

LEGAL INNOVATION POLICY FOR FREE TRADE AREA (A STUDY OF FREE TRADE AREA IN CHINA)

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Abstract

The rise of Free Trade Zones (FTZs) led by China marks a significant trend in the global economy. This study explores the legal validity of novel policies within Chinese FTZs; how legitimate are these policies? It assesses how FTZ policies align with national and global trade regulations by analyzing legislative frameworks, policy documents, and international treaties. Results show that China's legal advancements in FTZs, which feature regulatory streamlining and improved foreign investment practices, generally align with global standards but sometimes conflict with domestic regulations. These advancements are bolstered by targeted economic legislation designed to stimulate growth and test reforms for possible nationwide implementation. Furthermore, the study highlights FTZs as hubs for international trade and arenas for economic experimentation. The conclusion offers policy suggestions to strengthen the legal basis and global alignment of FTZ innovations, ensuring they effectively contribute to economic development.

Keywords: *Free Trade Zones, legal innovation, China, legal legitimacy, international trade law, economic policy.*

I. INTRODUCTION

A free trade zone (FTZ) is an area within a country's jurisdiction and separate from its customs area. Within a free trade zone, there are no import duties, value-added taxes, luxury goods sales taxes, and excise duties can also be defined as an area with clear physical boundaries so that access is limited within the region or a country, which is exempt from local customs regulations and functions as a means of free trade, loading and unloading, and storage of goods, as well as manufacturing with or without a fence, with limited access guarded by customs and excise officers.² This article analyzes the construction of China's FTZs from a legal perspective. This chapter presents the regulatory innovations in FTZs that have been carried out. Research on this issue is considered necessary to maintain the healthy and sustainable development of FTZs.

Currently, the World Trade Organization (WTO) multilateral trade negotiations are facing difficulties in reaching consensus, and some experts argue that the obstacles are caused by the WTO's structural problems.³ Mega-regional

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² Pratiwi, D. (2017) *Evaluasi Kinerja Badan Pengusahaan Kawasan Perdagangan Bebas dan Pelabuhan Bebas dalam Meningkatkan Pertumbuhan Ekonomi di Kabupaten Karimun.*

³ Cai, C. (2013) "Trans-Pacific Partnership and the Multilateralization of International Investment Law," *Journal of East Asia and International Law*, 6(2). doi: 10.14330/jeail.2013.6.2.03.

trade agreements are developing, such as the Trans-Pacific Partnership Agreement (TPP), the final text of which has been approved, and the Transatlantic Trade and Investment Partnership (TTIP), which aims to set high standards for international investment regulations.⁴ The United States is active in pursuing its economic interests at the international level through the negotiation of the above agreements, with an effort to set the rules for the global economy. Apparently, China lags far behind the United States in this aspect. Therefore, China feels the urgent need to reform its foreign trade and investment management system,⁵ which exists to increase its integration into the global economy and to achieve global standards in the world economic system, with the ultimate goal of playing a role in international economic law.⁶

To achieve this goal, China established four Free Trade Zones (FTZs), located in Shanghai, Tianjin, Fujian, and Guangdong.⁷ The four FTZs represent China's efforts to pursue legal reform and innovation to boost foreign trade and facilitate investment.⁸ China established its first FTA in Shanghai in 2013 and then established three other FTZs in 2015. The ideal existence of an FTZ is not only an economic demonstration zone, but also a regulatory innovation zone.⁹ From the perspective of China's domestic law, although the basic legal framework of FTZs has been established, there is still room for improvement in the areas of legislation, judicial review and law enforcement. From the perspective of international law, the construction of FTZs should include China's obligations under relevant international agreements, especially legal obligations under the WTO. In addition, designing a legal assessment mechanism for the operation of FTZs is crucial to the sustainable development of FTZs.

The problem this research "what is the legal legitimacy of legal innovation policies for Free Trade Areas (a study of Free Trade Areas in China)?" The research method used in this study is descriptive qualitative with data sources derived from secondary data, namely library materials and laws and regulations. Then the data collection technique used is to systematize research materials that are relevant to

⁴ Lester, S. (2015) "Rethinking the International Investment Law System," *Journal of World Trade*, 49(Issue 2), p. 211–221. doi: 10.54648/TRAD2015009.

⁵ Wu, H.-L., Chen, C.-H. dan Chen, L.-T. (2012) "Determinants of Foreign Trade in China's Textile Industry," *The International Trade Journal*, 26(2), p. 112–138. doi: 10.1080/08853908.2012.657586.

