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Establishing Free Zones for regional development

SUMMARY *Free Zones are geographic areas in which a governmental authority offers incentives, different from the host country's regular policies, to companies operating in the region. Given the nature of these incentives, designated zones are often said to function as "growth poles" for the region, or even beyond.*

Within the European Union, 74 Free Zones are defined under the Community Customs Code. Exemptions beyond customs arrangements can include services such as grants offered for research and development and advanced infrastructure. But tax incentives may also be offered and these may, especially on a regional level, distort competition. As such, the tax regime applied needs to be compliant with internal market and State aid rules.

As for customs regulation, the Modernised Community Customs Code, to take effect by the end of June 2013, may also have an effect on those Free Zones in which there is currently no physical control of goods leaving and entering the zone. A measure mostly meant to streamline customs procedures amongst Member States but also underlining the importance of sufficient regulatory oversight in such zones to avoid institutional problems and organised crime.

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In this briefing:

"Free Zones"

Defining Free Zones

Free Zones can be defined in many different ways, but are generally categorised in four groups: free trade zones (pure re-export of traded goods), export processing zones (export of goods with value added), special economic zones (multi-sectoral approaches to economic activity within the zone), and industrial zones (specific economic activities hosted in the zone). In general, however, the estimated more than 2 700 Free Zones in the world have in common that they form a designated zone in which the host country's normal customs regimes for import and export are suspended and replaced by, mostly, more liberal rules.

However, in the context of Free Zones, this facilitation of trade is not an end in itself, and is often meant to promote economic development of the region to which the exemptions apply, or of a specific industry, as well as to generate more employment. For this purpose, Free Zones mostly offer a broader set of incentives than just customs arrangements to attract companies to the region, such as further tax exemptions as well as a wide range of services, for example, simplified administrative procedures, streamlined customs administration and the provision of infrastructure. To facilitate their alternative policy frameworks, Free Zones are frequently administrated by a separate governmental authority.

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A European customs tool

The European Commission (EC) defines Free Zones under its customs policy as special areas within the customs territory of the European Union (EU). Goods placed in the zone are exempt from custom duties. When goods are imported into the zone from outside EU territory ("non-Community goods"), VAT and excise duties are suspended until the goods are exported out of the Free Zone into the EU (where they become "Community goods") or consumed within the zone, in production, for example.

The European typology

Free Zones within the EU have a fixed perimeter with entry and exit points that are subject to customs supervision. The areas are classified according to the way in which both Community and non-Community goods are dealt with upon import and export:

- *Control type I Free Zones* function to some extent like free warehouses, except for the fact that the Free Zone is not a building but a geographical location. This means that the zone is an enclosed area, physically protected by a fence or wall. All goods placed within the area automatically fall under the Free Zone regime and are checked by the customs authorities upon entry and exit, and even passenger traffic must stick to specific passages.
- *Control type II Free Zones* are run in a similar way to customs warehouses. Again, they concern geographical areas. Unlike Control type I zones, physical control does not take place at entry and exit points but on the basis of stock-taking by the companies present in the area. This means that goods only become subject to the different incentives offered in the Free Zone when they are declared.

Today, the EU is home to 56 Free Zones of type I and 18 type II zones. However, the forthcoming implementation of the Modernised Customs Code may have significant implications for them.

The rationale for Free Zones

Member States (MS) initially used Free Zones to smooth customs procedures and to decrease the administrative burden for traders. But Free Zones have become increasingly popular globally as a policy instrument for attracting export-oriented foreign direct investment (FDI), defined by the OECD as long-term and significant investments across borders. The effects of such investments can sometimes stretch beyond the designated region, to increase the total capital of the host country. More relevant for developing countries, Free Zones may also create technological transfers from companies established in the zone and spill-over effects of knowledge used by these companies.

To attract companies to a Free Zone, public authorities often propose several of the following incentives:

- First and foremost, companies may be attracted by the possibility to store imported goods under beneficial *customs arrangements*. Deferral of payment of taxes until the goods are actually used or re-exported, can benefit companies' cash flow.
- Another advantage for companies is the differential *tax regime* offered within the zone, mostly concerning tax incentives related to corporate or personal income tax and value-added tax on goods (VAT).
- Thirdly, *non-tax incentives* such as public grants for developing human resources and research and development (R&D) are important for companies, as is the potential promotion of land and building facilities at below-market rates by the authorities.
- These benefits are finally enhanced by the *advanced infrastructure* often in place, in particular for those Free Zones that are conveniently located in, or close to, ports or airports.

