorable business conditions. It should be also noted that the practice in developed countries indicates that free zones can foster local and regional development, as well as the development of a country as a whole.

The main purpose of this paper is to consider the benefits that free zones, particularly the Osijek free zone, can have on economic and social development of the area where they are located. Since the favorable effects generated by free zones are determined by the characteristics of the zone alone, in the second section of this paper, free zones are analyzed regarding their definition, roles, types and characteristics. In addition, favorable and unfavorable effects generated by free zones worldwide are listed. The third section deals briefly with the issue of free zones in the Croatian law and their future after accession to the European Union (EU). In the fourth section, benefits generated by free zones in Croatia are identified through the operation of the Osijek free zone. Conclusions are derived in the last section.

## **2. THE ROLE OF A FREE ZONE IN A COUNTRY'S ECONOMIC DEVELOPMENT**

There are numerous and heterogeneous free zones around the world and their roles are different in facilitating a country's economic development in which they are located. Not all zones have growth potential and not all of them positively contribute to the development of a country. It is a fact that favorable contribution to development is not an automatic response of zone existence. It is particularly important to know what kind of free zone it is, i.e. what are its goals, how it is designed, how it is managed, which clients it attracts and is it integrated with the other reforms conducted in a country.

### **Definition of free zone**

Different national and international institutions define free zone in different ways; for example:<sup>4</sup>

- “Free zone means a part of the territory of a contracting party where any goods introduced are generally regarded, insofar as import duties and taxes are concerned, as being outside the customs territory. (Revised Kyoto Convention, Annex D2).
- Free zone means parts of the customs territory of the community, separate from the rest of that territory, in which non-community goods placed in them are considered, for purposes of the application of import duties and commercial policy import measures, as not being within the customs territory of the community, provided they are not released for free circulation or entered under another customs procedure under the

<sup>4</sup> Source: FDI magazine: Challenges and opportunities, June 20, 2003, <http://www.fdimagazine.com/news/fullstory.php/aid/275>

conditions laid down in this regulation. (Council Regulation (EEC) No.2504/88 of 25 July 1988 on free zones and free warehouses).

- Export processing zones are fenced-in industrial estates specializing in manufacturing for export and offering their resident firms free-trade conditions and a liberal regulatory environment. (World Bank, 1992).
- Export processing zones are industrial zones with special incentives set up to attract foreign investors, in which imported materials undergo some degree of processing before being re-exported again. (International Labor Organization, 1998)."

In Croatia, according to the Law on free zones (NN, 44/96, article 2), a free zone is defined in following way: "A zone is a part of the territory of the Republic of Croatia, enclosed and marked, in which the economic activities are carried out according to some specific conditions." The legislator provided more detailed definition of a free zone in the Custom law (article 171, NN 78/99, 94/99, 117/99, 73/00 and 92/01). The Croatian definition of a free zone is appropriate for the establishment of a modern free zone with industrial characteristics. This type of zones is in the focus of the Croatian authorities due to beneficial effects that they can generate.

### **Free zone types and their basic characteristics**

Typology of free zones is extremely complicated because their historic development was long, and their heterogeneity large.

Difference between modern free zones (with industrial characteristics) and the zones having the function of custom supervision (for example, custom zones, free ports, custom warehouses) were pointed out by the members of the World Export Processing Zone Association at their constituting meeting.<sup>5</sup> They decided at the meeting that the term free (custom) zone will be avoided in order to avoid possible identification of modern zones with industrial characteristics with the zones with unindustrialized characteristics.

According to the UN (1990) modern free zones can be classified to:

- Trade zones exempted from customs – zones that allow the entrance of raw materials, intermediate goods and final goods being produced abroad without custom duties if they will be later, in refined, processed or finalized way exported (i.e. reexport). Paying duties on goods are performed only in the case when the goods will be sold in domestic market. Within this zone type, one can differentiate between free trade zones, free ports and free zones.

