2. Benefits and costs of zones for host economies and business

Zones provide numerous benefits to business. The advantages can include savings in taxes and customs duties, more flexible labour rules than those applicable in the customs territories of host countries, laxer regulation and oversight of corporate activities, fewer restrictions on corporate activities and opportunities to improve distribution of goods to diverse markets. Meanwhile, the costs for choosing to locate in a zone, which might include a variety of special zone fees, are often quite low, perhaps even lower than would otherwise be the case if the business were established in the customs territory of the host country.

In both developing and developed host economies, zones can function, and in practice have been used, to promote economic development. The potential benefits are greatest for the latter group of economies, where the zones are often instrumental in attracting foreign investment (particularly in high-tech industries), creating jobs (particularly higher-skill positions) and enhancing export performance. The benefits for host countries, however, come at a cost, to the extent that governments are reduced and not compensated by any revenue stemming from zone activities often failing to offset losses. Moreover, potential benefits to economies apply only to those zone activities which would not otherwise have been established in the customs territory of the host country. It is not easy to single out occasions when zone status may have played a decisive role in ensuring that a business was set up or maintained in a given country. Of course, after an investment decision has already been made, businesses can then seek out zone status if they believe that it will help them enhance their performance.

Beyond the revenue implications for governments, lightly regulated zones are also attractive to parties engaged in illegal and criminal activities. Zones have facilitated trade in counterfeit and pirated products, as well as smuggling and money laundering, and they have often provided bad actors with a relatively safe environment in which to carry out their illicit activities. The problem is aggravated in instances where governments do not control zones adequately; this can occur when zones are deemed to be foreign entities that are outside of the scope of domestic policing activities. It can be further compounded when zones are operated by private entities. These parties' main interests are likely to be in finding ways to expand zone occupancy and provide profitable services to zone businesses. They may therefore have little direct interest in and/or capacity for conducting law enforcement activities, and they may lack the capacity or authority to effectively monitor zone operations. Even where government authorities are actively involved in overseeing zone activities, there is evidence that co-ordination between these authorities and zone operators, particularly those that are private parties, can be weak, thus opening up space for bad actors to exploit zones for their illicit activities.

Implications for host economies

The rationale for government support for zones has changed over time. As discussed above, the initial purpose of zones was to facilitate the movement of goods being transhipped through intermediary ports by waiving normal customs procedures. The success that the Shannon zone had in spurring regional development in a depressed economic zone and the subsequent similar sorts of success in China brought about a change in thinking, as governments saw zones as a mechanism that could be employed in support of their broader economic aims.

The change in the focus of zones is reflected in the case of the United States. Legislation providing for the establishment of foreign-trade zones was passed in 1934, with a view towards expediting and encouraging foreign commerce in light of the effects of the increase in tariffs under the Smoot-Hawley Tariff Act of 1930 (Foreign-Trade Zones Resource Center, 2017[12]; Wikipedia Contributors, 2017[13]) was expected at that time that zones would be used primarily for warehousing and transhipment or for minor processing and subsequent exportation of products, which would help to reduce the administrative burdens associated with bonded warehouses and the processing of duty drawback claims (USITC, 1984[14]).

The US programme had its limitations, however, as reflected by the fact that in the years 1936-65 less than 10 zones were authorised. In 1950, manufacturing operations became authorised, but interest in zones only grew significantly in the early 1980s, when the Treasury Department issued administrative rulings indicating that manufacturers did not have to pay duties on value added in zones when goods were imported into US customs territory, nor on brokerage and transportation fees (Bolle and Williams, 2013[11]). By 2015, there were 186 active zones, with a total of 324 active production (Foreign-Trade Zones Board, 2016[15]). Employment topped 420 000, and shipments of foreign and domestic merchandise into the zones totalled nearly USD 660 billion, while exports to foreign countries amounted to over USD 85 billion.

While business has boomed in these zones, questions have been raised about the effects on the US economy as a whole, prompting a number of government reports since the early 1980s. A 1984 report by the US International Trade Commission (USITC, 1984[14]) came to the following conclusions:

- Zones had accounted for a growing volume of trade and had served effectively as transhipment points.
- Direct and indirect employment had grown substantially, but the jobs created were not necessarily "new". A similar conclusion was reached in an assessment carried out by the General Accounting Office, in 1984 (GAO, 1984[16]).
- The domestic content of merchandise exported abroad from zones had not been very considerable.
- It was not clear whether or not the economic activity in zones would otherwise have taken place in the absence of the zones. Moreover, in the case of manufacturing/assembly operations, it was noted that the benefits conferred to zone firms could in some cases result in the loss of tariff protection to domestic suppliers and affect competition in finished products, to the benefit of companies operating in zones.