⁶ Khan, Z., Changgang, G. dan Afzaal, M. (2020) "China-Pakistan Economic Corridor at the Cross Intersection of China, Central Asia and South Asia: Opportunities for Regional Economic Growth," *The Chinese Economy*, 53(2), p. 200–215. doi: 10.1080/10971475.2019.1688005.

⁷ Peng, D. dan Fei, X. (2017) "China's Free Trade Zones: Regulatory Innovation, Legal Assessment and Economic Implication," *The Chinese Economy*, 50(4), p. 238–248. doi: 10.1080/10971475.2017.1321886.

⁸ United Nations Conference on Trade and Development (2023) *The Role of China's Pilot Free Trade Zones in Promoting Institutional Innovation, Industrial Transformation and South-South Cooperation*. Geneva: UNCTAD Division on Globalization and Development Strategies.

⁹ Liu, W. (2004) "China's Free Trade Zones: A Study of Their Economic Effects," *China Report*, 40(4), p. 431–444. doi: 10.1177/000944550404000407.

the research topic. After the data collection process, the data is analyzed by reducing data, presenting data, and drawing conclusions.

II. DISCUSSION

1. Legal Innovation in China's FTZs

The theory and measurement of regulation have significant implications for economic and social governance.¹⁰ Therefore, legislation that is able to anticipate and follow developments in needs is a concern in legal reform.¹¹ Therefore, if you are going to create a law (legislation), then from the start you must make a mature plan and be able to record future legal needs.¹² Especially in special economic zones, such as FTZ, infrastructure as a primary need in supporting economic growth activities, currently still faces many problems. Not only the problem of funding sources, the protracted tender process, indiscipline in implementing programs, and the absence of legal certainty for private parties who have obtained permits.¹³ Over the next ten years, economic reforms involved the loosening of direct planning controls, the decentralization of economic decision-making, increased reliance on market forces in setting prices and output, the development of non-state economic entities, and the opening of China's economy to the outside world. In the agricultural sector, where reforms began, responsibility for production was shifted from collectives to households, and a system of contractual purchasing was introduced to replace compulsory procurement of key agricultural products. In the industrial sector, state-owned enterprises were given greater financial responsibility and greater freedom in determining their operations, while cooperatives and individually owned enterprises grew to occupy an important place in the Chinese economy. Price reforms reduced some distortions in the price structure and allowed a greater share of prices to be determined by market forces. In addition, external sector reforms increased incentives for exporters and allowed increased access to foreign resources through foreign direct investment and loans.

Since 1978, China has implemented several important reforms to increase its foreign trade and investment, such as the establishment of special economic zones.¹⁴

¹⁰ Stigler, George J. (1971). "The Theory of Economic Regulation." *The Bell Journal of Economics and Management Science* 2, no. 1: 3. <https://doi.org/10.2307/3003160>.

¹¹ Nurbaningsih, E. (2022) *Dinamika Praktik: Perencanaan Legislasi Nasional*. Jakarta: Rajawali Press.

¹² Putra, A. I. (2008) *Penulisan Kerangka Ilmiah Tentang Peran Prolegnas dalam Perencanaan Pembentukan Hukum Nasional Berdasarkan UUD 1945 (Pasca Amandemen)*. Jakarta: Badan Pembinaan Hukum Nasional Kementerian Hukum dan Hak Asasi Manusia.

¹³ Humas Kementerian Koordinator Bidang Perekonomian (2015) *Pengembangan Hukum untuk Mewujudkan Kawasan Ekonomi Khusus yang Unggul dan Berdaya Saing*. Tersedia pada: <https://ekon.go.id/publikasi/detail/1678/pengembangan-hukum-untuk-mewujudkan-kawasan-ekonomi-khusus-yang-unggul-dan-berdaya-saing>.

¹⁴ Soong, J.-J. (2022) "The Political Economy of China's Rising Role in Regional International Organizations: Are There Strategies and Policies of the Chinese Way Considered and Applied?," *The Chinese Economy*, 55(4), p. 243-254. doi: 10.1080/10971475.2021.1972550.