<sup>5</sup> World Export Processing Zone Association (WEPZA) was founded at Manila, Philippines in 1978 by the UN as an organization of 29 governments experienced in the development of export processing zones. Details are available on <http://www.wepza.org/>

- New zone types – these zone types are different from the classical zones not only with regards to the name, but also to the possibilities of decision making and the realization of decisions, as well as to the possibilities for doing business in different industries, from manufacturing to the services. Technological zones and scientific parks, as well as entrepreneurial zones, belong to these zone types.
- Other zone types – these zones include more or less bounded areas having specific elements of zone operating, like special economic zones (for example, in the coastal areas of China), import processing zones (for example, the zone in Manaus, Brasil), regional development zones, etc.

Guangwena (2003) gives typological diversity of free zones based on industrial structure and evolutive development.

### **Costs and benefits generated by free zones**

Since free zones have begun to play a prominent role in the national economies since the middle of 1960s, issues considering the costs and benefits of free zones have initiated a lot of debate (for review see Cling and Letilly, 2001; Kibritcioqlu, 2003).

Motives underlying the start-ups of free zones in Croatia have been derived from at least three favorable effects which they can induce: employment effects, balance of payments effects and competitiveness effects.

Opposite to the favorable effects and benefits that can be potentially realized by free zones, there are costs and unfavorable effects as well. Unfavorable effects and costs limit the benefits of the zone operating, making it more or less attractive instruments for goal achievement. One should point out especially the adverse effects on the balance of payments, on employment, competitions and on government budget. These adverse effects are mostly connected to the adverse effects generated by foreign direct investments. These favorable and unfavorable effects of free zones are discussed in Borozan (2006).

World experiences indicate that zone can, but not ultimately, effectively operate. For example, the zones in the South Korea, Malaysia, Sri Lanka, China and Indonesia are more efficient, generate much higher returns than estimated costs, and are also the source of employment and a promoter of entrepreneurship (Jayanthakumaran, 2003). However, free zone operating in Philippines resulted in the negative net current values due to the huge capital infrastructure costs arising at the time of start-up.<sup>6</sup>

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<sup>6</sup> See «Foreign direct investment», Challenges and opportunities, from 20.06.2003, (<http://www.fdimagazine.com/news/fullstory.php/aid/275>)

### 3. Legal frame of the free zone institution in Croatia

Free and custom zones that operated according to the Law on free and custom zones (Official Gazette SFRJ 3/90) at the time of Croatian struggle for independence (end of 1991) continued their operation in independent Croatia according to the new Law on free zones (NN, 53A/91, 94/93 and 25/96). However, this law was obsolete and impartial. It did not allow the transformation of these zones in modern free zones. Amendments to the Law on free zones in 1993 and in 1996 gave the time needed for new law formulation which should be appropriate for transformation of the existed zones and for start-up of new ones.

The new, current Law on free zones passed in the Parliament (Sabor) in May 17th, 1996 became effective eight days after announcement in *Narodne novine* (Official Gazette), no. 44, June 13, 1996. Eighteen different free zones were established based on that law in Croatia. The motives for free zone start-ups in Croatia are different; but, one should know that in a free zone one should, according to the article 33 (the Law on free zones): “make production and provide services. Beneficiaries of a free zone can do banking and the other financial activities, the insurance of properties and persons, as well as the activities of reinsurance only if they are in accordance with the activities prescribed in the paragraph 1 of this article.”

The entrance of foreign investors in a free zone has been induced by the exemption of tax on profit which height and exemption period are bounded. The incentive is defined in the article 36 of the Law on free zones as it follows: “Free zone beneficiary who constructs a building in the zone or participates in construction of infrastructural utilities in the zone in amount higher than 1,000,000 Croatian Kunas is exempt from the tax on profit for the first five years. The other zone beneficiaries are exempt from 50% of tax on profit.” The exemption is stated precisely in the article 15 of the Law on tax on profit (NN 127/00 and 163/03). Besides this incentive potential investors can be interested in exemption from custom and value added tax (this is regulated by the article 27 of the Law on free zones).