The report presents the views and recommendations of labour and US firms, as well as those of zone users. The former groups raised concerns about issues such as duty reductions and decreased customs presence and control. They contended that zones had resulted in a net decrease in US employment and had stimulated imports rather than boosting exports, thereby damaging domestic industries and suppliers and their employees. A 1988 update to the 1984 USITC report concluded in fact that the US auto parts industry had been adversely affected by zone activities, while the auto assembly industry had benefitted (USITC, 1988[17]). Zone users and proponents, on the other hand, contended that zones had a dynamic ripple effect on the local and national economy, attracting foreign investment while exerting a positive effect on the US balance of payments (USITC, 1984[14]).

Another analysis carried out by the General Accounting Office in 1989 focused on the need to address issues related to the administration and operation of zones, while yet another report by the Congressional Research Service (CRS) in 2013 highlighted security issues and provided an overall assessment of the zone programme (GAO, 1989[18]; Bolle and Williams, 2013[11]). The CRS report concludes that FTZs could potentially benefit the economy as a whole, to the extent that the savings accorded manufacturers from tariff reductions, administrative efficiencies, tax benefits and duty deferral encouraged US corporations to maintain operations in the US and provided an incentive for foreign producers to invest in manufacturing plants in the country. This in turn would potentially help communities hold on to businesses and the jobs associated with them. Consumers were likely to benefit from the cost savings, while federal, state and local tax revenues could also grow thanks to increased economic activity resulting both directly and indirectly from the zones.

On the other hand, zone activities were seen as possibly exacting costs on the US economy, particularly i) for domestic producers of the components being imported into zones, particularly to the extent that they lost tariff protection, and, eventually, ii) for domestic producers of the items produced in zones (Bolle and Williams, 2013[11]). Moreover, the tariff reductions could result in a loss of US tax revenue. It was also noted that zone critics had argued that the benefits of zones brought with them distorted competition, favouring a small number of businesses.

Numerous studies and assessments have also been carried out with respect to the situation in developing countries, where the focus has been on the role that zones could play in boosting export competitiveness and overall economic development. In this regard, Papadopoulus and Malhotra (2007)[20] developed a useful framework for assessing the broader potential economic benefits that zones could provide for countries, distinguishing the direct effects from the longer-term externalities, which eventually could be far more valuable, in particular to developing countries (Table 2.1).

Table 2.1. Typology of potential benefits of zones to host countries

Area	Potential benefits
Direct benefits:	
1. Exports	Increased exports increase foreign exchange reserves and improve the balance of payments.
2. Local supply chains	More business for domestic producers who sell inputs needed by zone-based firms.
3. FDI	Increased currency inputs, enhances the host country's capital formation process.
4. Employment	More jobs (that might have gone elsewhere).
5. Incomes	Wages may be lower than in developed countries but can be higher than in the host's domestic territory and can rise rapidly over time.
Long-term externalities:	
1. Technology and knowledge transfer	This is distinct from FDI, which does not necessarily entail such transfers.
2. Labour skills	The employability of workers outside the zones is enhanced and has implication throughout the economy.
3. Regional development	Zones can be established selectively in areas that can best capitalize on an economy's strengths and/or that need new business activity the most.
4. Infrastructure	Development of an efficient industrial infrastructure is critical for a successful zone program; it enables the host country to compete more effectively for FDI.
5. Support services	Successful zone require banking, legal, consulting, telecom, and other similar support services that, once developed for the zone(s), benefit the nation as a whole.
6. Controlled/partial deregulation	Enables host to participate in the international economy without compromising national policies or political ideologies.
7. Deregulation models	Where deregulation is desired, zones enable the testing of models prior to applying them nationally.
8. Broader catalyst and demonstration effects	Overall economic modernization, especially because EPZs help to attract foreign firms that might not otherwise have invested in the country

Source: Adapted from Papadopoulus and Malhotra (2007)[20].

The potential benefits are, however, sometimes questioned by critics who cast doubt on the value of the activities that zones attract and their poor records on labour rights and working conditions (Table 2.2). Adverse effects cited by labour organisations include human rights violations in the workplace, corruption among government zone managers, support for the informal or underground economy, low levels of tech transfer, labour migration to urban zones that cannot handle the influxes and an overdependence on zone investors who may tend to withdraw their investments when wages in zones rise (Papadopoulus and Malhotra, 2007[19]).

Table 2.2. Views of zone critics

Area	Zone critics
Foreign exchange earnings	Zones host import-dependent activities with low value-added.
Industrial activity	Zones perpetuate low-skilled assembly operations.
Policy reform	Zones help avoid countrywide reforms.
FDI	Zones attract FDI in low-tech, low-skilled activities.
Women	Zones segregate women and pay them lower wages.
Labour rights	Zones suppress labour rights.
Working conditions	Zones allow companies to get away with poor workplace health and safety conditions.
Environment	Zones exercise lax environmental controls in order to attract polluting industries.