By 1978, China's leaders had reached the conclusion that wider use of productive factors was not the best way to achieve large, sustained increases in output.¹⁵

To promote rapid growth and development, the economy needs to be restructured to increase productivity and efficiency of resource use. To achieve this goal, it was decided that market-oriented reforms would be implemented. However, the blueprint for the structure of the economic system that would form the basis of the reform process has not been established.¹⁶ Instead, Chinese authorities are taking a cautious and pragmatic approach. The aspects of reform that are easiest to implement will be implemented first.¹⁷ Successes in these areas helped build support for the reform process. Authorities were relatively quick to change programs to address the problems that arose.¹⁸ In addition, in order to avoid greater difficulties given the complexity of the task of restructuring the Chinese economy, reforms have been carried out in stages. Experiments with various types of reforms have been carried out on a small scale, and only implemented on a larger scale if they prove successful.¹⁹ It is on this side that legal innovation becomes important.²⁰

With regard to FTZs, the first regulatory innovation is the adoption of a “negative list” to regulate the acceptance of foreign investment, which is different from the “positive list” approach commonly applied in China in non-FTZ areas. According to the Catalogue of Foreign Investment Guidance Industries (2015, revised), foreign investment in China is divided into 3 (three) categories, namely (i) encouraged; (ii) restricted; and (iii) prohibited. Meanwhile, in FTZs, the Special Administrative Measures for Foreign Investment Access (negative list) formulated in accordance with foreign investment laws and regulations, do not provide national treatment to foreign investment projects if they are included in the negative list. In addition, foreign investors are prohibited from investing in industries that endanger national and social security, or are detrimental to public interests.

On March 15, 2019, China's long-awaited Foreign Investment Law (Foreign Investment Law) was passed at China's National People's Congress, opening a new chapter in the regulatory and legal regime for foreign direct investment in the

¹⁵Easson, A.J. and Li, J. (1987) “The Evolution of the Tax System in the People's Republic of China,” *Stanford Journal of International Law*, 23.

¹⁶Harding, H. (1987) *China's Second Revolution: Reform After Mao*. Washington: The Brookings Institution.

¹⁷Garnaut, R., Song, L. and Fang, C. (ed.) (2018) *China's 40 Years of Reform and Development: 1978–2018*. Canberra: ANU Press. Chow, GG (2004) “Economic reform and growth in China,” *Annals of Economics and Finance*, 5, p. 93–118.

¹⁸Chow, GG (2004) “Economic reform and growth in China,” *Annals of Economics and Finance*, 5, p. 93–118.

¹⁹Ge, Q.-Q. et al. (2023) “Has China's Free Trade Zone policy promoted the upgrading of service industry structure?,” *Economic Analysis and Policy*, 80, p. 1171–1186. doi: 10.1016/j.eap.2023.10.008.

²⁰Li, AHF (2016) “Centralization of Power in the Pursuit of Law-based Governance: Legal Reform in China under the Xi Administration,” *China Perspectives*, 2(106).

world's second-largest economy. The legislative process for the Foreign Investment Law began in 2015 and Chinese authorities have published two draft versions of the Foreign Investment Law for public consultation in 2015 (Draft 2015) and 2018 (Draft 2018) respectively. The Foreign Investment Law came into force on 1 January 2020 to replace three existing laws and their implementing regulations governing the establishment of foreign equity joint ventures, Sino-foreign cooperative joint ventures, and wholly foreign-owned enterprises and their operations in China. One of the most prominent changes outlined in the Draft 2018 is a substantial expansion of the protections offered to international investors and their investments in China. This appears to be intended to address concerns voiced by US and European companies in recent years. However, the law also provides a detailed list of industries that are restricted or limited for foreign investment ("Negative List") and a foreign investment Security Review system that applies to foreign investments that may affect national security or the public interest.

The Negative List for market access for foreign investment is revised almost every year. The latest edition published on March 12, 2022 contains a total of six categories of prohibited access (e.g., certain financial services, certain internet-related businesses, news media activities, sectors also prohibited for Chinese private companies such as sales of products under State monopolies, and so on) and 111 business activities subject to prior administrative licensing with relevant ministries on the grounds of public order or public interest (e.g., certain operations in sectors such as agriculture, food and medicine, health, energy, automotive, transportation, education, culture, and so on).

China officially seeks to align all national and local policies restricting foreign investment on this unique Negative List, and gradually reduce discrimination against Chinese investors. Similarly, domestic companies investing in China that engage in activities prohibited for foreign investment under the Negative List must be reviewed and approved by the government when transacting overseas or registering overseas.

