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L&RS Note

Overview of Freeports or Free Zones

Eoin McLoughlin, Senior Researcher (Economics)

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Abstract

This L&RS Note provides an overview of freeports or free zones and examines the rules and procedures around their establishment. It considers a previous Irish example with the establishment of the Shannon Free Zone as well as highlighting other international experiences in the development of such areas. The UK is currently considering establishing a number of freeports post Brexit, including in Northern Ireland. The paper concludes by addressing some of the main issues that have been raised in relation to the creation of free zones and freeports.

Key Points

- A 'free zone' relates to a designated area in which a governmental authority offers incentives, different from the host country's regular policies, to companies operating in the region. A 'freeport' is similar with the main difference being that these areas are designed to specifically encourage businesses that import, process and then re-export goods.
- Numerous examples exist of such zones being established and the success of these largely depends on their design, access to good infrastructure, and the availability of skilled labour and capital within the zone in question.
- The European Commission facilitates the establishment of free zones under the Union Customs Code, but they must be compatible with state aid guidelines.
- The UK Government is currently exploring the possibility of creating up to 10 freeports, with the first expected to come into operation by early 2021.
- Free zone status is currently being sought for Rosslare Europort to support its development as a base for offshore wind energy.

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Introduction

A 'free zone' relates to a designated area in which a governmental authority offers incentives, different from the host country's regular policies, to companies operating in the region. Any goods introduced are generally regarded, insofar as import duties and taxes are concerned, as being outside the customs territory. They generally fall into one of four categories: free trade zones, export processing zones, special economic zones, or industrial zones.

- **Free trade zones**, typically located near seaports or airports, mainly offer exemptions from national import and export duties on goods that are transiting through the port and are re-exported. Local services gain, though there is little, if any, value added to the goods traded.
- **Export processing zones** go a step further by focusing on exports with a significant value added, rather than only on re-exports.
- **Special economic zones** apply a multisectoral development approach and focus on both domestic and foreign markets. They offer an array of incentives including infrastructure, tax and custom exemptions, and simpler administrative procedures.
- **Industrial zones** are targeted at specific economic activities, say media or textiles, with infrastructure adapted accordingly.

Businesses operating in free zones are generally offered the following benefits:

- **Simplified customs procedure**;
- **Relief on customs duties** relating to transhipment, 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 tariff-free into a free zone, then processed and sold as a final product, incurring lower tariff rates.

As of November 2017, 82 'free zones' had been notified to the European Commission (EC). Croatia had the most free-zones (11) followed by Lithuania (10), the Czech Republic (8), Spain and Poland (7), Romania and Bulgaria (6), Greece and Latvia (4), Estonia (3) and Finland, France, Germany and Italy (2).

'Freeports' are similar to free zones, or 'enterprise zones'. They are designated areas that are subject to a broad array of special regulatory requirements, tax breaks and government support. The difference between a free zone and a freeport is that a freeport is designed to specifically encourage businesses that import, process and then re-export goods rather than more general business support objectives.

Creation of Shannon Free Zone

Regional establishment

Ireland already has experience in the creation of a free zone with the Shannon Free Zone (SFZ) generally considered to be the world's first free trade zone. It was established in 1959 by the Irish government to support the nearby Shannon International Airport in the era of jet-propelled aircraft. Enhanced aviation technology made it unnecessary for transatlantic flights to refuel in Shannon, threatening the region's economy.

The director of Shannon Airport at the time, submitted a proposal for a special manufacturing zone with special tax incentives to be created, covering the airport and its vicinity. The SFZ site, adjacent to the airport, was established in 1959, with a second zone, Smithstown, being incorporated into the area a number of years later. A regional development agency called Shannon Development was set up to attract overseas companies and to create employment. The SFZ is now managed by Shannon Commercial Properties, a commercial semi-state company and part of the Shannon Group.