The attraction of foreign investor as the main target of free zones has not been successfully enough realized. It is obvious that only solely reduction or complete exemption from tax on profit over certain time period is not a sufficient stimulus.

Regarding free zones in Croatia, there is ongoing conflict between two ministries – ministry of economy and ministry of finance. The first ministry is interesting in attracting more and more foreign investors. In order to ensure new job creation, it motivates investors through different fiscal and financial incentives. Just opposite to this, the ministry of

finance cares about the payment of income and prevention of business malversation, *inter alias*, by strengthening financial and custom supervision. The whole conflict is about the dilemma how, on one side, foreign investors can be motivated to invest in the Croatian free zones with all of benefits generated by them, and on the other side, how to stop the business malversation and to ensure expected budget income inflows from taxes.

Since the unemployment has been the biggest socio-economic problem, there is a permanent pressure on government in direction of more liberal and stimulate law on operation in free zones. Consequently, there were several initiatives for the change of existing law or complete formulation a new law that would cover all issues at once (currently, the zone operation is regulated by the Law on free zones and Custom law (NN, 78/99; 94/99; 117/99; 73/00; 91/01; 47/03). The last try to change the law was in November 2002 when last government<sup>7</sup> directed the Proposal for new law on free zones and free warehouses<sup>8</sup>. It was formulated with help of the Croatian Free Zone Association<sup>9</sup>. The Proposal foreseen that the amount of tax incentives and the percentage of tax on profit exemption should be determined by the investment amount in long lasting assets and that it moves from 50 to 100% in period from 3 to 15 years. Because of the intense resistance of some parties that made leading coalition at that time, the Proposal did not pass the Sabor's procedure and therefore it was neither considered nor adopted.

Current government<sup>10</sup> is aware of the issues of free zones and one expects that it gives own proposition on the law of free zones. It should be a part of its economic strategy aimed to minimize unemployment and increase production, export and GDP, as well as to increase living standard.

#### **4. FREE ZONES IN THE EU: FUTURE OF CROATIAN FREE ZONES AFTER ACCESSION TO THE EU**

Till the accession of new ten countries to the EU (May 1st, 2004), there were only free warehouses and free economic zones in the EU (UN, 1990). According to their characteristics, they can be divided as following:

- free custom zones (mainly in the big sea ports), like Madeira Free Trade Zone (Portugal), Giurgiu Free Trade Zone (Italy), Southampton Free Trade Zone (United Kingdom), etc.
- zones with developed industrial and service activities, like the Shannon Free Zone (Ireland).

<sup>7</sup> The government of premier Ivica Račan (2000-2004)

<sup>8</sup> The Proposal on new law on free zones and free warehouses is available on the web site: [http://www.mingo.hr/shared/download/n\\_slZone.pdf](http://www.mingo.hr/shared/download/n_slZone.pdf)

<sup>9</sup> More information about the Croatian Free Zone Association are available on the web site: <http://www.croatian-freezones.org/en/info1.php>

<sup>10</sup> The government of premier Ivo Sanader (mandate starts in 2004)



These zones aimed firstly (somewhere exclusively) to the cooperation with overseas countries. The new EU members use free zones as an instrument for FDI attraction. In 2004 there were:

- fourteen special economic zones<sup>11</sup> in Poland<sup>12</sup>; each of them had several subzones,
- business free zones (custom warehouses), industrial free zones, and industrial parks in Hungary,<sup>13</sup>
- special economic zones and industrial parks in Slovakia,<sup>14</sup>
- two free economic zones (Kaunas i Klaipėda) in Lithuania,<sup>15</sup>
- two special economic zones: in Liepaje and in Rezakn, as well as two free ports: Ventspils and Riga in Latvia,<sup>16</sup>
- ten free trade zones, than industrial parks in the Czech Republic,<sup>17</sup>
- two free economic zones (in Kopar and Maribor) in Slovenia<sup>18</sup>, etc.