Source: (FIAS, 2008[5]).

FIAS (2008)[5] reviews the situation in key areas, concluding that:

- Zones have proven to be highly effective at generating employment, especially for women, particularly in smaller countries. While there are exceptions (particularly with government-run zones), wage and working conditions tend to be better in zones than in the rest of the host economy.
- Zones can be effective at increasing the volume and diversity of exports.
- Zones can be an important tool for attracting foreign direct investment, offsetting what might be an adverse investment climate in a country.
- Commercial linkages with the local economy can be strengthened as shipments to zones are typically considered exports and therefore eligible for export benefits.
- Although this is not always the case, zones can sometimes serve as proving grounds where new policies can be implemented and tested on an experimental basis, prior to more widespread adoption in countries.

These conclusions are supported by other assessments at the individual country level. A review of studies on six government managed zones in Asia that was carried out in 2003 concluded that the zones, located in Korea, Malaysia, Sri Lanka, China and Indonesia, were unambiguously economically efficient and generated returns well above the estimated opportunity costs in those countries (Table 2.3) (Jayanthakumaran, 2003[20]). The zones were an important source of jobs in all cases, and they were found to support local entrepreneurs in the cases of Korea and Indonesia. The result for the Philippines, on the other hand, resulted in a net negative present value, reflecting the country's high infrastructure expenditures in setting up the profiled zone.

Table 2.3. Realisation of expected benefits of selected zones in Korea, Philippines, Indonesia, Malaysia, Sri Lanka and China

Expected benefit	Korea	Philippines	Indonesia	Malaysia	Sri Lanka	China
Employment	✓	✓	✓	✓	✓	✓
Foreign exchange earnings	✓	✓	x	✓	-	✓
Domestic raw materials	✓	x	✓	✓	✓	-
Domestic capital equipment	x	x	x	✓	x	-
Taxes and other revenues	✓	✓	✓	✓	✓	✓
Domestic profit	-	-	-	-	✓	x
Electricity use	x	x	x	x	x	x
Domestic borrowing	x	x	x	x	x	-

Notes: "✓" = realised; "x"=not realised
Source: (Jayanthakumaran, 2003[20]).

Other examples of success stories include Shenzhen in China and Mauritius (Papadopoulus and Malhotra, 2007[19]). Shenzhen grew from a small town of 20 000 in 1979, to city of 3.5 million with a high GDP per capita, and with many multinational firms operating in the area. Mauritius set up a zone in 1971, helping it to become one of Africa's leading exporters of merchandise, while reducing its reliance on sugar exports. In the process, export earnings rose by annual rate of 80% in the 1980s, and unemployment fell from 20% in 1971 to less than 2% in 1994, resulting in a need to import labour.

In transition economies and other developing countries, the zones studied tended to experience difficulties early on, but their performance improved over time as reforms were made, one of the more notable of which involved opening up the development and management of zones to private parties (FIAS, 2008[5]). The programmes in Europe and Central Asia were seen, on the whole, to have experienced moderate success, led by those in Poland, Bulgaria and Romania. Programmes in the CIS, on the other hand, were seen as having had to face barriers that limited their beneficial effects.

Further evidence of the benefits and costs of zones is provided by FIAS (2008)[5], which details implication for i) employment, ii) exports, iii) foreign direct investment, iv) industrial upgrading and technology transfer; v) foreign exchange earnings, vi) budgetary impacts, vii) social and environmental impacts (including labour standards, pay and working conditions, human resource development, and environmental impacts) and viii) impact on country-wide reforms. Following is an overview of the situation in terms of these key elements, based on the FIAS (2008)[5]'s assessment.

2.1. Employment

Zones play an important role in some economies thanks to the jobs they provide (FIAS, 2008[5]). Globally, the percentage of employment accounted for by zones is 0.21%. In Honduras, zones account for 4.6% of employment, and the levels are even higher in the Dominican Republic (6.2%), Tunisia (8%), Fiji (10%), the Seychelles (12%), Mauritius (24%) and the UAE (25%).

2.2. Exports

Some reports suggest that the volume of world trade channelled through zones is as much as 20%, and that the share in developing economies is much higher, about 40% overall (Table 2.4) (Papadopoulus and Malhotra, 2007[19]; FIAS, 2008[5]). Moreover, the share of many countries' exports passing through zones exceeded 70% (With respect to diversification, zones have proven to be effective mechanisms for expanding exports of manufactured goods (FIAS, 2008[5]). Most Caribbean and Central American economies, for example, exported mainly fruit and vegetables prior to the establishment of zones. In Costa Rica, the share of manufactured exports rose from less than 10% in 1990 to 55% in 2003. Over the same period, the main exports from zones there evolved from apparel and textile products to electronic components, which by 2003 accounted for over half of zone exports. Many other countries had similar experiences.

