

# WHAT IS THE EXTRA MILEAGE IN THE REINTRODUCTION OF 'FREE ZONES' IN THE UK?

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## KEY POINTS

- Since the referendum to leave the EU, there has been interest in the reintroduction of free zones in the UK to help boost British trade after Brexit.
- All measures used for free zones and enterprise zones must be compliant with the EU state aid rules as tax exemptions and fiscal incentives are a form of subsidy.
- Even free zones in non-EU countries operate under some form of state aid control: either through the obligations of the WTO Agreement on Subsidies and Countervailing Measures or through their preferential trade agreements with the EU, which usually contain some provisions on state aid control as a condition for improved access to the EU Single Market.
- There are potential benefits and savings that businesses operating in free zones can accrue from simplified customs procedures, relief on customs duties and tariff inversion, but these are likely to be limited in the UK context.
- There is scope for free zones to shape an export-oriented place-based regional development programme. However, it is essential that policymakers devise measures that (i) counteract possible diversion of economic activity from elsewhere, and (ii) offer a wider set of incentives than just free zones while keeping within our WTO obligations and any 'level playing field' obligations that arise from our future trade agreements.

## INTRODUCTION

Since the Brexit referendum, there has been talk of boosting British trade using free zones notably by some of the Members of Parliament (MPs), who formed All-Party Parliamentary Group (APPG) on Freeports,<sup>1</sup> as well as various studies discussing their potential economic effects.

In this briefing paper, we start by looking at definitions of 'free zones' versus the wider notion of 'special economic zones', and the potential benefits

that they offer. Free zones (often taking the form and name of free ports) are areas in a country's geographical territory but outside its customs territory. This offers the ability to defer payment of taxes on imported inputs and to avoid them altogether, if final goods are exported. Although we have spent little time discussing the costs of free zones we acknowledge that costs will be incurred by the taxpayers and there may be costs to private firms too as a result of running free zones.

1, For further detail, see: <https://publications.parliament.uk/pa/cm/smallparty/181121/freeports.htm>.

## WHAT IS THE EXTRA MILEAGE IN THE REINTRODUCTION OF 'FREE ZONES' IN THE UK?

We study the history of free zones in the UK, which existed until 2012 and the links with 'enterprise zones', which replaced them and where a broader set of incentives and regulatory modifications were used. We then look at the EU context where state aid rules limit the scale of assistance possible, noting that the UK would still be affected by these in some way post-Brexit.

We consider proposals for free zones as a device for regional regeneration. These are largely inspired by the US experience, so we look at US impact assessments. It turns out that there is limited evidence on net job creation as opposed to jobs that may have been shifted to the Foreign-Trade Zones, i.e. the US equivalent of free zones. A case can be made that the creation of such areas has shifted jobs to deprived areas, but this is quite different from arguments about net job creation. The strongest versions of free zones seem to involve relaxing social and environmental standards, but this does not appear to be proposed for the UK and it has not occurred as far as we are aware within the US. However, what does emerge is that US free zones are largely motivated by the wish to get anomalies in the US tariff structure, notably 'tariff inversion' where inputs bear higher duty than the final goods they go into. We conclude that in the UK context wider 'place-based' policies, i.e. policies directed at overall regeneration of an area, would be needed in addition to any customs benefits.

### DEFINITION OF FREE ZONES

Business and trade laws differ between countries so the exact definition and the operating models of free zones will be different for different countries. Free zones (alternatively free ports or free trade zones) are designated areas of a country, which are inside the geographic boundary of that country but are considered to be outside of that country for the purposes of the import duties. Free zones facilitate trading procedures by allowing fewer customs formalities for goods from the rest of the world. Goods that are imported into the free zones do not incur usual import procedures on entry and reexit, and import duties are not payable until these goods are released for free circulation in the domestic economy (or used or consumed within the free zone).

Businesses operating in free zones are offered the following benefits:

- **Simplified customs procedure;**
- **Relief on customs duties** relating to transshipment, handling and processing of goods destined for re-export;
- **Cash-flow benefits of duty deferral** until goods are released for free circulation in the domestic economy (or used or consumed within the free zone);
- **Added security** from the perimeter fence enclosing the free zone;
- **Tariff inversion:** some finished goods incur lower tariffs than intermediate goods; this means that intermediate goods can be imported to free zone tariff-free, processed and sold as a final product, incurring lower tariff rates.

Free zones are one type of '**special economic zones**', which are designated geographical areas within a country where business activity is subject to different rules from those prevailing in the rest of the country.

### FREE ZONES IN THE EU AND GLOBALLY

Within the EU, there are currently 80 free zones located across 21 EU Member States, according to a list for the EU Member States provided by the Directorate-General for Taxation and Customs Union (DG TAXUD).<sup>2</sup> These pertain to '**control type I free zones**', which are an enclosed geographical area (with a perimeter fence) instead of a building or premises, and where goods placed within the area are checked by the customs authorities upon entry and exit.<sup>3</sup>

In the EU, there also used to be '**control type II free zones**', where physical control of goods placed within the zone was done on the basis of stocktaking (rather than at entry and exit points to the zone) and additional physical inspections. But as of 1 May 2016, these were re-classified as customs warehouses<sup>4</sup> due to the application of the Modernised

<sup>2</sup>, For further detail on free zones in the EU, see: [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/resources/documents/customs/procedural\\_aspects/imports/free\\_zones/list\\_freezones.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/customs/procedural_aspects/imports/free_zones/list_freezones.pdf).

<sup>3</sup>, De Jong, W. (2013) Establishing Free Zones for Regional Development, Library Briefing, Library of the European Parliament. Available at: [http://www.europarl.europa.eu/RegData/bibliotheque/briefing/2013/130481/LDM\\_BRI\(2013\)130481\\_REV1\\_EN.pdf](http://www.europarl.europa.eu/RegData/bibliotheque/briefing/2013/130481/LDM_BRI(2013)130481_REV1_EN.pdf).