Company incentives

Other than the customs arrangements allowing for the deferral of tax payments of imported goods, the SFZ provided other special incentives. Additional incentives offered included an exemption from VAT on imported goods, including on goods used for production if 75% of the products manufactured are exported. Grants were available for companies (e.g. to support Research and Development (R&D) and staff training). Also, companies entitled to operate in the SFZ at first benefitted from a 10% corporate tax rate, a state aid that was approved by the European Commission in 1998. However, since 2005, the zone follows the 12.5% rate applicable throughout Ireland.

In order to benefit from these incentives, companies need a licence to operate under the *Irish Customs Free Airport (Amendment) Act 1958*. Qualifying criteria for eligible companies include proof of employment creation potential and an export orientation.

Economic performance

Today, economic output is mostly driven by the service sector, accounting for over 60% of the SFZ's economic activity. Currently approximately 100 companies operate in the region, employing around 7,000 staff, with business activities running from customer support to internationally traded services. It can be argued that the incentives, which to a great extent are no different to those offered in the rest of the Irish economy, are no longer the main attraction of the zone for companies. Rather, they are now more attracted by other services offered within the region (including well trained staff and good infrastructure links etc.).

International experience of Free Zones and Freeports

Ireland has had limited experience with the further development of free zones, although a freeport was established at Ringsakiddy in the 1980s. There has also been some recent discussions around the creation of a free zone at Rosslare Europort. However, outside of Ireland there are other international examples of where free zones and freeports have been established with varying degrees of success.

Statistics on the number of freeports globally are hampered by the lack of a universally-accepted definition. Terminology used across countries varies greatly with terms such as free zones, special economic zones, free trade zones, export processing zones, and freeports all used interchangeably. Notwithstanding this caveat, the United Nations Conference on Trade and Development (UNCTAD) estimate that there are over 5,000 such zones worldwide, with China in particular containing a large proportion of the total number (47%).

Table 1: Estimated number of Special Economic Zones by Region, 2019

	Total Number of SEZs	Additional SEZs Planned
Developed economies	**374**	..
- Europe	105	..
- North America	262	..
Developing economies	**4,772**	**502**
- Asia	4,046	419
○ China	2,543	..
- Africa	237	53
- Latin America and Caribbean	486	24
Transition economies	**237**	**5**
Total	**5,383**	**507**

Source: UNCTAD (2019), World Investment Report 2019 – Special Economic Zones

United Kingdom

In the UK, several freeports have been created previously, including those at Liverpool, Southampton, the Port of Tilbury and Glasgow Prestwick Airport. At one point, seven freeports existed in the UK between 1984 and 2012 (at which time the UK legislation that established their use was not renewed).[1]

The UK Government are currently exploring the possibility of creating up to 10 freeports post-Brexit, putting into effect a commitment contained in the Conservative Party Manifesto. The UK

Government published a consultation paper in February 2020 which sought the views of stakeholders and the public on the proposals, which included policies on customs, tax, planning, regeneration and innovation. The UK Government has said it intends to work with the devolved administrations so that freeports can be created in Northern Ireland, Scotland and Wales, in addition to those proposed for England.

In October 2020, it published its response to the consultation, setting out the next steps. A bidding process was launched on 16 November 2020 with the aim of having at least seven new freeports in operation, with the first expected to come online by 2021. While this may confer a competitive advantage to those areas that are successful, some commentators have expressed the view that it is unlikely that the UK will have tariffs on imports as high as those which made Shannon such an attractive destination in the 1950s and 1960s.[2]