During the negotiation processes for the EU accession, each countries – taking into consideration their legislation and economic interests – reached agreement on the transition period over which the zones will operate in unchanged form (for example, Slovenia to 2010, Lithuania to 2013). After transition period is over, they should operate as free economic zones directed to the cooperation with overseas countries or they should be closed. One should note that Ireland, as a member of the EU since 1973, has the Shannon Free zone with 8,000 employees and that it has no intention to close it.

There is a long negotiation period in front of Croatia in which it should negotiate transition period as longer as it can during which benefits and privileges in zone operating should be promoted and use for domestic and foreign investor attraction. If Croatia becomes one of the EU countries before 2010, it can keep its free zones till the end of concession terms or at least next ten years, all depending on the skillfulness of its negotiators.

## 5. OSIJEK FREE ZONE

In 2005, 18 free zones have been registered in Croatia. They are different regarding the achieved stage in their development and efficiency in reaching the targets. In continuation of this paper, the operation of the Osijek free zone will be analyzed.

<sup>11</sup> Source: <http://www.link2export.co.uk/marketprofiles/default.asp>, accession: December 2004

<sup>12</sup> Source: <http://www.link2export.co.uk>

<sup>13</sup> Source: <http://www.ikm.iif.hu/ipatk/index.html>

<sup>14</sup> Source: <http://www.slovensko.com>

<sup>15</sup> Source: <http://www.infolex.lt>

<sup>16</sup> Source: <http://www.kishtpc.com/index.htm>

<sup>17</sup> Source: [http://www.factbook.net.countryreports/cz/Cz\\_TradeRegs.htm](http://www.factbook.net.countryreports/cz/Cz_TradeRegs.htm)

<sup>18</sup> Source: <http://www.gzs.si>



### Start-up and the operation of the Osijek free zone

Initiative for establishment the Osijek free zone, before it really started in 1998, was announced twice, in 1993 by the Osijek's firm *Tranzit* and in 1994 by the Osijek-Baranja county, the Osijek county chamber, Osijek airport and the Osijek's firms *Tranzit*, *IPK Osijek* and *Teina*. But, the both announcement remained without positive answers from the authorized Ministry of economy. Only the third initiative for establishment of the Osijek free zone finished successfully. Increasing interest for structural reforms of Croatian society, liberal processes and emerging interest for establishment the free zones in 1996, as well as the Law on free zones and based on it the decision on giving a concession for establishing a free zone (NN 95/96), contributed favorably to it. The initiators were the Osijek-Baranja county, *Slavonska banka d.d.*, Osijek airport, *Klisa* and the Osijek's firms *Tranzit s p.o.*, *Saponia d.d.* and *Niveta d.d.* The Osijek free zone (Zone in further text) started in June 1st, 1998. Different motives of initiators have determined significantly the work and business performance of the Zone.

The Zone covers the area of 1,0 mil m<sup>2</sup>, including the area of so called New river port, East industrial zone in Nemetin (part of the area of *Saponia* and *Niveta*), parts of Osijek airport *Klisa* and firm *MIO Osijek*. In order to manage the Zone, concessionaires signed in May 5th, 1997 the Social contract on Osijek Free Zone d.o.o., i.e. they established trade company named the Osijek Free Zone d.o.o. (Company in further text). The Company was registered at the Osijek's Trade court in November 25th, 1997. Currently, the Osijek-Baranja county is dominant in the property structure of the Company with the highest share (86.67%), followed by *Tranzit* (8.34%), *Saponia* (3.33%) and Osijek airport (1.67%). It is important to point out that the growth of the Company and Zone is not measured as it is usual in business companies by the income and profit growth, but as a growth in terms of new zone members and new job creation. Besides managing the Zone, the Company is in charge of attracting new investors and creating favorable business conditions.