<sup>4</sup>, Alternatively referred to as 'bonded warehouses'.

Customs Code in the EU (see Article 288(2) of the Union Customs Code).<sup>5</sup>

More than 4,300 Special Economic Zones<sup>6</sup> (of which free zones are one type) may be in operation around the world, although the number is difficult to verify because no exact census exists.<sup>7</sup>

### FREE ZONES AND ENTERPRISE ZONES: THE UK EXPERIENCE WITH REGIONAL POLICY INTERVENTIONS

UK free zones were in operation from 1984 – when areas of Birmingham, Belfast, Cardiff, Liverpool, Prestwick and Southampton were designated to become the UK's first free zones<sup>8</sup> – until July 2012, when the UK stopped renewing the licenses for free zones. Prior to 2012, there were five free zones in the UK – located in Liverpool, Prestwick, Sheerness, Southampton and Tilbury – which were classed as '**control type II free zones**'. Technically not part of the UK nor the EU, a free zone is in operation on the Isle of Man.

While 2012 saw an end to free zones in the UK, it also saw the reintroduction of enterprise zones across the UK.<sup>9</sup> Alongside free zones, enterprise zones are another type of 'special economic zone': designated areas that provide tax breaks and government support, aimed at increasing new business start-ups and creating new jobs. Businesses operating in enterprise zones can benefit from fiscal incentives such as:

a) **businesses rates discounts** (worth up to £275,000 per business over a 5-year period),

b) **enhanced capital allowances** for companies investing in new plant or machinery,

c) **location-specific amenities** (such as rail, ports, high-speed broadband) and simplified planning process.

At present, there are 61 enterprise zones across the UK: 48 are located in England, eight are located in Wales, and four in Scotland (called 'enterprise areas'). Recently, Northern Ireland's first enterprise zone – Atlantic Link Enterprise Campus – was launched in Coleraine.<sup>10</sup> Operating models of enterprise zones differ, often focusing on particular sectors. For example, four enterprise zones in Scotland (located across 16 sites) include the Life Sciences Enterprise Area, General Manufacturing / Growth Sectors Enterprise Area, and two Low Carbon / Renewables Enterprise Areas.<sup>11</sup>

Enterprise zones were announced in 2011, reviving a 1980s concept. Hall (1977)<sup>12</sup> had originally proposed that these areas would be outside the United Kingdom exchange rate control, all goods would, therefore, be imported and sold free of customs duties and taxes, there would be free movement of labour and capital, and overseas businesses people would be free to come.<sup>13</sup> However, the 25 enterprise zones borne under the Thatcher Government of 1980s Britain focused on the built environment, tax subsidies, with 100% capital allowances on investment in property and exemption from local business rates. By focusing on capital-based incentives such as enhanced capital allowances for investment in plant and machinery, the enterprise zones of the 1980s led to some substitution away from labour towards capital, thus dampening any employment effect. They also failed to overcome regulatory barriers to growth: a report by the Centre for Cities maintains that some key elements, such as simplified planning processes, were not delivered in practice.<sup>14</sup>

5, For the Union Customs Code, see: <https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:02013R0952-20131030&from=EN>.

6, The Economist (2015) Special Economic Zones. Not So Special. Available at: <https://www.economist.com/leaders/2015/04/04/not-so-special>.

7, World Bank (2017) Special Economic Zones : An Operational Review of Their Impacts. Available at: <https://openknowledge.worldbank.org/bitstream/handle/10986/29054/P154708-12-07-2017-151264006382.pdf>.

8, Griffiths, A. and Wall, S. (2004) *Applied Economics*, Pearson Education, Harlow, Essex.

9, The UK ran a program of enterprise zones from 1981 to the mid-1990s and these covered areas of derelict industrial land in locations that had been hit by industrial decline. See: Neumark, D. and Simpson, H. (2014) Place-Based Policies, Oxford University Centre for Business Taxation Working Paper 14/10. Available at: [https://www.sbs.ox.ac.uk/sites/default/files/Business\\_Taxation/Docs/Publications/Working\\_Papers/series-14/WP1410.pdf](https://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Working_Papers/series-14/WP1410.pdf).

10, Official launch of Atlantic Link Enterprise Campus – Northern Ireland's first Enterprise Zone. Available at: <https://www.causewaycoastandglens.gov.uk/news/official-launch-of-atlantic-link-enterprise-campus-northern-irelands-first>.

11, For further detail on which of England's enterprise zones focus on which sectors, see: <https://enterprisezones.communities.gov.uk/enterprise-zones-by-sector/>.

12, Hall, P. (1977) *Green Fields and Grey Areas*. In Proceedings of Royal Town Planning Institute Annual Conference, Chester. London: Royal Town Planning Institute.

13, Hall, P. (1981) Enterprise Zones: A Justification, *International Journal of Urban and Regional Research*, 6(3): 416-421.

14, Larkin, K. and Wilcox, Z. (2011) What Would Maggie Do? Why the Government's Policy on Enterprise Zones Needs to Be Radically Different to the Failed Policy of the 1980s, Centre for Cities, London. Available at: <https://www.centreforcities.org/wp-content/uploads/2014/09/11-02-28-What-would-Maggie-do-Enterprise-Zones.pdf>.