Table 2.4. Exports from developing countries from zones, by area

Area	Total value (millions of USD)	Percentage of total exports
Asia/Pacific	510 666	41
Americas	72 636	39
Central and Eastern Europe and Central Asia	89 666	39
Middle East and North Africa	169 459	36
Sub-Saharan Africa	8 605	49
Total of above	851 032	41

Source: (FIAS, 2008[5]).

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Table 2.5. Share of zone exports in total exports of selected economies, 2005

Region	Economy	Zone export share (%)
Americas	Nicaragua	79
	Dominican Republic	77
	Panama	67
Asia/Pacific	Bangladesh	76
	Sri Lanka	67
	Philippines	78
	Pakistan	50
Sub-Saharan Africa	Ghana	22
	Madagascar	80
	Mauritius	34

Source: (FIAS, 2008[5])

2.2.1. Foreign direct investment

Zones can be an important destination for foreign direct investment (FDI) in some countries. A 2002 UNCTAD analysis concluded that the relationship between the location of foreign affiliates and the location of zones seems weak (UNCTAD, 2002[21]). That said, in some countries the share of FDI accounted for by zones was quite high: in the Philippines, zones accounted for 81% of FDI in 2000; in Bangladesh, two zones accounted for 32% of FDI; in Mexico, zones received 31% of the total manufacturing FDI between 1994 and 2001. Moreover, in Costa Rica some 75% of all foreign affiliates were located in zones, suggesting a significant FDI link. In China, zones accounted for over 80% of cumulative FDI at the start of the millennium (FIAS, 2008[5]).

2.2.2. Industrial upgrading and technology transfer

Some assessments have indicated that the skill levels of workers in zones have remained relatively static, citing cases in which little change has occurred over time (FIAS, 2008). A case study of Mexico carried out in 2002 concluded that zones in that country had been very successful at creating jobs and alleviating unemployment (Blanco de Armas and Sadni-Jallap, 2002[22]). The skill levels of zone workers, however, were notably lower than those outside the zone, with little growth experienced between 1988 and 1998. Although there was evidence of some modernisation and upgrading of skills in the zones, it was not clear that this had spread to other parts of the economy. Due to the high import component of zone operations and the low skill level of the work force, the activities of the zones were not expected to contribute to significant industrial upgrading in the country at large.

Assessments in other countries, however, have shown a more positive relationship between zones and industrial upgrading, in particular in economies in East Asia; Korea, Chinese Taipei, Malaysia and the Philippines were notable in this regard (FIAS, 2008[5]). A recent assessment of zones in Panama also finds a positive relationship (Haussman, Obach and Santos, 2016[23]). FIAS (2008)[5] concludes, however, that most research indicates that there are no significant differences between zone and non-zone-based export-oriented firms in terms of technology transfer and linkages.

2.2.3. Foreign exchange earnings

The success of zones in generating foreign exchange earnings from exports depends on the value-added in zones, which in turn is influenced by the extent to which local inputs are used in zones. Zones that have been particularly successful in this regard include Korea, which was successful in developing backward supply linkages and sub-contracting relationships with domestic firms, particularly in footwear operations. Value-added was over 60% in 2000, with figures of 62% for Indonesia in 1990, and 45% for the Philippines in 2003 (FIAS, 2008[5]). Other zones which demonstrated growth in value-added activities include Mauritius (where value-added rose from 23% in 1980 to 41% in 1995), Costa Rica (an increase from 18% in 1996 to 40% in 2000), Honduras (from 3.3% in 1990 to 24.5% in 1995, and El Salvador (from 3.8% in 1990 to 20.4 % in 1996).

Some other zones did not fare as well, notably those in Mexico, where the export ratio held at 30% from 1991 to 2000, and the Dominican Republic, where the ratio fell from 40-45% in the early 1980s to 25-30% by the end of the decade (FIAS, 2008[5]). Elsewhere, the export ratios of countries such as Nicaragua, Guatemala and Sri Lanka were all less than 10% in the 1990s. A number of factors have contributed to the failure to develop linkages, including:

- high import ratios of most zone activities: apparel, footwear and electronics operations have import ratios of 60-85%
- the impact of export access agreements that, for example, provide incentives for zone operators to import materials from the county that they will eventually export to
- bans on local sales by firms in zones, which might contribute to discouraging forward linkages
- a lack of competitiveness of local firms
- preferences on the part of global firms for international suppliers
- a lack of awareness and information about potential domestic suppliers.