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Main EU policies

Facilitation of Free Zones through customs policy

The EC has recently reviewed the 1992 Community Customs Code which facilitates the establishment of Free Zones. The Modernised Customs Code was adopted in April 2008 and its implementing provisions must be in place in all MS by 24 June 2013. The modernised Code is part of a new strategy for developing the Customs Union and focuses on simplifying the Code's structure and decreasing the administrative burden for all parties involved. Some major changes include the introduction of EU-wide administrative penalties, progressive computerisation of customs procedures and formalities, a merger of customs procedures and treatment in three categories (import, export and special procedures), as well as the abolition of control type II Free Zones.

Under the Modernised Customs Code, type II Free Zones will disappear to ensure greater consistency in the application of customs rules across MS. Whilst goods stored in type I Free Zones can still be considered non-Community goods, this change may have an impact on companies currently based in type II zones, such as the Shannon Free Zone in Ireland.

Internal market and State aid for Free Zones

Differences in the tax regimes of MS can lead to distortions of competition, and can represent significant barriers to trade and thus to the accomplishment of the European single market. According to Article 107(1) of the Treaty on the Functioning of the European Union (TFEU), a measure constitutes State aid if (i) an economic advantage is granted by a (ii) transfer of state resources (iii) favouring certain undertakings, and (iv) if the aid has a (potential) effect on competition and trade between Member States. Therefore, the EC usually considers tax incentives applicable in Free Zones to be State aid under Article 107(1) TFEU.

Whilst this definition reduces the options for Free Zone operations, some exemptions may be granted under Article 107(3)(a) and (c) TFEU which allows 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.

Establishing EU Free Zones

Shannon Free Zone

Regional establishment

The Shannon duty-free Processing Zone (SPZ) is a business park located on the west coast of Ireland. It was established in 1959 by the Irish government to support the nearby Shannon International Airport in the era of jet engines. Enhanced aviation technology made it unnecessary for transatlantic flights to refuel in Shannon which threatened the region's economy. As such, a regional development agency was set up to attract overseas companies and to create employment. Today called Shannon Development, the agency has an extended mandate for the wider Shannon Region. The SPZ still has its initial development mission but now also seeks to increase traffic at Shannon Airport (which recently merged with Shannon Development after facing financial difficulties).

Company incentives

Other than the customs arrangements that allow for the deferral of tax payments of imported goods, the SPZ provides special incentives on top of the regular tax incentives offered in Ireland. Additional incentives offered include an exemption of VAT on imported goods, including on goods used for production if 75% of the products manufactured are exported. Grants are available for companies (e.g. to support R&D

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and staff training). Companies entitled to operate in the SPZ at first benefited from a 10% corporate tax rate, a State aid approved by the EC in 1998. However, since 2005, the zone follows the 12.5% rate which applies 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 employment creation and export orientation.

Economic performance

Today, economic output is mostly driven by the service sector, accounting for 64% of the SPZ's economic activity. In 2008, more than 100 companies operated in the region, employing around 7 200, with business activities running from customer support to hosting company headquarters. Research shows that US investment in manufacturing is 70% higher than it would have been if Ireland's corporate tax rate was raised to the level of the next lowest MS. As such, the SPZ is Ireland's primary gateway for the entry of FDI, and some claim there are economic spill-over effects to the national economy. However, when it comes to measuring the overall impact of the zone on the Irish economy, others argue that causal effects are difficult to establish. The greatest achievement of the zone may be that it served as a pioneer for developing other Free Zones, including those in Asia. Economists further argue 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 the accommodating Shannon Development agency).

Madeira Free Trade Zone

Regional establishment

The Madeira International Business Centre (MIBC) was set up in the early 1980s to attract investment, and was authorised by the EC upon Portugal's accession to the Community in 1987. The zone was established to boost growth in Madeira, a region poorer than mainland Portugal and conveniently located for trade between Portugal and the African coasts.

Company incentives

Madeira benefits from the status of an autonomous region, with its own elected parliament and administration but most Portuguese laws are applicable. Several authorisations for regional tax reductions have been given by the EC, recognising that

Figure 1. Examples of European Free Zones

	Shannon Free Zone	Madeira Free Trade Zone	Katowice Special Economic Zone
Country	Ireland	Portugal	Poland
Year of establishment	1959	1980s	1996
Size (km^2)	2.43	798	20
Number of companies	> 100	≈ 2 900	> 200
Number of employees	≈ 7 200	≈ 1 600	≈ 9 000
Main tax incentives	10% Corporate income tax (applicable until 2005, now Irish 12.5%), VAT exemption	Maximum 5% Corporate income tax, maximum VAT of 22%	Tax relief up to 40% of investment costs and labour costs of first 2 operational years
Type of zone	Type II	Type I	Type I