The same report also concluded that lessons from the 1980s must be learned if the enterprise zones of the 21<sup>st</sup> century are to be a success. First, the enterprise zones of the 1980s often led to a displacement of economic activity, rather than new job creation, effectively 'pushing demand around the economy'. Larkin and Wilcox (2011) found that of up to 41% of the 58,000 jobs created in the enterprise zones of the 1980s were relocated from elsewhere in the UK. Second, the zones were also expensive: final evaluation of the enterprise zones found that the public sector cost per additional job created in the zone amounted to £17,000 per job in 1994-95 prices.<sup>15</sup> Third, the main factors that tended to attract businesses to enterprise zones were the availability of business rates relief and enhanced capital allowances. But in practice, business rates relief often led to higher rents, which benefited the landlords. The proportion of net rates relief captured by the occupiers was much lower: around 10-55% in urban zones, 30-50% in accessible zones, and between -25 to +45% in remote zones.<sup>16</sup>

A review by Gunther and Leathers (1987) drawing heavily on Tym (1985) came to even more pessimistic conclusions: *"The obvious lesson for US urban policy-makers from the British enterprise zone experience is that the enterprise zones tend to have major effects in influencing location of enterprises and very minor effects in stimulating new economic activities"*. They estimated the cost per job to have been \$250,000.<sup>17</sup>

Although 1980s enterprise zones successfully dealt with dereliction and led to considerable environmental improvement, they were often created in areas that only offered a limited chance of long-term success (for example, in areas with poor transport connectivity or with limited access to large, skilled labour markets, suppliers, customers). Enterprise zones located in inner cities were more successful at creating new additional jobs than those outside of urban centres and in remote areas.<sup>18</sup>

15, PA Cambridge Economic Consultants (1995) Final Evaluation of Enterprise Zones, Department of the Environment, London. Available at: <https://webarchive.nationalarchives.gov.uk/+http://www.communities.gov.uk/archived/general-content/citiesandregions/finalevaluation/>.

16, Ibid.

17, Tym, Roger and Partners. Monitoring Enterprise Zones: Third Year Report. London: Her Majesty's Stationary Office, 1985. cited by Gunther, W.D. and Leathers, C.G. (1987) British Enterprise Zones: Implications for U.S. Urban Policy, *Journal of Economic Issues*, 21(2): 888. See also: [Do Enterprise Zones Work? https://library.cqpress.com/cqresearcher/document.php?id=cqresrre1989042800](https://library.cqpress.com/cqresearcher/document.php?id=cqresrre1989042800)

18, Of the 22 enterprise zones evaluated in PA Cambridge Economic Consultants (1995), six 'urban' zones in inner cities generated more than half of the total employment growth, almost 40% of this growth was in 13 'accessible' zones outside urban centres but easily accessible from major population centres, and only one in 20 jobs was added by the three 'remote' zones.

## RULES ON THE OPERATION OF FREE ZONES AND ENTERPRISE ZONES IN THE EU

The operations of free zones – as well as enterprise zones – must be compliant with EU state aid rules. This is because tax exemptions and financial incentives offered to businesses choosing to locate in these zones can, in principle, be considered as a state subsidy that distorts competition – and would be in breach of the Treaty on the Functioning of the European Union (TFEU).

The General Block Exemption Regulation (GBER) defines categories of aid that are compatible with the EU internal market, and these depend on the size of the company. As such, medium-sized enterprises are entitled to aid of 10% of the total investment (in addition to any regional aid they have already received), while small companies are entitled to 20% more.

The requirement for compliance with the EU state aid rules constrains the options for free zone and enterprise zone operations, but exemptions may be granted under Article 107(3)(a) and (c) TFEU, whereby the use of state aid is considered beneficial to the economic and social development of underdeveloped regions of the EU (for example, aid for regional development, promoting innovation, improving environmental standards, assistance to small and medium-sized enterprises). Specifically, Article 107(3) (a) and (c) TFEU states that the following may be considered to be compatible with the internal market:

(a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment, and of the regions referred to in Article 349, in view of their structural, economic and social situation;

(c) aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest.

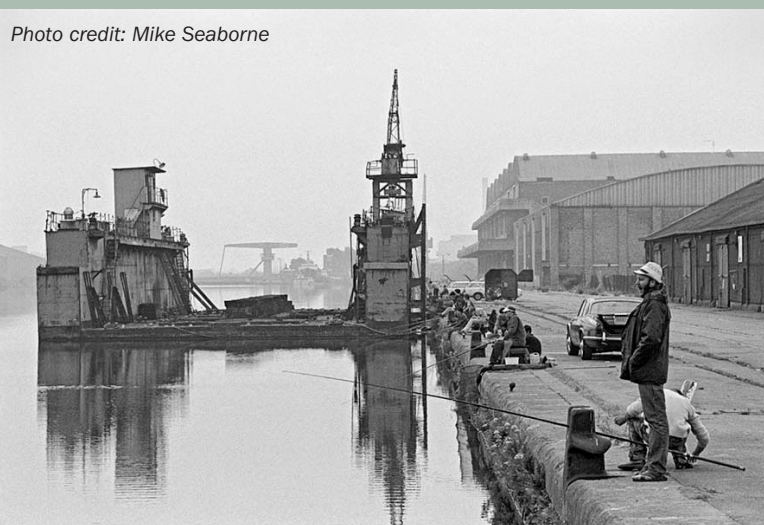
### Box 1: Success stories of 1980s enterprise zones: the Isle of Dogs Enterprise Zone

Following London's decline as a port, the Isle of Dogs became a redundant dock area – one that once could accommodate ocean-going cargo ships of about 5,200 net tonnage and 32ft draught.<sup>1</sup> The major factor that contributed to the decline of the Isle of Dogs and the Port of London was the introduction of container ships: these were larger than conventional cargo ships, too large for traditional docks and their associated handling equipment. The road network around the Isle of Dogs, constructed for lighter traffic, further contributed to the eventual decline of the Port of London as a distribution centre. The transfer of port operations down river caused a rise in local unemployment – between 1965 and 1978 some 150,000 jobs were lost – with the docks in the Isle of Dogs eventually becoming backwaters that played no part in the commercial life of London.<sup>2</sup> At the same time, ports on the east and south coast of England – such as Felixstowe – began to prosper.<sup>3</sup>

The Isle of Dogs was designated as an enterprise zone in 1982. A major regeneration scheme was carried out in a land area owned predominantly by the London Docklands Development Corporation (LDDC): office space and houses were constructed, including local amenities such as waterside shops, pubs and restaurants. Labour market failures were also alleviated by a combination of training projects and improvements in public transport accessibility including the Docklands Light Railway, which opened in 1987.

