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## **Written response to the Department for International Trade**

### **Freeports Consultation**

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#### **About UKTPO**

The UK Trade Policy Observatory (UKTPO), a partnership between the University of Sussex and Chatham House, is an independent expert group that initiates, comments on and analyses trade policy proposals for the UK and 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 University of Sussex has the largest collection of academic expertise on the world trading system in the UK, with specialists on trade policy, trade law and trade politics and European law and economy. The team includes experts in economics, international relations and law.

#### **Executive Summary**

Many of the policy ideas in the Government's consultation on Freeports are valuable and worthwhile. However, when tariffs are low,<sup>3</sup> the trade policy elements are probably the least important for the reasons outlined below:

- A. The direct benefits of Freeports as such are small when tariffs are low. 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. Indeed, most of them are available under long standing "Inward processing" rules. (see <https://www.gov.uk/guidance/inward-processing>)
- B. Larger gains could be made from wider use of enterprise zones. But to the extent that the advantages are 'hidden subsidies', the UK's departure from the EU will not widen the scope for their use very much as the UK would still be subject to rules of the WTO Agreement on Subsidies and Countervailing Measures. The UK would also potentially be subject to any commitments to EU state aid rules under 'level playing field provisions' (such as have been included in recent EU Free Trade Agreements) and which the EU is requesting in any post-Brexit trade deal with the UK. This encompasses all attempts to upset the 'level playing field'. The EU would almost certainly be concerned about any relaxation of labour or

environmental standards, and object to tax breaks. The EU could invoke countervailing duties (CVDs), against what it deemed unfair state aid even if the UK declined to make commitments beyond the WTO in a trade deal with the EU.

- C. Policy impact evaluations often suggest that the net benefit of Freeports is limited. The US experience is not very illuminating: whilst there are many jobs in the US Foreign-Trade Zones (the US equivalent of Freeports), there is little evidence of how many are net creations. The main effect of the US Foreign-Trade Zones appears to be to supply the domestic market without having to pay high tariffs on imported inputs (Wong 2019).
- D. Whilst some form of Freeports could help with shaping export-oriented and place-based regional development programmes, this should go hand in hand with governmental measures that (i) counteract possible diversion of economic activity from elsewhere, and (ii) offer a wider set of incentives than just Freeports, while keeping within the WTO and any 'level playing field' obligations that arise from UK trade agreements.
- E. The UK Government must also focus on ensuring that frictions to UK-EU trade are minimised in order to attract businesses to the UK after the transition period. Freeports added as another layer to existing enterprise zones may indeed simplify some trade in goods, although the Government should start to think more of the 80% of the UK economy – i.e. services – to which there is surprisingly little reference in the Freeports consultation paper.

**Note:** The UKTPO has provided a relatively detailed analysis of the cases for and against Freeports – [Serwicka and Holmes \(2019\)](#) and [Holmes \(2019\)](#), [Winters \(2020\)](#) – as well as an accessible [animation](#) explaining the main points – UKTPO (2020). This evidence summarises the main points outlined above.

### **Tariffs and Customs**

The only concessions a Freeport offers its firms are on customs duties in terms of simplified procedures, deferral of duty payments on goods imported into the Freeport and then transferred to the rest of the UK, and freedom from duties for goods imported into and then re-exported from the Freeport to a third country. The UK Government is also considering coupling these with policies such as tax concessions equivalent or similar to those provided to Enterprise Zones, of which the UK already has 61, and also relaxations of planning regulations.

The value of the concessions on customs duties is related to the height of the duties that would otherwise be paid. The new Global Tariff offers minor reductions in tariffs relative to current rates, which are determined by the EU's Most Favoured Nation (MFN) tariff; they reduce the weighted average tariff from 2.1% to 1.5%: see [Gasiorek and Magntorn Garrett \(2020\)](#). Moreover, the UK Government's intention to agree a zero-tariff trade agreement with the EU, plus the Continuity Trade Agreements that have already been signed, would set tariffs to zero on more than half of UK imports. Thus, the value of the tariff concession will be very low, and would do little to encourage economic activity within the Freeport. We understand that it is the UK Government's intention that exemption from duties should not include exemption from trade remedies - which are the most significant levels of duty - to avoid a situation where transformation in a Freeport would be a route for example to avoid anti-dumping, countervailing and/or safeguard duties (i.e. circumvention).

