

DETAILED EXPLANATORY NOTE

Regarding the Draft Law on Amendments and Additions to the Law on Free Zones

The draft law on amendments and additions to the Law on Free Zones has been developed based on the provisions of Article 38, Part 2, Clause 3 of the Constitution of Mongolia, which states that the Government shall "... to elaborate and implement measures on sectoral, inter-sectoral, as well as regional development matters"; Article 23.8.16 of the Law on the State Great Khural of Mongolia, which specifies "regional development policy"; Article 27, Section 27.5.4, which states that "the Regional Development Subcommittee shall consider regional development policy, regional and local development issues"; Article 10, Section 3, of the Law on the Government of Mongolia, which states that the Government shall "...ensure a relatively even development of aimags and regions, and to develop and implement the common principles and models of establishing and expanding the proper economic ties between them..."; and Article 20, Section 5, Clause 2, which specifies "integrated development policy and planning for free zones and special economic zones."

In addition, Goal 9.5 of the "Vision-2050" long-term development policy of Mongolia, approved by Parliamentary Resolution No. 52 of 2020, states: "Develop satellite cities that create national tourism, cultural services and industries reflecting unique national features, and serve as transport, logistics and international hubs in Northeast Asia". Under Section 3.1.17 of the Basic Direction for the Development of Mongolia for 2021-2025, it is stated that "The infrastructure construction of free zones will be carried out in phases, creating conditions for the development of trade, services, and light industry aimed at export and domestic markets, and supporting foreign and domestic investors."

Furthermore, the "Action Program of the Government of Mongolia for 2024-2028," approved by Resolution No. 21 of the Mongolian Parliament in 2024, sets forth the following objectives: 1.2.2.1: "The investment sources for the construction of the eco-smart Hunnu satellite city, featuring tourism, transport, logistics, an international financial center, and a free economic zone, will be resolved in stages, and the infrastructure of the heating plant and treatment plant will be built;" 1.2.2.5: "Based on the free zone in Hunnu City, the 'Silicon Valley' data center will develop a combined greenhouse and renewable energy model enterprise;" 1.3.5.4: "A freight transportation and construction material logistics center will be established in the Khushi Valley and Altanbulag free zones;" 1.4.1.6: "A free zone, special zone, and industrial park will be established in the region to connect it with ports and neighboring cities;" 3.2.2.11: "Based on the priority areas, characteristics, resources, and location advantages of the zones, special economic zones will be established, and the existing tax-free zones will be fully utilized;" 3.2.2.12: "The general development plan, partial and detailed plans of free zones will be clarified, infrastructure construction work will be carried out in phases, and the legal and regulatory environment of the free zone will be updated;" 3.3.5.5: "Establish a free tourism zone based on historical, cultural, natural scenic resources, archaeological, and

paleontological resources and increase the flow of tourists;” 3.3.7.4: “Develop tax-free zones and science parks for information technology, research, development, and innovation activities;” and 4.4.2.14: “Establish business incubator centers in free zones and support entrepreneurs through foreign trade raw materials and technology exchanges.”

In line with global economic trends and the unique characteristics of the country, the State Great Khural established the “Altanbulag Free Zone” (Resolution No. 38, 2002), the “Zamyn-Uud” Free Economic Zone (Resolution No. 17, 2004), the “Tsagaan Nuur” Free Trade Zone (Resolution No. 74, 2005), and the “Khushi Valley Free Economic Zone” (Resolution No. 10, 2022), determining their land area, locations, and border crossing intersections.

More than 10 years have passed since the concept and legal framework for free zones were established in our country, and despite significant investments from the state budget during this period, no specific results have been achieved.

The “Concept of Regional Development of Mongolia,” approved by Resolution No. 57 of the Mongolian Parliament in 2001, initially aimed to establish special trade and customs (free) zones based on the “Altanbulag” and “Tsagaan Nuur” ports on the border with Russia and the “Zamyn-Uud” port on the border with China. In accordance with international standards, these zones were intended to create a mutually beneficial and cooperative business environment for domestic and foreign traders and investors. Within the framework of the goal to expand the establishment of special (free) investment zones in the interior of Mongolia in appropriate types and directions once sufficient experience is gained, the “Altanbulag”, “Zamyn-Uud”, and “Tsagaan Nuur” free zones were established.

However, the current activities of the free zones of “Altanbulag”, “Zamyn-Uud”, and “Tsagaan Nuur” are characterized by a lack of progress in urbanization, construction, and industrialization, failing to implement the initial goals of economic contribution.