A report from the Cambridge Policy Consultants Ltd found that these policy interventions addressed multiple market failures, including those in labour, land, housing, and commercial property markets.<sup>4</sup> Among the main benefits, the report listed creation of over 24,000 housing units and over 80,000 gross jobs in the Urban Development Area (UDA) (of which Isle of Dogs Enterprise Zone was a part), with a further 23,000 jobs created as a result of these interventions across central London. In terms of value for money, the report also found that every £1 million of Exchequer expenditure had generated, in the UDA as a whole, 23 additional jobs, 8500m<sup>2</sup> of office floorspace and 7.8 housing units, though the impact was highest in the non-enterprise zone area of the UDA.

Overall, the Isle of Dogs Enterprise Zone is considered to be by far the most successful of the 1980s enterprise zones: a conclusion reached by reports by the Centre for Cities<sup>5</sup> and the Work Foundation.<sup>6</sup>



1, Eveleigh, S. (1991) Enterprise Zones and Industrial Changes: The Cases of Corby, Salford and the Isle of Dogs, MPhil thesis, London School of Economics and Political Science (United Kingdom). Available at: <http://etheses.lse.ac.uk/1188/>.

2, Ibid.

3, Overman and Winters (2006) looked at the impact of the UK accession to the European Economic Community and found that led to a significant re-orientation of trade towards the EEC members, with goods increasingly entering and exiting the UK market through the ports located in the South and the East of England. For further detail, see: Overman, H. and Winters, L.A. (2006) Trade Shocks and Industrial Location: The Impact of EEC Accession on the UK, CEP Discussion Papers dp0588, Centre for Economic Performance, LSE, London.

4, Cambridge Policy Consultants Ltd (1998) Regenerating London Docklands, Department of the Environment, Transport and the Regions (DETR), London. Available at: <http://www.most.ie/webreports/reportjune2010/Policy07/Ivan/Regenerating%20London%20Docklands%20-%20Communities%20and%20Local%20Government.htm>.

5, Larkin, K. and Wilcox, Z. (2011) What Would Maggie Do? Why the Government's Policy on Enterprise Zones Needs to Be Radically Different to the Failed Policy of the 1980s, Centre for Cities, London. Available at: <https://www.centreforcities.org/wp-content/uploads/2014/09/11-02-28-What-would-Maggie-do-Enterprise-Zones.pdf>.

6, Sissons, A. and Brown, C. (2011) Do Enterprise Zones Work?, The Work Foundation, London. Available at: [http://www.cooscountywatchdog.com/uploads/8/7/3/0/8730508/do\\_enterprise\\_zones\\_work\\_february\\_2011.pdf](http://www.cooscountywatchdog.com/uploads/8/7/3/0/8730508/do_enterprise_zones_work_february_2011.pdf).

This 'economic development exemption' clause may explain why many free zones and enterprise zones in operation in the EU are located in the 'new' EU Member States in Central and Eastern Europe,<sup>19</sup> whose level of GDP per capita often lags behind that of the 'old' EU.<sup>20</sup> Poland has been particularly active in this field. Most countries in Central and Eastern Europe began setting up special economic zones in the mid-1990s as a way of attracting foreign direct investment (as they were making a transition from centrally-planned to market economies), offering incentive schemes such as tax holidays, reduced corporate income tax rates or customs duty exemptions / deferrals. In the run-up to the EU accession, however, these countries were required to revise their incentive schemes to make them compatible with EU state aid rules.

### RULES ON THE OPERATION OF FREE ZONES AND ENTERPRISE ZONES IN NON-EU COUNTRIES, INCLUDING EU PREFERENTIAL TRADING PARTNERS

But even free zones in non-EU countries operate under some form of state aid control. First, free zones are bound by the obligations in the WTO Agreement on Subsidies and Countervailing Measures.<sup>21</sup> Second, free zones located in countries that have preferential trade agreements with the EU are often subject to EU state aid rules. This is because EU trade agreements usually contain some provisions on state aid control, as a condition for improved access to the EU Single Market, particularly for accession countries.<sup>22</sup>

For example, the Western Balkan countries have all signed Stabilisation and Association Agreements with the EU, through which they are committed to harmonising their legislation with the EU *acquis communautaire*. Although none of these countries has officially opened negotiations with the EU on Chapter 8 of the *acquis* (competition policy and state aid), being signatories of the Stabilisation and Association

Agreements requires them to align their state aid rules with those of the EU within four years of signing the agreement.<sup>23</sup>

As far as the UK position is concerned, in the White Paper on 'The future relationship between the United Kingdom and the European Union', the Government proposed to establish a new free trade area and maintain a common rulebook with the EU for goods.<sup>24</sup> To guarantee 'an open and fair trading relationship', the Government specifically pledged to apply a common rulebook for state aid, to be enforced and supervised in the UK by the Competition and Markets Authority (CMA).

### ANALYSES OF THE POSSIBLE IMPACT OF FREE ZONES IN THE UK

Since the Brexit vote, there have been a number of proposals and studies of free zones, notably by Sunak for the Centre for Policy Studies and by Mace. They tend to see the US experience as a template that can be replicated in the UK after Brexit.