At the beginning of its work, the Zone operated as a free custom zone because the Zone's domestic and foreign beneficiaries only stored goods in closed or open warehouses, imported used cars and UNPROFOR's goods. Only after the Protocol on establishment the firm Benetton Croatia d.o.o. in Osijek was signed in May 17th, 2000, and after it started in February 1st, 2001, the Osijek free zone was transformed in a modern industrial free zone. This paper discusses the benefits generated by the Zone. The question whether this transformation meets the expected economic and social interests is in the focus of the paper. Since the benefits are conditioned by the ability of the Zone and Company to solve problems they are facing within determined framework, business challenges are identified in the following section.

### The Osijek free zone: business challenges

In the early of 2000s, the Zone and the Company have faced many business challenges, among them the following ones can be especially pointed out:<sup>19</sup>

1. the model of behavior and work,
2. insufficiency of funds for financing regular business and building up the necessary infrastructure,
3. frequent changes of management boards,
4. overactive influence of political structure of the Osijek-Baranja county on leadership of the Company, and therefore,
5. giving up and indifference of the other founders on their work and future.

The land for which the Zone got the concession to work on in 1997 has been the state property with the right to use by *Luka Tranzit Osijek s p.o.*, *Panonija d.d.*, *Drava d.d.* and *Intereurope – Medjunarodno otpremnistvo d.d. Tranzit* included in the Zone's base capital approximately 47 ha of land. During the transformation and privatization that ended in spring of 2004 none of Zone founders tried to contact and discuss the exemption of land on which the Zone operated from the transformation. Since 1997, the Company has been investing important funds in taking care of some else's land and in building infrastructure.

The property on land has determined the Zone model of behavior and work. Before the building their infrastructural utilities, *Panonia* and *Drava* had made contract with the firm *Luka Tranzit*, which was at that time socially owned firm, for the land use in duration of 99 years. Similar contract was also made with the firm *Ascommerce*. In 1997, the Zone made commitment through the contract on land lease to pay rental fee to *Tranzit*. At the same time, the Zone users pay sub-lease for land to the Company. Although monthly amount of sub-lease is not high, the users will multiplicity pay off the value of land on which they operate which at the same time they will never become its owners. In addition, the Company had invested and it still has to invest a lot of money into building infrastructure on someone else's land.

None of Italian entrepreneurs that following Benetton in Croatia has built own buildings. All are working in leased business space. Therefore, they started a business without significant costs while remaining at the same time independent and mobile. If (or when) Benetton decide to move its business to the East (i.e. to the Eastern Europe or to the Far East), they will be able to follow Benetton without big costs. Thus, relying on Benetton itself is quite risky for the Zone's operation.

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<sup>19</sup> Analysis of the Osijek free zone, its weakness and strengths, its surrounding and competition is made in the master paper titled "A free zone – the engine of business activities and entrepreneurial opportunities" by Željko Klepo (September 2005).

By buying the halls of *Drava* and *Panonia*, the Company exceeded its financial capacity. Consequently, it is not able to build or to buy utilities that it can rent, or to find investors who will be able to build them on the *Tranzit's* land. Therefore, it is almost certain that nobody can expect new Benetton's cooperants to come. Also, it is hard to expect that some other investors will be ready to build real estates on someone else's land for which they will pay the lease over years, instead of buying its own land.

Compared to the Osijek free zone, the Varazdin free zone is based on different model of behavior and work. Since it is Croatian most successful free zone, where the successfulness is measured by investment especially those of greenfield character, expected employment and export results, understanding of its model of behavior and work is quite important. The Varazdin free zone get concession in 2001, and it is one of the youngest Croatian free zones. Buying out the private land, the city of Varazdin and the Varazdin county ensured approximately 70 ha of land in an attractive location in the community Trnovec Bartlovacki, located not so far from Varazdin. In order to create precondition for new investors after the transformation of the property, they built roads and the other necessary physical infrastructure and then parceled the land. Afterwards, they started proactively to seek investors. When all firms start with their operation, employment in the Varazdin free zone will find approximately 3,000 workers and export will exceed 500 mil euros.<sup>20</sup> This experience of the Varazdin free zone is instructive for further development of the Osijek free zone.