Therefore, it is necessary to improve the legal environment in accordance with current development requirements and international leading practices, based on the principle of transforming free zones into entities that are self-financing and contribute to the state budget.

As of 2024, about 5,400 special economic zones (SEZs) are operating in 145 countries around the world, which generate an export turnover of approximately 500-600 billion US dollars and provide jobs for 100 million people.¹

The draft law is prepared in the form of a draft law on amendments to the law specified in Article 24 of the Law on Legislation, and a detailed presentation of the draft law is presented in accordance with Article 33, Section 33.3 of the Law.

¹ UNCTAD. World Investment Report 2019: Special Economic Zones. United Nations Conference on Trade and Development, Geneva, 2019.

The draft law includes the following changes:

One. Regarding the definition of a free zone:

Article 3.1.1 of the Law on Free Zones defines a free zone as a part of the territory of Mongolia considered outside the customs territory for duties and taxes, with a special economic regime. However, the laws on the Legal Status of Hunnu City and the Legal Status of Ulaanbaatar have duplicated similar purposes under names like "Free Zone," "Free Economic Zone," "Special Economic Zone," and "International Financial Center." This creates legal confusion and conflict.

In other words, there is a legal need to clarify and unify concepts regarding whether the Law on the Legal Status of Hunnu City or the Law on Free Zones shall have prevailing effect in the Khushi Valley Free Zone, or whether the Law on the Legal Status of Hunnu City shall serve as the general law while the Law on Free Zones acts as the detailed law.

Due to this uncertainty in the definition of a "free zone," the issue of determining the special regime of a free zone remains legally unclear. Therefore, it is necessary to regulate the types, forms, and special regimes of free zones in a detailed manner.

In the context of international legal comparison, countries such as Japan, Indonesia, the Philippines, Myanmar, and Cambodia have titled their legislation as the "Law on Special Economic Zones." The term "Special Economic Zone" (SEZ) is a broad concept that encompasses various types of free zones, including free trade, export processing, economic, industrial, and economic cooperation zones.

In our country, the Law "On Free Zones" related to the establishment of free zones by the Resolution 4 of the State Great Khural and the Resolution 2 of the Capital City People's Representatives' Meeting can be understood as a legal regulation that can apply to all types of free zones by changing it to "On Special Economic Zones".

Clause 3.1.11 of Article 3 of the Law on Free Zones and Section 6.5 of Article 6 of the Law on Free Zones define the term "economic cooperation zone" in a way that is different from the concept of other free zones, and Article 39.1 of the Law on the Legal Status of the Capital City of Ulaanbaatar, which states "Directions for Establishing Special Zones," indicating that free zones differ in their purposes and types, and thus require a unified nomenclature and regulation.

In international research, Special Economic Zones (SEZs) are classified by developmental stages into SEZ 1.0, SEZ 2.0, and SEZ 3.0. The free zones currently operating in Mongolia essentially possess the characteristics of the SEZ 1.0 and SEZ 2.0 stages. For instance, free zones such as Altanbulag, Zamyn-Uud, and Tsagaannuur were established to support trade, services, logistics, and export activities, embodying the features of traditional zones aimed at expanding foreign trade through tax and customs exemptions. This aligns with the SEZ 1.0 model, which focuses on supporting export

manufacturing and trade; however, research indicates a pressing need to transition toward the SEZ 3.0 model.

Two. Regarding the types and forms of free zones:

The purpose of the Law on Free Zones, adopted in 2015, is defined as "determining the legal basis for the establishment, modification, and liquidation of free zones, their locations, management authority, control systems, and the special regimes for taxation, customs, inspections, registration of legal entities and citizens, and employment, and regulating relations related to their implementation" and the law further states its objective is to "create a favorable legal and investment environment in the zone to support the exports and imports of citizens and enterprises, develop export-oriented production, attract new sectors of trade, services, tourism, and investment, increase transit transport and logistics, localize advanced techniques and technologies, facilitate trade, and accelerate regional development, thereby increasing economic growth." Despite these broad objectives, the types and specific forms of free zones have not been legislated in further detail.

The general global trend for free zones is shifting toward developing zones focused on technology-driven, competitive products, manufacturing, and services rather than purely trade-based models. Depending on their geographical location, unique characteristics, infrastructure conditions, environment, and natural resources, countries are defining their own policies for diverse and specialized zones. These include free trade zones, export promotion zones, special industrial zones, special maritime ports, science/technology parks, chemical technology zones, transport and logistics centers, financial free zones, airport-centered logistics hubs, and special customs zones, all tailored to meet national economic needs.