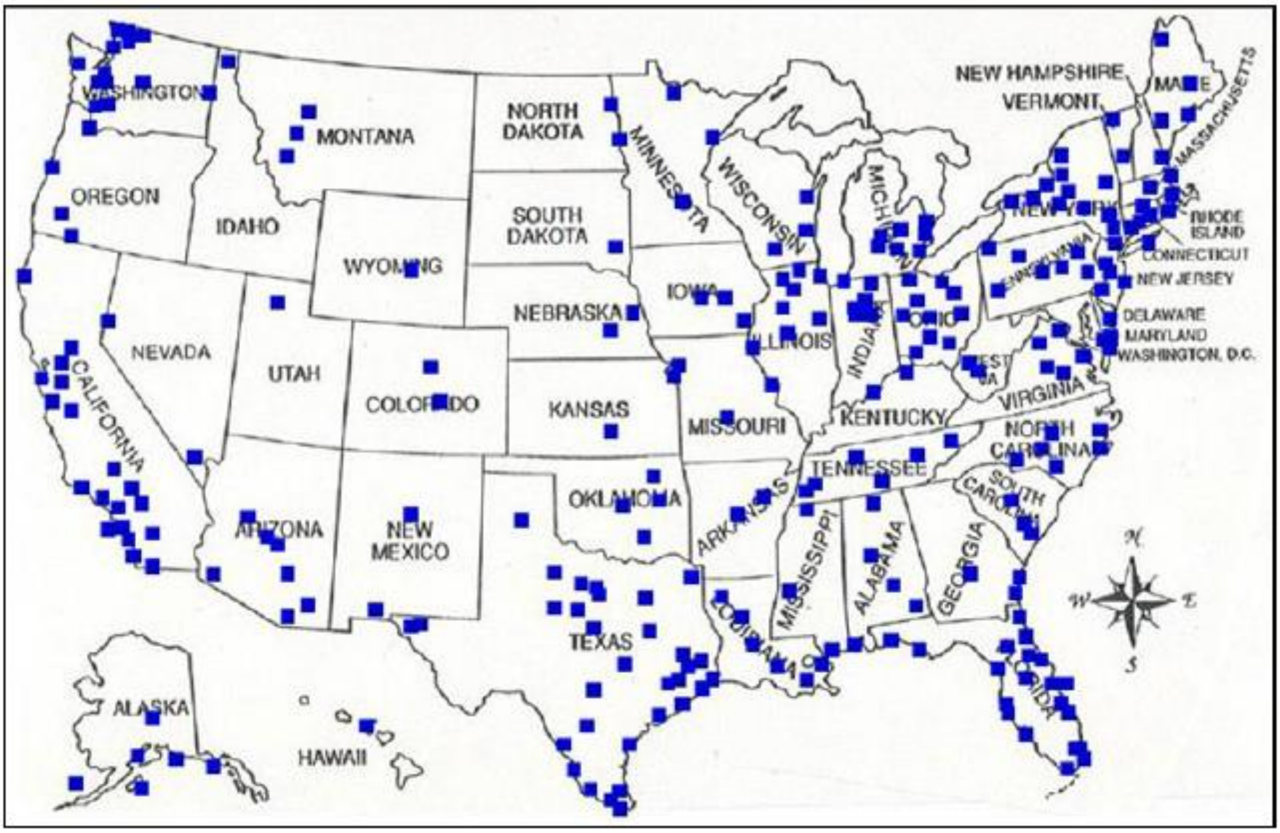
United States

The US Free Trade Zone (FTZ) programme was created by Chapter 1A of Title 19 of *The United States Code* often referred to as the *Foreign Trade Zones Act* in 1934, in the midst of the Great Depression. The legislation allowed for the creation of the FTZ Board, which was given the power to approve applications for zone status. The legislation also entitled each US port of entry to at least one zone, and prescribed physical conditions and standards for each zone, activities permissible in zones, the applicability of all US laws to zones, and requirements for zone operation and recordkeeping.

The US FTZ programme started slowly and by the time the Shannon Free Zone was underway 25 years later in 1959, it was still quite small. Gradually though, several factors accelerated zone use, including redesignation to allow manufacturing in zones, and increased international price competition that led U.S. businesses to seek new ways of saving costs.