It has been claimed that Foreign-Trade Zones in the US stimulate economic activity within their zones (Sunak 2016). This, however, is mostly due, we believe, to a feature of the US tariff structure that is largely absent in Europe: tariff inversion. In the US, several sectors, but most notably automotive, pay higher tariffs on their imported inputs than they pay on the finished product. Hence producers can reduce their liability to tariffs by locating in a Freeport so that the inputs pay no tariff on entry and, as part of the final product, pay the lower rate on exit into the US economy. That is, Foreign-Trade Zones in the US are essentially *import processing zones* focussed on petrochemicals, cars and electronics (Tiefenbrun, 2014). Wong (2019) notes that finished cars in the US have a 2.5% tariff while components have duties of 4% to 11%. The overwhelming majority of sales from the zones are within the US. Because the UK's new tariff proposals have set as a goal the elimination of tariffs on imported inputs (see Winters et al 2020), similar opportunities to take advantage of Tariff Inversion will not be available in the UK. Import procedures may be simplified, but they will not be abolished and any good leaving the Freeport for the rest of the UK would have to complete regular customs procedures at that stage. Moreover, whereas a good entering the UK from outside faces one set of formalities, a good entering via a Freeport would face two: i.e. on both entry to and exit from the Freeport. In the US it has been found that there are high set-up costs that firms must incur to register for tariff exemptions in Foreign-Trade Zones. This leads to modest per unit cost savings and so a bias in favour of large firms who can gain small profit increases per unit in a large volume of sales. The infrastructure of the Freeport is also potentially costly, all the more so in the post-COVID-19 context, which will require additional health and safety checks. Moreover, by definition, a Freeport will not be freely open for retail or tourism activity, as visitors will have to cross a frontier.

The operations of Freeports – as well as Enterprise Zones – must be compliant with rules in the WTO Agreement on Subsidies and Countervailing Measures. (ASCM). (See Lexology, 2020, Coskun 2019). If the UK grants financial support and subsidies within the Freeport, which another party considers to affect its trade they can bring a case against the UK at the WTO, or put on CVDs to offset these subsidies after undertaking investigations. There have been a number of WTO cases brought against alleged illegal subsidies due to the effects of Free zones, notably the case brought by the US against India on Special Economic Zones.

## **Tax and Planning**

The Freeports consultation paper suggests other areas in which there may be scope to stimulate activity: including tax regulation and planning procedures. The former is already available in Enterprise Zones and the latter have long been seen as a route to increasing economic growth in the UK: see for example Cheshire et al. (2012) and LSE (2013), albeit mainly in the areas of housing, retailing and major infrastructure, none of which is particularly pertinent to Freeports. The Freeports consultation paper stresses a number of other areas in which it would try to make Freeports more useful and to reduce any adverse effects e.g. on money laundering, but these developmental and environmental instruments are not spelled out, and again are not particularly specific to Freeports, except where there can be experimentation with new technology for monitoring goods crossing borders.

The government speaks of challenge funds and creating environments in which new ideas can be trialled. But again, it fails to spell out why these should be geographically restricted and why, if they are, ports are the preferred location. The notion of a port is loosely defined, and is not limited to sea or airports, but appears to always refer to areas where economic activity is based on imported goods. It is not at all clear why Newhaven in Sussex should be eligible but not nearby Hastings (just because it is not a port) which, even though it is on the coast, has no specific goods trade related activity. The notion of “regulatory sandboxes” is interesting but it is not made clear how one encourages trials. It could be by relaxing regulations, but the government asserts that Freeports will involve no compromise in standards.