Internationally, Special Economic Zones (SEZs) are classified into the following primary types based on their purpose and field of operation: free trade zones, export processing zones, industrial parks, science and technology parks, and integrated special zones.²

Three. Regarding the establishment, modification, and liquidation of free zones, determination of their boundaries and location:

Under the Law on Free Zones, the State Great Khural (Parliament) holds the full authority to establish, modify, or liquidate a free zone, and to determine its boundaries and location upon submission by the Government. It is stipulated that free zones shall be established in border areas proposed by the Government. Furthermore, issues regarding the establishment, reorganization, or liquidation of a free zone, as well as its location and territorial limits, are to be determined by the State Great Khural based on the Government's proposal. However, cross-border free zones may be established through intergovernmental agreements, with their policies and operations regulated by such

² UNCTAD. (2019). World Investment Report: Special Economic Zones.

agreements. Consequently, the current regulation places the authority to establish or liquidate free zones within the jurisdiction of the State Great Khural.

However, the process of establishing free economic zones in Mongolia has not been particularly successful, leading to public criticism.³ This lack of success is attributed to numerous factors, including high levels of state intervention, management and organizational issues, cooperation with neighboring countries, and the nature of our country's export products. Crucially, it also depends on the clarity of the legal and regulatory environment and whether the interests and investment guarantees of investors are fully secured.

From this perspective, it can be concluded that issues such as the specific purpose for establishing a free zone, the determination of its types and forms, management and organizational structures, land allocation, land-related legal relations, and the definition of a special legal regime remain unclearly regulated within the existing legislation.

Internationally, the parliament typically establishes the legal foundation for free zones, while the government is responsible for establishing and implementing specific zones. Establishing free zones by Government decision facilitates the prompt implementation of policy; in other words, the Government can quickly make decisions to establish zones in alignment with economic development policies and investment strategies, thereby creating conditions for a flexible response to economic shifts. Furthermore, since the Government is responsible for regional infrastructure, financing, management organizations, and ensuring coordination between state agencies, it is considered advantageous for resolving infrastructure and investment organization in a centralized manner.

Article 6.1 of the Law on Free Zones states that “the State Great Khural shall, upon submission by the Government, resolve issues regarding the location of the free zone, the size of the land to be allocated to the free zone, and the establishment or modification of boundaries.” However, this provision fails to fully guarantee land use and leasing security for business entities and investors operating within the free zone.

Fourth. Regarding the management of the free zone and the rights and obligations of the participants:

In accordance with Article 8.2 of the Law on Free Zones, the member of the Government in charge of free zone affairs shall appoint and dismiss the Governor of the free zone and approve the free zone's charter, organizational structure, and staffing levels. The Governor manages and organizes the daily operations of the free zone within the scope of authority specified by relevant legislation and regulations.

³ З.Мөнгөлжин, Э.Анударь, Эдийн засгийн чөлөөт бүс (Харьцуулсан судалгаа), Хууль дээдлэх ёс сэтгүүл, № 83, цуврал 3, УБ, 2021 он, 166 дахь тал.

According to the law, the Free Zone Administration is a state administrative legal entity with functions to organize and coordinate the implementation of investment and development policies; develop infrastructure and land relations; monitor, analyze, and evaluate legal regulations and their implementation; expand the free zone's foreign relations and cooperation; and assist in implementing Government policies and activities aimed at attracting investment and creating a favorable economic environment. Furthermore, the Free Zone Administration is financed by the state budget and implements its functions within the limits of its approved budget and staffing.

This regulation has many decision-making stages, unclear functions of implementing organizations, and relatively limited independence and decision-making authority of the regional administrative organization, which makes it impossible to attract investment, organize activities quickly, create a favorable environment for entrepreneurs, and implement a single-window policy for licensed activities in free zones.

This current regulatory framework involves numerous decision-making stages, and the functions of implementing agencies remain unclear. Additionally, the administrative body of the zone possesses relatively limited independence and decision-making authority and remains highly dependent on the central government. These conditions make it impossible to effectively attract investment, organize operations promptly, create a favorable environment for entrepreneurs, or implement a "one-stop shop." policy for licensed activities within the free zones.