### THE CENTRE FOR POLICY STUDIES REPORT

The Centre for Policy Studies report<sup>25</sup> claims that an introduction of free zones in the UK would have the potential to create some 86,000 jobs if they were as successful as the Foreign-Trade Zones in the United States. The arithmetic behind this number is simple: it takes the total number of jobs across the existing 250 Foreign-Trade Zones in the US (420,000) and assumes these are additional jobs and adjusts this number for the size of the UK labour force (33mn, versus 161mn in the US). A US Congressional Research Service study is sceptical about the extent of additionality of such jobs.<sup>26</sup>

19, Of the 80 free zones in operation in the EU, 58 are located in the 'new' EU Member States. For a complete list of free zones in the customs territory of the Union, see: [https://ec.europa.eu/taxation\\_customs/sites/taxation/files/resources/documents/customs/procedural\\_aspects/imports/free\\_zones/list\\_freezones.pdf](https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/customs/procedural_aspects/imports/free_zones/list_freezones.pdf).

20, Also within the UK, existing enterprise zones tend to be located in areas with weak economies. For further detail see: What Works Centre for Local Economic Growth (2016) Evidence Review: Area-Based Initiatives: Enterprise Zones. Available at: [http://www.whatworksgrowth.org/public/files/Policy\\_Reviews/16-01-04-Area-based-initiatives-EZ.pdf](http://www.whatworksgrowth.org/public/files/Policy_Reviews/16-01-04-Area-based-initiatives-EZ.pdf).

21, Torres, R.A. (2012) Free Zones and the WTO Agreement on Subsidies and Countervailing Measures, *Global Trade and Customs Journal*, 2(5): 217-223.

22, Young, G. and Bickler, R. (2018) Post-Brexit State Aid Rules in the UK. Available at: <http://www.cms-lawnow.com/ealerts/2018/02/post-brexit-state-aid-rules-in-the-uk>.

23, OECD (2017) Tracking Special Economic Zones in the Western Balkans: Objectives, Features and Key Challenges. Available at: [http://www.oecd.org/south-east-europe/SEZ\\_WB\\_2017.pdf](http://www.oecd.org/south-east-europe/SEZ_WB_2017.pdf).

24, HM Government (2018) White Paper: The future relationship between the United Kingdom and the European Union. Available at: [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/725288/The\\_future\\_relationship\\_between\\_the\\_United\\_Kingdom\\_and\\_the\\_European\\_Union.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/725288/The_future_relationship_between_the_United_Kingdom_and_the_European_Union.pdf).

25, Sunak, R. (2016) The Free Ports Opportunity: How Brexit Could Boost Trade, Manufacturing and the North, Centre for Policy Studies, London. Available at: <http://www.cps.org.uk/files/reports/original/161114094336-TheFreePortsOpportunity.pdf>.

26, Bolle, M.J. and Williams, B.R. (2013) U.S. Foreign-Trade Zones: Background and Issues for Congress, Congressional Research Service Report. Available at: <https://fas.org/sgp/crs/misc/R42686.pdf>.

## THE MACE REPORT

A report by Mace<sup>27</sup> claims that in an 'optimistic scenario' proposed 'Supercharged Free Ports' (i.e. free zones integrated with enterprise zones) would generate some 150,000 new jobs, boost trade by some £12bn a year, add some £9bn a year to the UK economy, and narrow the North-South divide.<sup>28</sup> These gains come from assumed first-round price effect (i.e. a 1% decrease in the price of imports and exports leads to a 1% increase in the quantity of imports after 10 years) and also from induced agglomeration effects within the free zone zones (these boost trade impacts by +150%). With an assumption that a 1% increase in trade translates to a 0.75% increase in gross value added (GVA) – at the high end of parameters used in Brexit modelling<sup>29</sup> – this means that a £12bn boost in trade, leads to a £9bn increase in GVA. In turn, assuming that free zones activities lead to a creation of high-value-added jobs averaging £60,000 per job, a £9bn increase in GVA implies some 150,000 new jobs.

Neil Lee from the London School of Economics questioned the assumption that benefits of agglomeration in free zones in the North of England can be assumed equal to those in the US Foreign-Trade Zones saying that: *"The agglomeration literature in the US tends to find relatively large effects. In the UK, everything is closer together so agglomeration is less important"*.<sup>30</sup> And there is, of course, also a possibility that the 'Supercharged Free Ports' simply divert economic activity from elsewhere rather than lead to the creation of new jobs.

## THE US EXPERIENCE OF OPERATING FREE ZONES

The House Ways and Means Committee asked the International Trade Commission (ITC) and the General Accounting Office (GAO) to study the US free zones (known as Foreign-Trade Zones) in 1984. The GAO report title sums up their findings: *"Foreign Trade Zone Growth Primarily Benefits Users Who Import*

27, Mace (2018) Mace Insights. Supercharged Free Ports. The Ultimate Boost for Britain's Economy. Available at: [http://www.infrastructure-intelligence.com/sites/default/files/article\\_uploads/Insights%20-%20Supercharged%20Free%20Ports.pdf](http://www.infrastructure-intelligence.com/sites/default/files/article_uploads/Insights%20-%20Supercharged%20Free%20Ports.pdf).

28, The report envisages that the seven 'Supercharged Free Ports' are to be located at Grimsby & Immingham Hull, Liverpool, Manchester Airport, Rivers Hull & Humber, Tees & Hartlepool, and Tyne.

29, See, for example, Table 14 in Ebell, M. and Warren, J. (2016) The Long-Term Economic Impact of Leaving the EU, *National Institute Economic Review*, 236(1): 121-138 for comparison of parameters used in various Brexit modelling exercises.

30, Smith, K. (2018) Supercharged Free Ports: Putting Mace's Big Idea for the North in the Dock, *Construction Research and Innovation*, 9(3): 68-72.