The Osijek Free Zone d.o.o. financed the infrastructure building from its base capital till 2002. After finances have been exhausted, the Company obtained twice financial assistance from the Osijek-Baranja county's budget (400,000 Kunas in 2000 and 800,000 Kunas in 2003) as well as from the state budget (3.5 Million Kunas in 2004). Currently, the Company is not financially self-sustainable, i.e. it is not able to service its credits or regular expenses from its own regular incomes.

In seven years of its existence the Company has changed four management boards. The boards have been working too short time to understand and solve all of the issues facing the Zone and to finish their mandates. In addition, the break of managerial contracts and the costs of court process with ex management boards represent a heavy financial burden.

The Osijek-Baranja county appoints and replaces the management boards. The County's prefect chairs the board meetings, Deputy County's prefect is a president of supervision board (SB), the member of the county government is a member of SB, the member of the city authority of Osijek is the second member of SB. The Osijek-Baranja county, assembly or Company's SB tried to interfere with the work of the board (the company

<sup>20</sup> Information about the Varazdin free zone is available on the Zone website: <http://www.slobodna-zona.hr/hrv/naslov-na.php>. See also in Privredni vjesnik, no. 3415, November 14, 2005, pp. 5-7

management). Too big influence of the County and the politization of the work of the Company and Zone could lead and has been led to the passivity and later to withdrawal of some founders (business shares in the Company were sold first by the *Slavonska banka*, than *Niveta*. *Saponia* has not participated actively in the work of the assembly for several years.

The arrival of the Benetton Group in Osijek and Zone has meant the engagement of the free capacities in the textile industry not only in the County but in whole Croatia. Benetton Croatia generated a numerous benefits to the Zone and Osijek, but mostly to unemployed who found a job in Benetton Croatia or with its cooperants. However, after the Benetton and Italian entrepreneurs came in the Zone, the Company should not cease to attract foreign investors. It is quite indicative that none of well-known investors came into Zone after 2002. To base the entire future of the Zone solely on Benetton Croatia is extremely risky.

### **Contribution of the Osijek free zone to the Osijek-Baranja county's socio-economic development**

Although the operation of the Zone and Company is burdened by numerous problems, it is possible to identify a lot of socio-economic benefits generated by the work of Zone and Company as well as by the arrival of Benetton and the establishment of Benetton Croatia. Since the precise quantification of the benefits requires the detailed and for the public available statistical data base, and estimation for some benefits (e.g. for the spillover effects), this paper considers the following benefits on a descriptive level:

- Image improvement of the Osijek-Baranja county and Croatia. The Osijek free zone was the first one in Croatia that attracted big and well known foreign investor. Benetton arrival in Osijek was a sign to other investors that Croatia and its free zones are safe and favorable location for investment.
- Arrival of Benetton's Italian cooperants. Quickly after the Benetton Croatia started, three Italian entrepreneurs - cooperants shown the intention to start-up in the Zone. But, two of them actually started; the third investor opened its plants in the Podunavska free zone.
- Creation of new value-added. Zone firms and firms located out of the Zone, but closely tied with the Zone firms, have contributed significantly to the creation of new value-added in the Osijek-Baranja county. For example, the share of the Benetton's value-added in the total value added of the Osijek-Baranja county was 2.67% in 2002, and 4.56% in 2004 (according to the data of the Centre for intellectual capital).
- Employment. Benetton Croatia employs directly approximately 200 workers. Although the salaries are lower than the average Croatian salary, it employs