2.2.4. Budgetary impact

The budgetary impact of zones on governments depends on the scope and magnitude of incentives provided to zone users (Box 2.1). Firstly, reduced corporate income tax provisions, import duty exemptions and indirect tax abatements all contribute to reducing government revenues, without necessarily providing a benefit to the country concerned; a benefit is only realised if the investments in a zone operation would not have occurred in the absence of the incentives offered (FIAS, 2008[5]).

Box 2.1. Government costs and revenues form zone operations

Potential revenues

- corporate income taxes
- personal income taxes
- permit fees and service charges
- rental or sales fees
- import duties on products sold locally
- concession fees for utilities and the like that are linked to the zones

Potential costs

- wages for staff to oversee and/or manage zone operations
- internal and/or external infrastructure
- import duties lost due to smuggling
- tax revenue lost when firms relocate from the domestic customs territory to zones
- subsidies

Source : FIAS, 2008.

On the other hand, governments tend to reap gains from the personal income taxes paid by zone employees and income from tariffs assessed on merchandise imported into the host country (FIAS, 2008[5]). These revenues can be substantial. In the case of Madagascar, over 20% of employers' social contributions are sourced from zone companies, and the companies contributed 2% of the country's GDP in 1998. In the case of government-run zones, revenue is also raised from fees and service charges and land and building rentals and sales.

Zones can become financial drains if they require large outlays for onsite and/or offsite infrastructure, if the zones are not operated on a cost-recovery basis, and/or if they receive subsidised inputs, such as utilities and services (FIAS, 2008[5]). Earlier zones established in developing countries often incurred costs that were absorbed by host jurisdictions. More attention, however, has been paid in recent periods to reducing such costs, particularly with respect to infrastructure outlays.

2.2.5. Social and environmental impact

A 2015 UNCTAD analysis looked at the performance of zones in advancing general environmental and social goals linked to sustainable development (UNCTAD, 2015[24]). The report examines the situation in 100 zones in 20 emerging economies. It concludes that most zones do not have in place mechanisms to support good environmental and social practices. The weakest area was in corporate governance; very few zones provided assistance for companies to combat corruption.

Labour standards, pay and working conditions

Concerns have been raised in the past about zone issues related to gender, wage levels and benefits, workers' rights, working conditions and environmental impact (FIAS, 2008[5]). The situation has improved over time, with significant progress made in changing the anti-union and labour suppressing aspects of some zones. In 2003, the ILO and International Confederation of Free Trade Unions, however, raised the following concerns about zone operations in a number of countries (FIAS, 2008[5]):

- restrictions on freedom of association and collective bargaining
- failure to recognise the right to strike
- non-observance of national labour legislation.

There are also concerns about weak labour inspection practices, intimidation of workers, limited access to zones by labour organisers, formation of company-controlled unions and other anti-union practices (FIAS, 2008[5]). In addition, women's rights have been raised as an issue in some zones, notably with respect to equal pay and to policies concerning pregnancy and child care.

An assessment of the situation suggests that problems are not pervasive, affecting only a fraction of zones worldwide (FIAS, 2008[5]). Wages can be higher in zones than outside them, and foreign multinationals located in zones maintain occupational health and safety practices which are often better than those maintained by domestic enterprises outside zones. Moreover, adverse labour and social policies are most closely associated with zones developed and run by governments.

Human resource development

While there have been claims that zones fall short in promoting an upgrading of skills in their host economies, there is evidence that in some places spill-overs have been significant, especially in zones catering to higher value-added industries or more knowledge-intensive zones (FIAS, 2008[5]). Zones in Malaysia, the Dominican Republic, Thailand, the Philippines and Mauritius stand out specifically in this regard.

Environmental impact

Environmental performance has raised questions in a number of jurisdictions, including Mexico and older zones in Sri Lanka, the Dominican Republic and Mauritius (FIAS, 2008[5]). Recently constructed zones and those not scattered throughout a country tend to exhibit better performance; in these instances, effective environmental management is a key selling point to potential zone tenants.

2.2.6. Special economic zones and countrywide reforms

Zones have often been viewed as a mechanism for addressing the anti-export bias of countries, thereby offering a second-best solution (the preferred solution being countrywide reform) (FIAS, 2008[5]). In this context, zones could serve as a means to temporarily address these biases until broader reforms are introduced. Having such a temporary solution in place could, however, actually slow the impetus for reforms. On a national level, the debate focuses on whether zones serve as catalysts for reforms, or whether on the contrary they actually slow reforms. Analysis suggests that zones in Korea, Jordan and Kuwait served as catalysts, while those in the Dominican Republic and Tunisia did not. In Korea, the zone programme launched in 1970 promoted economy-wide structural reforms, with expanding linkages between zones and the local economy. In contrast, little integration occurred in the Dominican Republic in the 30 years following the establishment of the first zone.