*For Domestic Commerce"*.<sup>31</sup> The GAO's 1989 update confirmed that *"the primary reason for rapid zones growth has been the opportunity to use inverted tariffs to lower duty rates on imported parts,"* with cars as the main example.<sup>32</sup> A subsequent 2017 GAO study stressed that there was inadequate evidence to assess the number of new jobs created by Foreign-Trade Zones.<sup>33</sup>

The tariff inversion phenomenon is very significant in the US. The Congressional Research Service<sup>34</sup> study quotes the US Foreign-Trade Zones Board who approve such applications as estimating that half the cost savings from Foreign-Trade Zones in the US arise from tariff inversion. The annual report of the US Foreign-Trade Zones Board shows that a high share of production in US Foreign-Trade Zones is in fact in petroleum products due to higher tariffs on crude than refined products.<sup>35</sup> The same report incidentally shows that the majority of inputs and outputs of the US zones are domestic not imports or exports.

A Canadian study of the US also stresses the importance of tariff inversion in petroleum, cars and consumer electronics.<sup>36</sup>

## THE ECONOMIC IMPACT OF FREE ZONES AND ENTERPRISE ZONES

As explained before, a free zone in one country may not be exactly equivalent to a free zone in another (and the terms may be used interchangeably across different studies). For this reason, we will consider the impact of broader special economic zones (SEZs), be they focused specifically on supporting trade, or boosting new investment and job creation.

31, U.S. General Accounting Office (1984) Foreign Trade Zone Growth Primarily Benefits Users Who Import For Domestic Commerce, Report To The Chairman Committee On Ways And Means, House Of Representatives, Washington D.C. Available at: <https://www.gao.gov/assets/150/141214.pdf>.

32, U.S. General Accounting Office (1989) Foreign Trade Zones Program Needs Clarified Criteria, Report to the Chairman, Committee on Ways and Means, House of Representatives, Washington D.C. Available at: <https://www.gao.gov/assets/150/147348.pdf>.

33, U.S. Government Accountability Office (2017) CBP Should Strengthen Its Ability to Assess and Respond to Compliance Risks across the Program, Report to the Ranking Member, Committee on Finance, U.S. Senate, Washington D.C. Available at: <https://www.gao.gov/assets/690/686218.pdf>.

34, Bolle, M.J. and Williams, B.R. (2013) U.S. Foreign-Trade Zones: Background and Issues for Congress, Congressional Research Service Report. Available at: <https://fas.org/sgp/crs/misc/R42686.pdf>.

35, 79<sup>th</sup> Annual Report of the Foreign-Trade Zones Board to the Congress of the United States, November 2018. Available at: <https://enforcement.trade.gov/ftzpage/annualreport/ar-2017.pdf>.

36, Ferguson, M. and Steverango, C. (2013) Maximizing the Potential of the Foreign Trade Zone Concept in Canada, McMaster Institute for Transportation & Logistics, McMaster University, Hamilton, Ontario. Available at: [http://mitl.mcmaster.ca/reports/MITL\\_FTZ\\_Report.pdf](http://mitl.mcmaster.ca/reports/MITL_FTZ_Report.pdf).

Siroën and Yücer (2017)<sup>37</sup> have done a cross country gravity model on the effect of free zones focusing on countries with broader types of zones, especially export processing zones. Their conclusion is that these mainly act as a device for reducing the impact of high import duties, promoting imports by more than exports, which is consistent with the US case. With low tariffs the effect of free zones as such is small.

A comprehensive review and evaluation of area-based initiatives such as enterprise zones was done by the What Works Centre for Local Economic Growth (WWC).<sup>38</sup> Using 30 impact evaluations that met the minimum standard,<sup>39</sup> the WWC review established that most evaluations found a positive effect of enterprise zones on employment – but some also found either mixed or no effects. Although the issue of displacement of economic activity was not considered in all impact evaluations, those that did, often found evidence of displacement. Impact evaluations reviewed by the WWC also tended to find mixed evidence on the impact of enterprise zones on wages: half of these found a positive impact but the remainder found no effect.<sup>40</sup>

Importantly, the impact evaluations reviewed by the WWC focused only on enterprise zone policies in the United States and France – even though the concept of enterprise zones originates in the UK. The WWC concluded that no UK-based evaluations of enterprise zones met the minimum criteria, and as such were discounted on methodological grounds. The impact evaluations covered zones such as the US Empowerment Zones, the US Enterprise Zones and French Zones Franches Urbaines – but also (in the smaller number of cases) the US Enterprise Communities, the US Renewal Communities and French Zones de Revitalisation Rurale.

In a contribution to the Spatial Economics Research Centre (SERC) Policy Paper on 'strategies for underperforming places',<sup>41</sup> Henry Overman argued that urban and regional policy in Britain has been too much focused on public expenditure as a strategy to 'turn around' declining places and that these interventions have not been very successful. Instead, Overman argued that policy should be more focused on encouraging labour market activity and removing barriers to mobility through targeted interventions in skills provision, but also by expanding commercial and residential property supply in Britain's most economically vibrant places.

### POSSIBLE SAVINGS FROM THE INTRODUCTION OF FREE ZONES IN THE UK

To the best of our knowledge, precise estimates of the market value of the potential costs and benefits of free zones worldwide do not exist,<sup>42</sup> but most of the financial benefits that businesses derive come from:

- duty reduction on inverted tariffs,
- cash-flow savings from zone efficiencies affecting inventory control,
- duty exemption on exports,
- duty deferral.

We provide simple, illustrative calculations that demonstrate the scale of the potential benefits and savings that businesses could accrue from free zone operations. These calculations are not intended to be precise estimates but could help to gauge whether these potential savings would be substantial in the UK context.