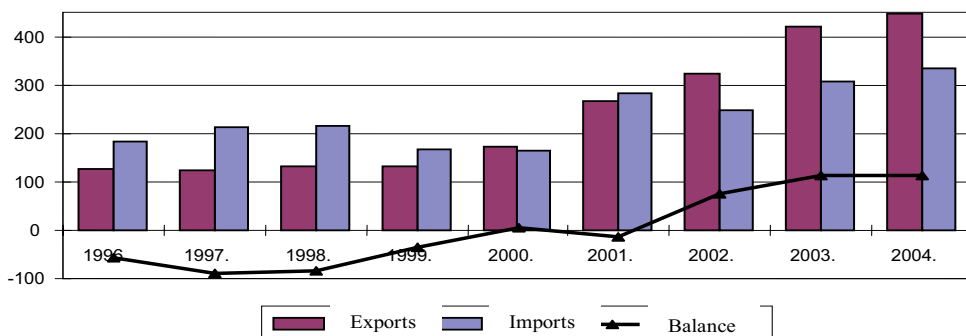
mostly the most endangered category of work force on labor market – women with lower educational level. Consequently, besides economic effects (value added creation), employment has also a favorable social component. In addition, Benetton's workers acquire new knowledge and skills, which contribute to the increase in human capital of the County.

- Textile cluster establishment. Simultaneously with the initiation of the manufacturing in Osijek, Benetton worked on the development of the cooperative network. In order to find cooperants that could meet the rigorous quality inquiries, Benetton's experts visited almost all firms in Croatian textile industry that showed interest for cooperation. In textile cluster, 46 firms have been networked; they employ more than 4,000 employees (13 firms are located in the Osijek-Baranja county). Since the firms in textile cluster are close to each other, they can, through the spillover effect of knowledge and good business practice, create higher value added and have better business performance.

One should note that the whole industry in Osijek was badly hurt by the Homeland war and the process of privatization. Textile industry particularly suffered at that time. The most part of textile industry vanished through the bankruptcies before the Benetton came (*Svilana, LIO*), or they were in the process to bankrupt (*Mara, Tekos, BTI*). Since this industry employed mostly women work force, Benetton has been for them the only hope to keep job in existing firms or to obtain the job in newly opened firms.

- New entrepreneurial opportunities generation and intensification of entrepreneurial activities. Many existing textile firms found the exit from crises in which they, as well as whole Croatian textile industry, has been. There are many cases in which new firms were established only for business cooperation with Benetton Croatia (for example, *Osijek konfekcija* and *Konfekcija Antonazzo*). Furthermore, Italian region Veneto has developed good business cooperation with the County in many business fields; the Osijek county chamber has good business relations with the Veneto's craft chamber. Region Veneto is one of the most industrially developed Italian regions.
- Increase in exports of the Osijek-Baranja county. Export-import activities in the Osijek-Baranja county have significantly risen after the arrival of the Benetton Group while deficit in 1990's started to stagnate (see Figure 1). Benetton Croatia is not only the biggest exporter in the Osijek-Baranja County, but also it is one of the biggest exporters in Croatia. For example, in 2004, they ranked 6th on the top Croatian exporter list (Privredni vjesnik, No. 3404, from July 14th, 2005). According to the Osijek county chamber, the biggest share in the County's export structure comes from the export of clothes and *equipment* (44.76%).

**Figure 1:** Foreign trade statistics for the Osijek-Baranja county during 1996 – 2004 (in 000 USD)



*The source of data:* Statistical report (different numbers), State administrative office in the Osijek-Baranja county, Office for Statistics