Today in the US, a company may operate within the defined area of a FTZ or it can have ‘zone status’ imbued on its facilities. Zones may be used for manufacturing, warehousing and other logistical activities. A majority of goods entering FTZs are used in production activities (63%), while the remaining are used in warehouse and other logistical activities (37%). As of 2018, there were 195 FTZs active during the year, with a total of 330 active manufacturing operations.[3]

Figure 1: US Foreign Trade Zones by State

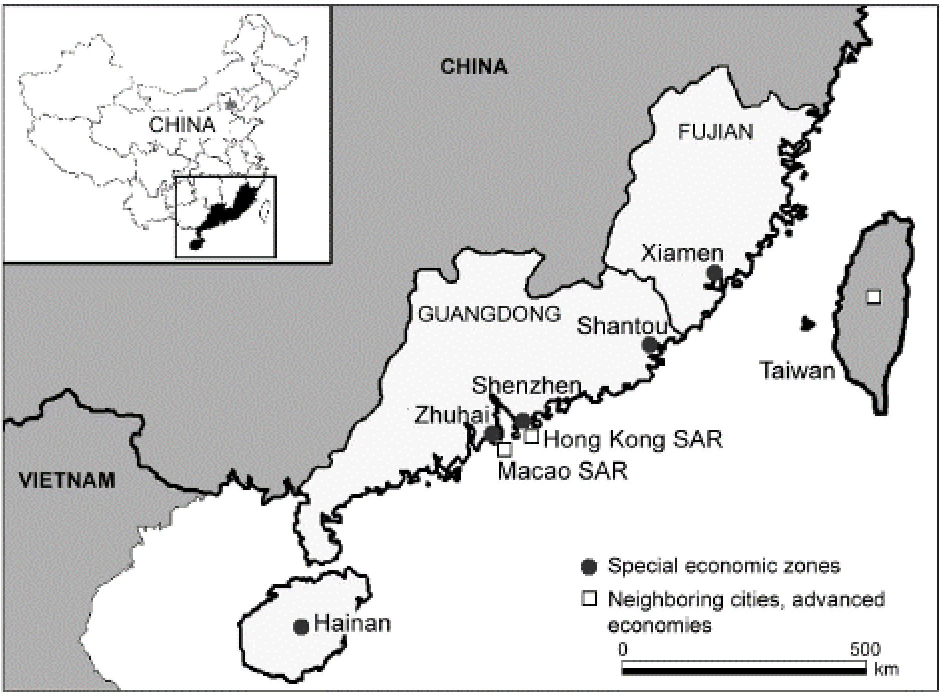


Source: Congressional Research Service (December 2019), [U.S. Foreign-Trade Zones: Background and Issues for Congress]

China

Reportedly inspired by Ireland's success in the development of the Shannon Free Zone,[4] after decades of a centrally planned economy, the Government of China adopted the Open-Door policy in 1978. In July 1979, it decided that Guangdong and Fujian provinces should take the lead in opening up to the outside world by implementing "special policies and flexible measures". By August 1980, Shenzhen, Zhuhai, and Shantou in Guangdong Province were designated as special economic zones, followed by Xiamen in Fujian Province in October 1980. The SEZs were all quite similar in that they comprised large areas within which the objective was to facilitate broadly-based, comprehensive, economic development. They all enjoyed special financial, investment, and trade privileges.

Figure 2: Regional Setting of China's SEZs



Source: Journal of Eurasian Geography and Economics (2009), China's Special Economic Zones at 30

The combination of favourable policies and the right mixture of production factors resulted in unprecedented rates of economic growth in the SEZs. Encouraged by initial successes, the Government of China created more SEZs, mostly in the form of economic and technological development zones (ETDZs), informally known as China's 'national industrial parks', which were smaller than the earlier zones.

As noted by the World Bank, SEZs have made important contributions to China's economic development and, in particular, helped to test the market economy and served as a blueprint for the rest of the country to follow. They have contributed significantly to national GDP, employment, exports, and attraction of foreign investment. In some regions, industrial parks account for anywhere between 50% to 80-90% of growth in GDP. SEZs have also aided the increased openness and resource clustering by offering a vehicle and platform for the entry of capital, technology, talents and R&D activities from all over the world.[5]

EU legal framework on Free Zones

The EC defines free zones under its customs policy as special areas within the customs territory of the European Union (EU). Free zones are enclosed areas within the customs territory of the Union where non-Union goods can be introduced free of import duty, other charges (i.e. taxes) and commercial policy measures. Following a period in which the goods remain in the free zones, they may be released for free circulation (subject to payment of import duty and other charges), or be placed under another special procedure (for example, inward processing, temporary admission or end-use procedures – under the conditions laid down for these procedures) or be re-exported.[6]

Union goods may also be imported, or stored, moved, used, processed or consumed, in free zones. Such goods may afterwards be exported or brought into other parts of the customs territory of the Union.