37, Siroën, J.-M. and Yücer, A. (2017) Trade Performance of Export Processing Zones, *The World Economy*, 40(5): 1012-1038.

38, The What Works Centre for Local Economic Growth is a collaboration between the London School of Economics and Political Science (LSE), Centre for Cities and Arup. The full text of their evaluation of enterprise zones is available at: [https://whatworksgrowth.org/public/files/Policy\\_Reviews/16-01-04-Area-based-initiatives-EZ.pdf](https://whatworksgrowth.org/public/files/Policy_Reviews/16-01-04-Area-based-initiatives-EZ.pdf).

39, As such, this review from the What Works Centre for Local Economic Growth excluded those impact evaluations that provided a simple before and after comparison only for areas designated as enterprise zones. This was on the grounds that any causal effect cannot be attributed to the enterprise zones. It also excluded simple case studies and evaluations that focused on 'how was the project implemented?' rather than 'what was the effect of the project?'. For example, with 198 studies that covered the enterprise zone policies, the What Works Centre for Local Economic Growth discounted 168 of these based on methodological grounds.

40, Summary outcome tables that report the breakdown of results in impact evaluations reviewed by the WWC is available at: [https://whatworksgrowth.org/public/files/Evidence\\_Tables/Evidence\\_table\\_area\\_based\\_initiatives.pdf](https://whatworksgrowth.org/public/files/Evidence_Tables/Evidence_table_area_based_initiatives.pdf).

41, Lawless, P, Overman, H.G. and Tyler, P (2011) Strategies for Underperforming Places, SERC Policy Paper 6, London School of Economics, London. Available at: [http://eprints.lse.ac.uk/59236/1/\\_lse.ac.uk\\_storage\\_LIBRARY\\_Secondary\\_libfile\\_shared\\_repository\\_Content\\_LSE%20Spatial%20Economic%20Research%20Centre\\_SUNAINA%20SERC\\_sercpp006.pdf](http://eprints.lse.ac.uk/59236/1/_lse.ac.uk_storage_LIBRARY_Secondary_libfile_shared_repository_Content_LSE%20Spatial%20Economic%20Research%20Centre_SUNAINA%20SERC_sercpp006.pdf).

42, Bolle, M.J. and Williams, B.R. (2013) U.S. Foreign-Trade Zones: Background and Issues for Congress, Congressional Research Service Report.



Table 1: The five sectors with the highest tariff wedge on intermediate goods vs final goods

ISIC4 sector	EU MFN tariff on intermediate goods (A)	EU MFN tariff on final goods (B)	Tariff Wedge: A - B	UK imports (intermediate goods in this sector) in million of US\$; share of total UK imports in parentheses
1062 Manufacture of starches and starch products	34.53%	7.35%	27.18%	564.3 (0.19%)
1050 Manufacture of dairy products	47.40%	39.88%	7.52%	270.1 (0.09%)
1080 Manufacture of prepared animal feeds	36.93%	30.01%	6.92%	513.3 (0.17%)
2640 Manufacture of consumer electronics	6.59%	3.78%	2.81%	425.3 (0.14%)
3100 Manufacture of furniture	2.64%	0.42%	2.22%	1,656.7 (0.55%)

## SAVINGS ON TARIFF INVERSION

The US Foreign-Trade Zones are driven very much by the desire to avoid higher tariffs on inputs – than final outputs – and the US motor vehicle sector is one of the sectors where tariffs on inputs are higher. For example, because of inverted tariffs, a Volkswagen plant in Tennessee was estimated to save \$1.9 million – or \$13 per car – on producing 150,000 cars annually in Foreign-Trade Zones.<sup>43</sup>

This issue is less significant for EU tariffs or likely UK tariffs. For example, in the motor vehicle sector (ISIC4 2910) EU tariffs are not inverted: importers of automotive parts face lower tariffs (4.5%) than importers of final cars (10%).<sup>44</sup> The EU is, in fact, more often accused of tariff escalation rather than inversion.

43, Pare, M. (2011) Volkswagen Could Save Nearly \$2 million a Year in Tariffs, Times Free Press <https://www.timesfreepress.com/news/business/aroundregion/story/2011/mar/19/volkswagen-could-save-nearly-2-million-year-tariff/45301/>; cited by Bolle, M.J. and Williams, B.R. (2013) U.S. Foreign-Trade Zones: Background and Issues for Congress, Congressional Research Service Report. Available at: <https://fas.org/sgp/crs/misc/R42686.pdf>.

44, See: the Society of Motor Manufacturers and Traders (SMMT), Brexit issue papers. Available at: <https://www.smmt.co.uk/industry-topics/brexit/brexit-issue-papers/>.

To gauge the potential savings in tariff inversion, we identified the 4-digit ISIC4 sectors where the inversion wedge between the tariffs on the corresponding intermediate and final goods was greatest. Using the concordance tables from the OECD and the UN Statistical Division, we matched the HS tariff lines to the 4-digit ISIC4 sectors and the Broad Economic Categories (BEC) respectively. The BEC categories were then classified into capital, intermediate and final goods.

Table 1 shows that the sector with the largest wedge between tariffs on intermediate and final goods is in 'manufacture of starches and starch products' (ISIC4 1062), with an ad-valorem wedge of 27%. But this sector has a relatively low share of UK imports: in 2017 imports of intermediate inputs used in the manufacturing of starches were worth US\$564.3mn, a small 0.19% of UK total imports.

The above suggests that in some sectors tariff inversion savings could be made, but overall, there is limited scope for substantial savings in the UK context.

## SAVINGS ON DUTY DEFERRAL

The size of potential savings that businesses could accrue from duty deferral will depend on the following:

a) the value of goods imported, b) the size of the tariff, c) the interest rates on loans (i.e. cost of money) and d) the average time that intermediate inputs are stored in a free zone before they are released for circulation.