The negative list regime for foreign investor market entry has been gradually established in China since 2015, initially in Free Trade Zones and then across China. The latest version of the negative list issued in 2018 has been significantly shortened compared with the previous version, indicating a step forward in easing market access restrictions for foreign investment. If foreign investors invest in areas where the negative list of foreign investment access states that investment in the area is prohibited, the competent department shall order them to stop investment activities within a certain period of time and restore the situation before investment by divesting shares and assets or through other necessary measures; if there are any illicit proceeds, they shall be confiscated. If the investment activities of foreign investors violate the administrative measures for special restrictions on access as specified in the negative list of foreign investment access, the relevant competent

department shall order them to make corrections within a certain period of time and take necessary measures to meet the requirements for special administrative measures for access; if they fail to make corrections within the specified period, they shall be handled in accordance with the provisions of the preceding paragraph. If the investment activities of foreign investors violate the provisions of the negative list of foreign investment access, in addition to being handled in accordance with the preceding provisions, they shall also bear corresponding legal responsibilities.

The second legislative innovation is that FTZs are committed to providing pre-existing national treatment to foreign investors. Currently, national treatment to foreign investors is only granted after they are established in a non-FTZ. The purpose of pre-establishment national treatment is to provide national treatment to foreign investors at the initial stage of their establishment, which means that FTZs will provide no less favorable treatment to foreign investors than to domestic investors at the pre-establishment stage; and the merger, division, dissolution or change of foreign companies is only required to comply with the registration procedures. In FTZs, foreign investment is automatically entitled to pre-established national treatment, unless the investment is included in a prohibited or restricted sector in the negative list.

In other words, industries not on the negative list can be accessed by foreign investment without prior government approval. Although China rarely makes commitments regarding pre-establishment national treatment in international investment agreements,²¹ pre-establishment commitments are a common practice in IIAs with an increasing trend. At the end of 2014, there were 228 IIAs that included pre-establishment commitments (125 “other IIAs” and 103 bilateral investment treaties-BITs),²² while China rarely makes such commitments in IIAs by taking steps to grant pre-establishment national treatment in FTZs. China has demonstrated its determination to continue opening up its economy to foreign investors and expanding the scope of investment freedom for foreign companies.

²¹ An international investment agreement (IIA) is a type of agreement between countries that addresses issues relevant to cross-border investment, usually for the purpose of protecting, promoting and liberalizing such investment. Most IIAs cover both foreign direct investment (FDI) and portfolio investment, but some exclude the latter. Countries that conclude an IIA commit to comply with specific standards regarding the treatment of foreign investment in their territory. An IIA further defines procedures for dispute resolution if these commitments are not met.

²² A Bilateral Investment Treaty (“BIT”) is an international agreement between two States concerning the provisions for private foreign investment by nationals of one State in the other State. Such agreements are intended to encourage foreign direct investment in the host State by ensuring standards for the treatment of foreign investors, including compensation for expropriation of foreign investment, protection against unfair and unjust treatment of foreign investors, and protection against discriminatory treatment and lack of protection and security.

2. Legitimacy from an International Law Perspective

The legitimacy of FTZs is embedded in the Chinese Constitution (1982) and the Legislation Law (2000). Article 89 of the Constitution stipulates that the State Council has the authority to determine the territorial division of provinces and formulate administrative regulations. Article 9 of the Legislation Law further stipulates that the National People's Congress and the Standing Committee may authorize the State Council to formulate regulations to fill the legal gaps. In 2013, the Standing Committee of the National People's Congress authorized the State Council to establish SFTPZs and selectively adopted parts of the Foreign-Owned Enterprise Law, the Sino-Foreign Equity Joint Venture Law, and the Sino-Foreign Contractual Joint Venture Law to create a new legal framework for the zones. In 2015, the Standing Committee also authorized the State Council to establish three other FTZs. Therefore, the establishment of the four FTZs has its own legitimacy.

China is a member of the WTO and must comply with its obligations under the legal framework of the WTO. The concept of FTZ can be found in the Protocol of Accession of the People's Republic of China to the WTO, which proposes the establishment of special economic zones, including FTZs. Article 2 of the Protocol stipulates that the provisions of the WTO agreements and this Protocol shall apply to the entire customs territory of China, including border trade areas and minority autonomous regions, special economic zones, coastal open cities, economic and technical development zones, and other areas where tariff, tax and regulatory regimes are specially established. Thus, the establishment of FTZs falls within the scope of the WTO agreements.

Although it is legitimate for China to establish FTZs under WTO rules, China must keep in mind the specific WTO requirements that it must comply with. First, China must notify the WTO and other WTO members of all laws and regulations concerning FTZs. According to Article 2(B) of the Protocol, China must notify all relevant laws, regulations and other measures relating to its special economic zones within 60 days after their entry into force and indicate the geographical boundaries. Meanwhile, China will regularly publish publications providing information on the foreign trade system and regulations and administrative directives relating to foreign trade on the website of the Ministry of Commerce of the People's Republic of China and in magazines. According to China's WTO commitments, China will ensure that any preferential arrangements granted to foreign-invested enterprises located in special economic zones will be granted on a non-discriminatory basis.