China, Malaysia, Jamaica, Kuwait and Jordan have used zones to test the impact of potential new policies that would then be applied countrywide (FIAS, 2008[5]). Marketoriented reforms to FDI regulations and land and tax policies were first introduced and tested in zones in China, before being implemented countrywide. In Jamaica, telecommunications deregulation was first tried in zones, before being introduced more generally. In Panama and India, more flexible labour policies were being tried out in zones, as a precursor to broader reforms. In the Middle East, zones were used to test the effects of liberalisation of FDI.

2.2.7. Global value chains

In its assessment, FIAS (2008)[5] argues that zones can continue to play an important role in developing and developed countries alike, provided they evolve in response to global integration and regional free trade agreements. The United Nations Conference on Trade and Development (UNCTAD) explored the possible way forward in its work on global value chains (UNCTAD, 2013[25]).

The UNCTAD assessment notes that multinational corporations are increasingly under pressure to demonstrate corporate social responsibility (CSR) in their operations worldwide. Indeed, codes of conduct have been developed by a number of organisations to this end, the OECD Guidelines for Multinational Enterprises being a prime example. The ability of firms to exercise CSR has become more fraught in light of the development of global value chains (GVCs), as firms may face difficulties in influencing the behaviour of their affiliates and suppliers worldwide.

It has been noted that zones are already important hubs for GVC activities, and that they are in good position to be used by governments and businesses to further CSR objectives. This is especially the case when zones can be transformed into centres of excellence that meet high standards, which can be an effective mechanism to promote CSR-acceptable behaviour and practices among affiliates and suppliers worldwide (UNCTAD, 2013). Creating such an environment is seen as enhancing the ability of zones to attract and retain FDI.

There are, however, challenges to be met if zones are to be transformed. A survey carried out by UNCTAD of 100 zones in 20 emerging countries in 2013 concluded that only a handful of pioneering zones provided an environment that was highly supportive of CSR/sustainability objectives. The initiatives of the leading zones included: i) support for the formulation and implementation of responsible labour practices, ii) well-developed environmental reporting requirements, iii) policies and regulations governing occupational health and safety, iv) mechanisms to assist firms in combating corruption. With respect to the latter requirement (combatting corruption), few zones had addressed the matter, and the response seems to have been weak in those that did (UNCTAD, 2015[24]).

2.3. For business

The benefits offered to businesses locating in zones has expanded over time, moving from simple import duty exemptions to include advantageous corporate tax rates, exemptions from indirect and local taxes, unrestricted repatriation of capital and profits and unrestricted management of foreign exchange (FIAS, 2008[5]). Moreover, zones in the Middle East and North Africa often go further, providing personal income tax exemptions for expatriate workers and zero corporate income taxation, in perpetuity. Zones in the United Arab Emirates, for example, are able to bring in foreign labour at pay rates that are below those mandated for workers outside the zone, and with fewer benefits.

As discussed in the section on global value chains, zones can play an important role for firms engaged in international commerce, providing them with opportunities to create exchange networks and achieve nearly seamless supply and marketing chains as part of an international system, while operating under highly advantageous trade and FDI regimes (Papadopoulus and Malhotra, 2007[19]). Coupled with import-oriented zones, zones can be viewed as important parts of a “virtual network” that can enable the production, movement and marketing of goods in a barrier-free environment from their conception to just before the final sale.

Table 2.6 sets out some of the key potential benefits that firms can capture by operating in zones. The first part of the table identifies those benefits that are available in developed and developing countries alike, while the second part lists the general benefits that can be attained by operating in developing countries. The table is followed by a brief description of these and other benefits.

Table 2.6. Potential benefits for international firms locating in zones

Benefits specific to zones
1. Duty-free imports
2. Avoidance of duties/taxes on waste or consumed materials
3. Simplified administrative procedures
4. Lower insurance costs (premiums based on duty-free value of items)
5. Lower inventory costs through centralised warehousing
6. Flexibility in bulk-breaking, packaging and labelling for different foreign markets, while benefitting from duty-free status
7. In light of the above, more cost-effective position as a central distribution hub
8. Product assembly or manufacture in a duty-free environment
9. Tax and other concessions beyond duty savings
10. Duty-free import of capital equipment
11. Lighter environmental and labour regulations
12. Right to establish fully-owned or majority-controlled enterprises
13. Full repatriation of profits and/or capital
14. Superior and often subsidised infrastructure
15. Greater protection against crime as zone perimeters are normally secured by host countries
16. Dynamic zone improvement environment as zone operators seek to maintain and enhance their competitiveness in relation to other zones
Benefits associated with location in a developing country generally
1. Inexpensive labour
2. Plentiful labour
3. Access to raw and intermediate materials
4. Access to large internal markets
5. Strategic country locations near major target markets for exports

Source: Adapted from Papadopoulus and Malhotra (2007)[20].