## 6. CONCLUDING REMARKS

Experiences accumulated from the Osijek free zone, which obtained work permit in June 1<sup>st</sup> 1998, indicate that the Zone alone is not organized on the model that will enable it to reach better business results, attraction of more investments (domestic and foreign) and bigger contribution to the economic growth and development of the County. The reasons why this is so are linked with the problems burdening the Zone and Company operation: doing business on the land that belongs to *Tranzit*, model of behavior and work, insufficiency of financial funds, frequent changes of the management boards, overwhelming impact of political structure on the leadership of the Company and consequently indifference of some founders for the Zone work and its future as well as leaning only on Benetton Croatia. Land property determined the model of behavior and work of the Zone. The Zone made commitment to pay the lease to *Tranzit* by the Contract on land lease. At the same time, the zone beneficiaries pay sub-lease to the Company for the land. It is hard to expect the existence of strong interest to build on someone else's land. On the other side, the Company invested and still needs to invest a lot of money for infrastructure building on someone else's land. Furthermore, the Company is able neither to service a credit, nor to finance regular expenditure from its regular income. In seven years of its existence the Company changed four management boards. The boards functioned too short period of time to realize what an existing situation is and to do their mandate. Too big influence of the county (the County names and replaces the Boards, etc.) and a politization of the work of the Company and the Zone lead to passivity, and later to withdrawal of some founders. The arrival of Benetton Group in Osijek and the Zone meant employment of free capacities not only in the County's textile industry, but

in Croatia as a whole. However, from 2002 the Company failed in attraction of new big foreign investors. Besides Zone management, the main task of the Company is to attract new investors and to create favourable business conditions.

Although the operation of the Zone and the Company has been burdened by numerous problems, it is possible to identify many socio-economic benefits that resulted as a consequence of the Zone operation, the Benetton arrival and start-up of Benetton Croatia. Some of them include: improvement of the Croatian image as the country which is safe for foreign investors, increase in value added, reduction of unemployment, improvement of foreign trade balance, textile cluster organization, and new entrepreneurial opportunities generation. Considering these benefits, the Zone has justified certain levels of its operation and invested funds.

The experiences accumulated from the Osijek and Varazdin free zones indicate that the zone efficiency should not be measured only by the number of the zone clients, the number of newly created jobs, and by the export outcomes of the zone firms, but also by the contribution which zone has in creating the region's value added, in the increase in intellectual capital and in improvement of the region's competitiveness. In addition, it is equally important to know how much zone contributes to the increase in the quality of life and economic prosperity of the region in general. Real dimensions of the economic benefits from the Osijek free zone can be estimated only by taking into account the long run relations between the costs and benefits (considering also their ecological, economic, socio, and other dimensions). The case of the Osijek free zone indicates that during the assessment of benefits, *inter alia*, the following issues should be considered:

- the Zone attracted the labor intensive industry from abroad, i.e. the clients which use relatively simple technology, for which usage is not required highly educated labor force,
- the full operation of the Zone foreign firms is poorly transparent,
- long run interest of firms in Zone for doing business within the Zone is very poor; they also do not show the responsibility for the life quality improvement in the Zone environment,
- the Zone employees are poorly paid; most employees are of lower education levels. Because the unemployment rate of these workers' categories alone is the highest in the Osijek-Baranja county<sup>21</sup>, they are easily replaceable, which makes their bargain power regarding work conditions extremely low.
- the absence of professional and responsible policy of human resource management among the most important Zone firms is visible,
- labor costs, availability and expertise of work force, generous initiatives and low costs of start ups were the key attractors for coming the Benetton's – the biggest and the most important Zone's client.

<sup>21</sup> The Osijek-Baranja county is one of the 21 Croatian counties.



The experiences of the developing countries indicate foreign firms, which are only attracted by these attractors, are inclined to continuously reevaluate the attractiveness of other locations in order to cut further the costs of operating and in some cases to blackmail the host country. In addition, such foreign firms do not show serious intentions to improve labor productivity through investments in new technologies or improvement in knowledge and skills of their employees.

Inadequate policy of human resource management and the low social responsibility of zone firms have limited the benefits generated in the zone, and especially its growth potential. In addition, poor transparency of zone firms, incoexistence with the space, environment and the society in which they are living, the failures of local authorities to establish adequate legal regulations and an efficient mechanism for continuous monitoring of the impacts on environment have become very serious problem.

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