Source: Regional development companies sites and tax consultancy research

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companies established in this outermost region needed assistance to overcome structural handicaps. Regularly amended over time, the current regime will run until the end of 2020. Incentives offered to companies operating under this regime include the possibility of not paying taxes on interest payments under certain conditions and tax credits for R&D expenses of up to €1.5 million. For non-Portuguese companies that establish in the region, the corporate tax rate does not exceed 5%. To be eligible for these incentives, companies need to create one to five jobs during the first half year, and a minimum investment of €75 000 in assets is necessary during the first two years of activity. With the approval of the 2012 Portuguese state budget, some other tax incentives have been eliminated, such as the former property tax exemption, and corporate and personal income tax are no longer exempted for credit (financial) institutions. The standard VAT rate under the regime increased from 16% to 22% and the lowest reduced rate was raised from 4% to 5%.

Economic performance

Of four sectors in the MIBC, the Industrial Free Trade Zone, the International Shipping Register, the International Services Centre and the International Financial Services Centre, the last two seem to have been most successful. However, as the financial sector is now explicitly excluded from the incentive scheme, that sector was wound up by 2011. Today, companies operating successfully in the MIBC are mostly providers of services, with activities ranging from management to consulting support. Whilst it took some time for the Free Zone to gain momentum, the number of licensed international service companies rose from 188 in 1990 to 2 900 in 2009 and certain politicians believe that the MIBC has increased the island's GDP by between 20 and 30 percent. However, after the approval of the 2012 Portuguese budget, more than 100 businesses left the Free Zone. In parallel, some analysts question the use of EU structural funds and Madeira's increasing debt.

Katowice Special Economic Zone

Regional establishment

In 1995, the first Polish Free Zone was established under the Polish system of special economic zones, a programme launched by the national government to accelerate growth in 14 designated regions. In 1996, the Katowice Special Economic Zone (KSEZ) was set up, comprising 35 different sites in four subzones. Acceleration of growth had become particularly relevant in this old industrial centre of Poland as employment in its coal mines declined. Poland's decentralised approach to development became more pronounced upon accession to the EU in 2004.

Specific incentives

The KSEZ was established with the 1994 Act on Special Economic Zones (amended in 2008 to comply with EU State aid rules) until the end of 2020. Aid in the form of tax relief is offered to companies, and calculated on the basis of investment costs (with tax relief of up to 40%) and jobs created (again 40% tax relief on the total labour costs of new jobs created within the first two years). Both of these reliefs are increased for medium-sized (additional 10%) and small (additional 20%) companies. In addition to these tax incentives, the Katowice Development Corporation provides additional services such as mediation on the real estate market, one-stop shops for investor support, human resources training and office and storage space rental.

Economic performance

Whereas other Polish regions involved in the special economic zone programme are said to have faced negative effects such as economic activity substitution, the KSEZ is claimed to be one of the most successful Free Zones of Poland, a success that extends beyond the region according to certain analysts. By 2008, more than 200 companies were established in the region, mainly in the

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manufacturing (automotive) and high-tech industries, with around 9 000 employed.

Free zones: beyond incentives

Guaranteeing transparency

As Free Zones mostly operate as specific entities within a larger administration, it is important that roles are clearly distributed. In the case of State aid for example, the host MS needs to report to the EC on activity within the region, but is often dependent on auditing and reporting done by the region itself. This is a sensitive issue as some might perceive Free Zones as reducing trade in competing "normal" jurisdictions, whereas, on the other hand, local constituencies could perceive enquires to be intrusive.

A second risk of problems in regulatory oversight is that Free Zones not only attract legitimate business but may also offer opportunities for organised crime groups and counterfeiters. Some reduced or delayed requirements for business could be used by counterfeiters to "sanitise" shipments and documents or to "finish" imported products with counterfeit trademarks. And when it comes to financial services, Free Zones are sometimes feared to function like off-shore jurisdictions.

Other economic success factors

Whilst Free Zones are defined in many different ways, aside from the proper legal framework of incentives, they are believed to share a set of economic factors that contribute to their success. Such factors attracting companies to Free Zones include advanced infrastructure, flexible regulation to accommodate different sectors, a convenient location for trade, and other non-tax incentives. These factors are likely to increase in importance as customs procedures get streamlined (including the abolishment of Type II Free Zones) and tax incentives compliant with internal market rules may provide less of a competitive advantage.

Further reading

Types of tax concessions for attracting Foreign Direct Investment in Free Economic Zones / Woon Nam, C., Radulescu, D, (2004), CESifo Working paper, Munich, Germany.

Free Trade Zone and port hinterland development / Valentine, V., Park, J., (2005), United Nations ESCAP, New York, US.

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