Critics (Murphy) have expressed fears that Freeports risk becoming a new form of offshore tax haven. The Consultation document clearly states that this is not the intention but is a little vague on what aspects of domestic jurisdiction will be maintained and what relaxed. Clearly the more strictly domestic rules are applied, e.g. on corporate registration and reporting, the less the Freeport has to offer as a haven.

### **Regeneration**

Probably the most important adverse impact of Freeport creation is that creating benefits for one area is almost certainly harmful to others, this is known as displacement. The Centre for Cities (2019a,b) recently carried out an analysis of the impact of Enterprise Zones, which have similar effects to Freeports. They estimated that “of all the jobs in the zones in 2017 that were not there in 2012, at least one third moved from elsewhere”.

Supporting areas of the UK that are doing less well than average is clearly important. However, there is little case for coupling such support to freeports. They will create additional bureaucracy (two borders – on entry and exit – rather than one), and they are likely to create simple assembly and warehousing operations rather than high-technology activity. The Centre for Cities (2019a) has argued that the key to restoring prosperity in less prosperous areas is improvement of the skill level of jobs and of the workers who do them. The Freeports consultation paper refers to the need for supporting skills but once again there is no rationale for linking this to Freeports.

Once benefits are geographically restricted, one opens up the possibility that you relocate activity from outside to inside the favoured area. The Centre for Cities (2019a) reports evidence that significant shares of the jobs ‘created’ in Enterprise Zones are actually just displacements. Even if firms do not relocate from elsewhere with the introduction of a Freeport, as the economy evolves, if an Enterprise Zone is effective, firms outside it will be less competitive and in an economy they may decline in relative size. (see Lee, 2017).

Instead, new efforts should go into regional development schemes, which even if geographically restricted, should be located in areas which have both need and a plausible path for regeneration. These may be around ports – seaports and airports – but even then the focus on “ports” is very unlikely to contribute significantly to the broader goals.

It is also important to remember the importance of services in the UK economy. There are 4 references to services in the consultation document but only in the context of services related to the handling of traded goods. The paper refers to the need to promote high-skill activity but has no detail and, if the Centre for Cities analysis is correct, the kind of service activity that will happen from Freeports is largely warehousing activity. A good skill base would have to have been already created for higher value-added jobs to take off.

### **Additional policy considerations**

A further issue for Freeports is the opportunity for money laundering and the warehousing of illicit items, which may include stolen goods. This has been extensively discussed and we are not in a position to add specific examples to the existing body of evidence, which includes a report by the European Parliament, summarised by the Institute for Government (2019). See also Helgadóttir (2020), who warns, in particular, about the risks of Luxury Freeports “where art, gold, wine and other luxury goods are traded anonymously and stored for unlimited periods without tax and duty payments”.

Many developing countries have made a success out of geographically restricted Freeports (although far from all attempts have been successful), but it is important to contrast their experience with that of the UK. In many developing countries, there is a case for restricting the coverage of concessions to Freeports because in many cases physical and administrative environments for business are generally poor, and there is no capacity for rapidly economy-wide upgrading. Frequently, tariffs and regulatory regimes are very restrictive and there is a case for experimental relaxation, as in China’s Shenzhen Special Economic Zone. In Ireland, the successful use of a Free Zone at Shannon Airport was necessitated by the end of any need for refuelling stops for transatlantic flights and, being predicated on Ireland’s high tariff barriers, was eventually superseded by Ireland’s nationwide reduction in tariffs when it joined the EU. Moreover, without a strong industrial base, there is a case for encouraging concentration of industrial development in order to reap the benefits of agglomeration. Neither consideration applies in the UK, at least in the sectors that freeports are likely to encourage: see Lee (2017).

The role of Freeports in “creating a hotbed for innovation” is also stressed in the Consultation Document. Clearly there is an opportunity to experiment with new import and export tracking technology, since there will be a new border created on the internal side of each new Freeport. But otherwise it is not at all clear how Freeports as such can generate innovation. In developing countries with high tariffs, inadequate infrastructure and poor regulation, localised changes can be a good way forward but these conditions do not apply in the UK, and Freeports do not seem to be an obvious way to stimulate post-COVID innovation.

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