For example, assume the following:

- a) value of imports = £10,000
- b) tariff = 3%
- c) interest rate = 5%
- d) time in inventory in free zones = 3 months

The savings on duty deferral will then be equal to £3.75, a marginal amount.

The formula used to arrive at the £3.75 is as follows:

tariff liability = value of imports \* tariff

savings on duty deferral = tariff liability \* interest rate \* (days in inventory / 365)

Assuming that the average tariff rate on manufactured products stands at 3%, the prevailing interest rates on loans stand at 5% (p.a.) and that it takes 3 months for the inputs to be processed in a free zone and then released for circulation, the savings in duty deferral account for 0.0375% of the value of goods imported.

Of course, the higher the value of goods imported, the higher the value of savings that businesses can make from duty deferral. But even if the goods imported were worth much higher, say, £1,000,000, this still leaves only £375 made in savings.

Let's look at gearboxes (HS code 870840), for example.

In 2017, the UK imported some US\$3.037bn worth of these (i.e. total UK imports). These faced an MFN tariff of 3.81%. Assume that only 10% of these gearboxes can be imported and processed in free zones (this is because of space constraints). And as above, let's assume an interest rate of 5%, and an average processing time in a free zone of 3 months. The total value of savings that will be made on deferring duty payments on gearboxes imported to free zones will be equal to US\$140,000 – which at the current GBP/USD exchange rate of 1.29 makes it equal to a total £110,000.

There is also a question of whether it will cost

businesses more to store goods in a free zone, consequently reducing any savings made on duty deferral. On the one hand, storage costs will be incurred by businesses regardless of whether goods are stored in a free zone or elsewhere. On the other hand, it is possible to argue that storage costs will be higher in a free zone: because of the added security, and potential for businesses to make these additional savings in duty deferral and tariff inversion. We leave this issue aside but this is something to bear in mind.

In addition to these potential savings that businesses can accrue from a free zone location, there is also the question of the costs that will be incurred by the taxpayers as a result of running free zones. While we feel that this is a valid question to ask, we intentionally leave it unanswered as we have no hard facts and numbers to provide strong answers.

## CONCLUSION

### Can free zones be a successful tool for attracting businesses to the UK after Brexit?

Since the EU referendum, there has been a growing interest in the reintroduction of free zones in the United Kingdom. Those advocating free zones believe that they will help to boost British trade after Brexit and promote economic growth. However, free zones should not be seen through the prism of post-Brexit opportunities as a tool that – unfettered by the EU state aid rules – can deliver a major boost to economic growth potential after Brexit. This is for the following reasons.

First, when tariffs are low the direct benefits of free zones are small. They do not allow suppliers to obtain duty-free access to final markets (except where inverted tariffs are avoided), and they merely defer any duty payments, a small gain to cash-flow. Although there are potential benefits and savings that businesses can accrue from simplified customs procedures, and relief on customs duties and tariff inversion, we believe that such benefits will be very limited in the UK context.

Second, bigger gains could be from wider use of enterprise zones. But to the extent that the advantages are 'hidden subsidies', Brexit would not widen their scope very much as the UK would still be subject to WTO Subsidies Agreement rules and to any commitments to EU state aid rules under 'level playing field provisions' (such as have been included in recent EU FTAs) and would certainly be included in any post-Brexit trade deal. This encompasses all attempts to upset the 'level playing field' and the EU would almost certainly be concerned about any relaxation of labour or environmental standards, and object to tax breaks. In consequence, the EU could invoke Anti-dumping or Countervailing duties, even though the UK White Paper of 2017 declared that it does not wish to include tax rules in the agreed state aid regime.

Third, policy impact evaluations often suggest that the net benefit of free zones is limited. The US experience is not very illuminating: whilst there are many jobs in the US Foreign-Trade Zones, there is little evidence of how many are net creations. The main purpose of the US Foreign-Trade Zones appears to be to supply the domestic market without having to pay high tariffs on imported inputs.

The overall conclusion would seem to be that whilst some form of free zones could help with shaping export-oriented and place-based regional development programmes, policymakers should devise measures that (i) counteract possible diversion of economic activity from elsewhere, and (ii) offer a wider set of incentives than just free zones, while keeping within the WTO and any 'level playing field' obligations that arise from our trade agreements.

To devise a strategy for attracting businesses to the UK after Brexit, the UK Government must also focus on ensuring that frictions to UK-EU trade are minimised. Free zones added as another layer to existing enterprise zones may indeed simplify some trade in goods, although starting to think more of the 80% of the UK economy – i.e. services – which to date has largely been ignored,<sup>45</sup> is more urgent.

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<sup>45</sup> Winters, L.A. (2018) What about the remaining 80 percent – services? The 'Customs Union' and 'Unilateral Free Trade' share the same flaw. UK Trade Policy Observatory Blog. Available at: <https://blogs.sussex.ac.uk/uktpo/2018/07/06/what-about-the-remaining-80-percent-services-the-customs-union-and-unilateral-free-trade-share-the-same-flaw/>.

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## FURTHER INFORMATION

The UK Trade Policy Observatory (UKTPO), a partnership between the University of Sussex and Chatham House, is an independent expert group that:

- 1) initiates, comments on and analyses trade policy proposals for the UK; and
- 2) trains British policy makers, negotiators and other interested parties through tailored training packages.

The UKTPO is committed to engaging with a wide variety of stakeholders to ensure that the UK's international trading environment is reconstructed in a manner that benefits all in Britain and is fair to Britain, the EU and the world. The Observatory offers a wide range of expertise and services to help support government departments, international organisations and businesses to strategise and develop new trade policies in the post-Brexit era.

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