2.3.1. Inventory control

Zones can be advantageous when used to stock goods so as to avoid peak season freight rates, with companies thereby achieving reductions in landed costs (Hainsworth, 2017[26]). The stocking of goods in zones also allows businesses to manage inventory in a cost-effective manner, avoiding what in some instances can be significant import duties if the goods in question are destined for the local market (Hainsworth, 2017[27]).

2.3.2. Fiscal incentives

Duty-deferral and duty-free treatment of exports are basic features of all zones. Exemptions from or reductions in inventory taxes, excise taxes and local taxes also exist in some places. Other incentives vary considerably from zone to zone. One of the more generous programmes in this regard is found in the United Arab Emirates. As shown in Box 2.2, corporate income and personal income are exempt from taxes.

Box 2.2. Profile of Jafza Free Trade Zone

The Jafza Free Trade Zone in Dubai was created in 1985. It is currently operated by DP World, which is a company specialising in marine terminal management. The zone has grown from a small operation of 19 companies into a business community of over 7 000 companies from more than 100 countries, employing over 144 000 workers. It accounts for more than 32% of foreign direct investment in the United Arab Emirates, and more than 50% of Dubai's exports. For investors, location in the zone offers:

- 100% foreign ownership
- 0% corporate tax for 50 years (a concession that is renewable)
- no restrictions on capital repatriation
- 0% import or re-export duties
- 0% personal income tax
- no currency restrictions
- no restriction on foreign talent or employees
- ability to mortgage premises to a bank or financing company
- onsite customs.

In order to form a company within the zone, investors are required to choose between i) a Free Zone Establishment, which is essentially a limited liability company (LLC), with one shareholder, ii) a Free Zone Company, which is an LLC with up to 50 shareholders, iii) a Public Listed Company, which is an LLC that can offer shares to the public or iv) a Branch of a Company, which is 100% owned by its corporate parent (which is located outside the zone) and bears its name. Operating licences are required, with their nature depending on the type of activities to be carried out.

Sources: (Jafza, 2017[28]; DP World, 2018[29])

Zones can also sometimes be used to reduce duties on products that are processed or manufactured there and then shipped into the host country's market. This occurs in cases when the tariff structure is "inverted" (i.e. when the tariff rates on a finished product are lower than those applicable to the inputs used to make that product). In the case of the United States, for example, tariffs on many finished pharmaceutical products are "zero" while the tariffs on the active ingredients used to make those products are significant (British American Business, 2017[30]).

Moreover, as mentioned in Table 2.2, duties on waste or materials consumed in the manufacturing of a finished product can be avoided when the product is imported into the host country; also, the domestic value-added to goods manufactured in zones is not taxable. Finally, as no duties on exports are applied, the duty draw-back procedures that would otherwise apply to goods re-exported from a host country can be avoided.

2.3.3. Simplified customs procedures

Customs procedures for zones may differ significantly from those applicable to goods entering a country directly. In the United States, for example, reporting for goods entering zones is subject to a "Weekly Entry" provision which allows importers to report to customs once per week instead of once per shipment. This can result in direct savings, as the merchandise processing fee assessed for each formal entry processed by customs would only be applied once, at a maximum cost of USD 485 (Foreign-Trade Zones Resource Center, 2017[12]; U.S. Customs and Border Protection, 2017[31]).

2.3.4. Zone-to-zone transfers

Goods can often move between zones without duties being assessed (Ferguson and Steverango, 2013[32]). Goods associated with low-risk/repetitive shipments can, in the United States, also move from a port of entry to a zone without triggering charges and inspection.

2.3.5. Insurance benefits

Customs supervision of zones may lead to lower security costs and reduced insurance costs; in the case of insurance, as duties are not paid, they do not figure in the calculation of the value of the insured good (Ferguson and Steverango, 2013[32]).

2.3.6. Infrastructure

Zones are likely to be located in strategic ports of entry, and they have often benefitted from targeted government infrastructure upgrades, particularly in developing countries that have made zone development a priority. Moreover, jurisdictions may seek to attract investment through supporting site, facilities and equipment development, as well as workforce training (Ferguson and Steverango, 2013[32]).

2.3.7. Working conditions

Special regimes may exist with respect to rules and regulations governing working conditions; these may or may not serve the interests of workers. Use of foreign labour, for example, is sometimes facilitated, and special conditions may apply. In the case of Panama, some, but not all zones have regimes which prescribe: i) a fixed surcharge of 25 per cent for overtime work; ii) flexibility to assign days off, iii) flexibility to operate on Sundays and holidays, and iv) the possibility to terminate labour contracts because of market or demand changes (Pancanada, 2017[33]).