Originally there were two types of free zones allowed in the EU:

Type 1. This is where there is a physical boundary around the area designated as a free zone. A fence or boundary is placed around the free zone. The zone is manually controlled by Customs Officers via fixed entry and exit points. All goods or vehicles entering or leaving the free zone must report and make written declarations to Customs as to the consignments they are carrying.

Type 2. This was where the free zone was a designated or a mapped-out area with no physical boundary or fence. With the introduction of the Union Customs Code in 2016 (see below), Type 2 zones were abolished and replaced by normal EU Customs procedures, that is, Inward Processing, Customs Warehouses and End Use. Unlike Type 1 zones, physical control did not take place at entry and exit points but on the basis of documentary checks and stock-taking by the companies present in the area.

Shannon Free Zone started out as Type 1 but was changed to Type 2 in the late 1980s, due primarily to the amount of staffing resources required to control a Type 1 zone.

Facilitation of Free Zones (Freeports) through customs policy

The EC facilitates the establishment of free zones under the Union Customs Code (UCC).[7] The UCC defines the legal framework for customs rules and procedures in the EU customs territory. It is a regulation and therefore directly applicable to all Member States.

The UCC considers the placing of goods in customs warehouses or free zones (freeports) as 'special storage procedures'. Under a storage procedure, non-Union goods may be stored in the customs territory of the Union without being subject to import duty, other charges as provided for under other relevant provisions in force, and commercial policy measures.

Member States may designate parts of the customs territory of the Union as free zones. For each free zone, the Member State shall determine the area covered and define entry and exit points. Member States must inform the Commission of any free zones in operation within their territories.

Free zones must be physically enclosed. The perimeter and the entry and exit points of the area of free zones must be subject to customs supervision. Persons, goods and means of transport entering or leaving free zones may be subject to customs controls (UCC, Article 243).

The construction of any building in a free zone shall require the prior approval of customs authorities. Subject to customs legislation, any industrial, commercial or service activity is permitted in a free zone.

The carrying out of such activities must be notified, in advance, to the customs authorities. Customs authorities may prohibit persons from carrying out an activity in a free zone if they fail to provide the necessary level of assurance of compliance with the customs provisions (UCC, Article 244).

Internal market and state aid for Free Zones

Differences in the tax regimes of Member States can lead to distortions of competition and can represent significant barriers to trade, affecting the overall goal of the European single market.

According to Article 107(1) of the Treaty on the Functioning of the European Union (TFEU), covering state aid:

> " … any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market".

State aid includes support measures that:

- are granted out of state resources,
- confer a selective economic advantage to undertakings, and
- are capable of distorting competition and affecting trade between Member States.

On the surface, this definition reduces the potential for any free zone operations. However, some exemptions may be granted under Article 107(3)(a) and (c) TFEU, allowing for the use of state aid to tackle regional problems.

All measures used for free zones which constitute state aid must be notified by the respective Member State for approval by the EC, unless they fall under the *de minimis* Regulation or the General Block Exemption Regulation.