Second, under the WTO agreement, China has committed that it will provide WTO members with translated versions of all laws, regulations and other measures that may affect trade in goods, services and intellectual property, which are called

WTO-plus obligations and require a lot of translation work.²³ Currently, foreign investors can find key legal documents of FTZs in English, which shows China's strong determination to legalize the establishment of FTZs.

Third, China should cooperate with the WTO in reviewing all trade policies, laws and regulations implemented in FTZs. In fact, in 2008, the WTO trade policy review report showed that there were nearly 2,000 special economic zones and other zones in China, including Shanghai Pudong New Area, 222 development zones approved by the Chinese central government, and 1,346 development zones approved by local governments. (Trade Policy Review of China, 2008). According to the requirements of the WTO Trade Policy Review Mechanism (TPRM), the trade policies and practices of all members must be reviewed periodically, and China, as one of the first four identified trading entities, must be reviewed every two years. The purpose of the WTO TPRM is to identify illegal laws and acts committed by its members, so as to improve members' compliance with WTO obligations. Therefore, measures regarding trade policies in China's FTZs will also be reviewed by the WTO and the WTO will require China to conduct a review and identify all measures that may be inconsistent, make prompt notification of such possible inconsistencies, make plans to eliminate WTO-inconsistent measures, and formulate an implementation plan.²⁴

Improving the effectiveness and efficiency of dispute resolution mechanisms in FTZs is an indispensable part of FTZ institutional construction. Given the fact that administrative actions in FTZs have been deregulated, it is more important to rely on dispute resolution mechanisms to resolve disputes and clarify the rules for the sound operation of FTZs. At present, dispute resolution methods in SFTPZs include administrative review and litigation, as well as commercial litigation, arbitration and mediation. For example, the SFTPZ Administrative Measures stipulate that "enterprises in FTZs may file lawsuits with the People's Court or apply for commercial arbitration or mediation as agreed upon in the event of commercial disputes" (Order 7, Articles 36 and 37). The China (Shanghai) FTZ Court was established in 2013, aiming to receive and adjudicate civil and commercial cases, especially in the fields of investment, trade, finance, intellectual property and real estate. The establishment of the court plays an important role in meeting the new demands on judicial services and the new challenges in dispute resolution.

Since FTZs have a clear geographical coverage, it is not difficult to formulate a legal assessment mechanism to evaluate the operation of FTZs in the areas of regulation and policy, investment environment, transparency, and level of service and supervision.

²³Gao, N. and Zheng, F. (2017) "The WTO-Plus Obligations: Dual Class or a Strengthened System?," in *Trade Multilateralism in the Twenty-First Century*. Cambridge University Press, p. 357-368. doi: 10.1017/9781108367745.019.

²⁴Creskoff, S. and Walkenhorst, P. (2009) *Implications of WTO Disciplines for Special Economic Zones in Developing Countries*. Washington, DC.: World Bank.

To ensure the authority and reliability of the assessment, China can invite a neutral third party to assess the legal environment of FTZs. At the domestic level, lawmakers and policymakers, judicial workers and researchers of FTZs, and enterprises and individuals in FTZs can be members of the assessment group. At the international level, members from some countries such as the United States and Singapore can be neutral third parties, as these countries have a longer history of operating FTZs and have mature FTZ legal systems. Comprehensive participation from various fields can ensure the reliability of the assessment results.

III. CONCLUSION

The legal legitimacy of the legal innovation policy for the Free Trade Zone in China is a commitment as a WTO member with 3 (three) consequences: (i) China must notify the WTO and other WTO members of all laws and regulations concerning the FTZ; (ii) China has committed that it will provide WTO members with translated versions of all laws, regulations and other measures that may affect trade in goods, services and intellectual property; and (iii) China must cooperate with the WTO in reviewing all trade policies, laws and regulations implemented in the FTZ. Indonesia can learn from China's steps to innovate the law. This is because Indonesia developed a Free Trade Area and Free Port (KPBPB) policy, an area within the jurisdiction of Indonesia that is separate from the customs area. KPBPB is free from import duties, value added tax, sales tax on luxury goods, and excise. KPBPB was developed in four regions, namely Sabang, Batam, Karimun, and Bintan.

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