2.3.8. Bulk-breaking, packaging and labelling

Zones provide a platform where goods can be handled and prepared for shipment to different markets, while preserving duty-free status (Ferguson and Steverango, 2013[32]). This can include repackaging and labelling.

2.3.9. Marketing and distribution networks

Zones can represent an important platform for businesses to enhance their distribution and commercial networks, especially in countries where zones are primarily a mechanism for boosting exports. The Colón Free Zone in Panama is a case in point (Box 2.3).

Box 2.3. Colón Free Zone

The Colón Free Zone (CFZ) in Panama, established in 1948, is the second largest in the world; it is managed by the government. In 2015, more than 2 500 merchants, employing close to 30 000 workers, operated in the zone, which is strategically located on the Atlantic Ocean, near the Panama Canal. Operations permitted in the zone include i) importation and export of goods ii) manufacturing, iii) sale, commercialization and distribution of goods and iv) the refining and processing of goods. In 2015, imports topped USD 10 billion; the leading sources were China (33%), Singapore (26%) and the United States (10%). Europe and other Asian economies accounted for another 12% and 9%, respectively. Re-exports reached USD 11.4 billion; the top destinations were American countries (99%), led by Puerto Rico (21%), Colombia (13%), Venezuela (12%) and Panama itself (10%). Value-added in zone operations was on the order USD 1 billion.

Source: (Haussman, Obach and Santos, 2016[23]).

On the supply side, Asian and US exporters shipping to American markets are often interested in shipping large containers of like products. Using the CFZ, they can sell to one merchant in the zone, with the expectation that their products will then be distributed and retailed throughout Central and South America and the Caribbean (ITA, 2016[34]). The distribution is facilitated by the many buyers who travel to the zone with an interest in filling containers with smaller quantities of a broad range of goods (Moore Stephens International, 2006).

2.3.10. Administrative accommodations

Streamlined administrative procedures including "one-stop" services to support businesses setting up in zones and a relatively light regulatory environment can provide further incentives for businesses to locate in zones. In the case of the United Arab Emirates (Petch, 2017[35]; UAE Government, 2017[36]) for example:

- Unlike businesses located in the UAE customs territory, which require a local partner with majority ownership if the business needs a commercial or industrial license to operate, business in in zones can be 100% foreign owned.
- The approach to paperwork is simplified; less documentation is required when setting up and running a company in zones and much of the documentation is available in English.
- Share capital requirements can be low or even non-existent; moreover, there are no capital requirements if the zone operation is a branch of an existing firm.
- Some zones do not require much, if any, physical office space (residency, however, may be required)
- Visas for family and employees are relatively quick and easy to get for zone residents.
- While annual audits may be mandatory, in some cases none are required.

Moreover, an individual can establish a one-person enterprise as a "freelancer" in a zone in the United Arab Emirates, further cutting down on administrative requirements.

The ability of this more relaxed regulatory environment to address key corporate governance matters was questioned in (FATF, 2010[37]). The report notes that important laws and regulations that are applied within the customs territories are often not applied in zones, Anti-Money Laundering/ Combating Financing of Terrorism (AML/CFT) regulations being a case in point. Inadequate control by customs agencies was seen as potentially raising problems in the fields of intellectual property, supply chain security, valuation fraud and other non-fiscal offences. And there were concerns over the lack of sufficient oversight of firms forming companies to operate in zones. Many zone authorities, it was noted, operate separate company formation services from those that exist in the rest of the jurisdiction, and they market the ease of setting up a legal entity in an FTZ to attract business; these authorities often request little or no ownership information on the companies interested in setting up operations in the zone.

2.3.11. Trade measures

Goods that are subject to quotas or are barred from direct entry into a country's home market may nonetheless be admitted for entry, storage and/or manipulation in a zone. In such instances, companies importing goods under quota could eventually either i) hold the goods in the zone until such time as new entries were permitted under the quota, ii) export the goods to foreign markets or iii) use the goods in the zone to produce new items that were not subject to quotas, thereby making them eligible for import into the customs territory of the host country. By the same token, it might be possible, in certain instances, for processers/manufacturers in the zone to use prohibited goods imported into zones to produce new items that can then be shipped to the host country's domestic market.

There may also be instances where products subject to dumping, subsidy and safeguard remedies can be imported freely into zones, without being subject to those measures. In these instances, as above, i) goods could be exported to foreign markets freely and ii) the goods imported into the zones could be used to produce new items that were not subject to the trade remedies, thereby making possible their import on more liberal terms.

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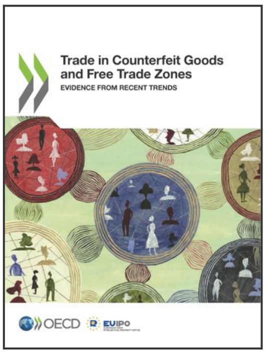

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