Issues raised in relation to Free Zones and Freeports

Economic impact

As explained by the Institute for Government, freeports and free zones are intended to try and stimulate economic activity in the designated areas. Supporters argue that benefits can arise due to the government stimulus or tax breaks available. Benefits may also derive from the 'agglomeration effect', where increased economic benefits result from clustering the economic activity of a particular sector, or related sectors, in one place.[8]

Some economic studies have found the main advantage of freeports is that they encourage imports by lowering duty and paperwork costs.[9] Manufacturing businesses that are inside the freeport can benefit from cheaper imported inputs/components in comparison to those outside the area. On the other hand, the UK Trade Policy Observatory (UKTPO) and OECD cautions that evidence of wider economic benefits of freeports and other zones are mixed and depend very much on access to transport infrastructure, labour and capital, and the overall design of the zone in question.[10]

In the US, FTZs primarily benefit manufacturing firms and may benefit consumers, if cost savings for businesses are passed along in the form of lower prices. Savings from tariff reduction, administrative efficiencies, tax benefits, and duty deferral may help to motivate US corporations to maintain operations in the country and may attract foreign producers to establish manufacturing facilities in the United States.

According to the US Congressional Research Service, these benefits of zone use may result in potential costs to the US economy as a whole. Granting tariff reductions on imported components might disadvantage domestic producers of competing components whose products would otherwise be somewhat protected by the tariffs. Further, if certain producers in an industry obtain zone status to save production costs, this could put other domestic producers of the final products in the same industry at a competitive disadvantage. Finally, the tariff benefits that companies enjoy by operating in FTZs can result in some loss or deferral of tariff revenue for the state.

Displacement

Another issue raised in relation to freeports and free zones is the risk that they fail to create *new* economic activity. Rather, they divert existing business into the area with the offer of tax breaks, coming at a cost to the taxpayer in the form of lost revenue. Researchers at Sussex University point to a risk that they will simply transfer business away from other areas, without increasing the overall size of the economy.[11]

However, there may be an argument where the creation of such areas could be used among a broader set of policy tools to promote economic and regional development. For example, the UK Government’s February 2020 consultation paper makes reference to the regeneration aspects of freeports which can help to revive disadvantaged towns and cities by attracting new investment.

Illegal activity

The European Parliament has raised concerns about risks associated with tax evasion and money laundering activities in freeports. A paper was commissioned at the request of the European Parliament's Special Committee on Financial Crimes, Tax Evasion and Tax Avoidance. The report argues that freeports provide operators

> “ … with a safe and widely disregarded storage space, where trade can be conducted untaxed and ownership can be concealed”.

The lack of scrutiny on imports means that high-value items like art, for example, can be bought and easily stored in freeports, without the normal checks and controls.[12].

The February 2020 UK consultation paper notes that concerns have been raised about links between freeports and illicit cross-border activities, such as smuggling, and as a result the UK Government has made a commitment to “consider carefully how anti-tax-avoidance rules and measures to counter risks of evasion and fraud can be best applied within Freeports”.

Endnotes

[1] House of Commons Library (2020), *Briefing paper on Freeports,* Available at: https://commonslibrary.parliament.uk/research-briefings/cbp-8823/

[2] The Irish Times, *The UK already has a plan that would break the Brexit backstop deadlock.* Available at: https://www.irishtimes.com/business/economy/the-uk-already-has-a-plan-that-would-break-the-brexit-backstop-deadlock-1.4001590

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[6] Further information in relation to these 'special procedures' is available on the Revenue website at: https://www.revenue.ie/en/customs-traders-and-agents/processing-goods-enduse-and-warehousing/index.aspx

[7] See Regulation (EU) No 952/2013 of the European Parliament and of the Council of 9 October 2013 laying down the Union Customs Code (UCC).

[8] Institute for Government (2020), *Trade: freeports and free zones* Available at: Trade: freeports and free zones | The Institute for Government

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[12] European Parliamentary Research Service (2018), *Money laundering and tax evasion risks in free ports.* Available at: https://op.europa.eu/en/publication-detail/-/publication/362d2465-e3d4-11e8-b690-01aa75ed71a1/language-en

Contact:

Houses of the Oireachtas
Leinster House
Kildare Street
Dublin 2
D02 XR20

www.oireachtas.ie
Tel: +353 (0)1 6183000 or 076 1001700
Twitter: @OireachtasNews

Library & Research Service
Tel: +353 (0)1 6184701
Email: library.and.research@oireachtas.ie