Five. Regarding the one-stop shop policy:

The Law on Free Zones stipulates that government services within the free zone shall be based on an electronic "one-stop shop" service to facilitate trade, taxation, business activities, and investment. However, the law does not provide detailed regulations on which specific services are to be included, the procedures for implementation, or which entity bears the responsibility for these functions.

Article 1.5, Part 11 of the Law on Permits states that "Authorized entities may organize the issuance and renewal of certain types of interrelated permits in the form of a one-stop shop," and Article 9.2 of the Law on Free Zones specifies that "Government services shall be based on electronic one-stop shop services to facilitate trade, tax relations, business, and investment." Despite these legal provisions, the implementation of this requirement has remained insufficient to date.

In Mongolia, activities conducted under government authorization are regulated by the Law on Permits. This law identifies 253 types of special permits across 13 sectors issued by 87 authorized entities, and 123 types of ordinary permits across 12 sectors issued by 34 authorized entities. Currently, the specific relations regarding the issuance, renewal, refusal, suspension, and revocation of these permits are governed in detail by more than 160 separate sectoral laws.

Under Article 8.1, Section 1.21 the "possession and use of land," and under Section 12.13, the special permit for the "sale and service of alcoholic beverages" within the territory of a free zone are legislated to be issued by the Governor of the free zone. Similarly, under Article 8.2, Section 1.9, the "possession and use of land," and under Section 11.6, the ordinary permit for the "sale of tobacco products" within the territory of a free zone are also to be issued by the Governor of the free zone.

While relevant laws have set the objective of introducing a "one-stop shop service" in free zones, implementation studies note that actual progress remains limited. For instance, all activities conducted within a free zone—such as the planning and construction of buildings and structures on allocated plots, the construction of clean water networks and facilities, the commencement and continuation of construction work, and the development of technical and economic feasibility studies, blueprints, construction, maintenance, and repair of roads and road facilities—are currently dependent on local authorities, requiring permits from the local Citizens' Representatives' Khural and various other government agencies.

Furthermore, the right to use land allocated for a given year in accordance with the free zone's general development plan and partial plans is granted through an open selection process. This specific procedure is currently managed and executed by the Government Agency for Policy Coordination on State Property and Procurement.

The fact that permit relations are regulated separately by various laws and regulations, and that these processes remain fragmented, limits the possibilities for investment and business operations within the free zone and creates significant complications.

There is a pressing need to establish a unified database consisting of information on the registration of legal entities in the free zone, entities with foreign investment, investment data, and foreign labor statistics. Furthermore, it is necessary to ensure the storage and security of this database and to approve procedures for the mutual exchange of information with relevant state organizations through this system.

Based on the assessment report on the implementation of the Law on Free Zones, the draft law on amendments to the Law on Free Zones and its accompanying draft laws shall be developed in accordance with the procedures specified in the Law on Legislation, reflecting the following relations:

- Define the purpose, objectives, and scope of the law as a Special Economic Zone (SEZ) and transition to the Special Economic Zone model;
- Diversify Special Economic Zones into types such as free trade zones, export processing zones, industrial parks, science and technology parks, and integrated special zones depending on their purpose and field of activity, and define relevant terminology;

- Grant the Government of Mongolia the authority to establish, modify, or liquidate free zones and to determine their boundaries and locations in order to ensure the prompt and flexible implementation of economic policy;
- Ensure the management system of the free zone is centralized and independent, with flexible operations and clearly regulated decision-making authority;
- Reform legal regulations to base public services in free zones on the "one-stop service" principle;
- Transition to a risk-based control system and digitize permits and related information;
- Establish a unified database for information related to activities regulated under the special regime implemented within the territory of the free zones;
- Regulate an independent judicial system for the resolution of disputes within the free zone.

The draft law on amendments to the Law on Free Zones will transition free zones into the form of special economic zones, enabling diversified development, strengthening the management system, and providing public services to citizens, business entities, and organizations in an open, transparent, and accessible manner. Furthermore, it will facilitate the transition to a risk-based control system, the digitization of permits and information, and the creation of a unified database.

By introducing these principle-based changes to the Law on Free Zones, Mongolia will develop free economic zones in line with prevailing global economic trends and the country's unique characteristics. These reforms are of significant importance for improving economic circulation, accelerating national development, increasing the state budget and investment, and mitigating population concentration through the urbanization, construction, infrastructure, and industrialization that accompany the development of free zones.

In connection with the issues addressed in the draft law, amendments will be made to more than 30 laws to ensure inter-legal consistency and coherence, reflecting changes in legal terminology and fundamental principles.