UK IN A CHANGING EUROPE

FREEPORTS

INTRODUCTION

Freeports will be the centrepiece of the Budget, presented as a concrete sign, especially to 'left behind' communities, both of the benefits of Brexit and the Government's commitment to the 'levelling up' agenda. And for those looking to create 'Global Britain', freeports send out a message: we're open for business.

The commitment goes to the top. When he was still a backbench MP, Rishi Sunak, now Chancellor of the Exchequer, wrote a report for the Centre For Policy Studies extolling the virtues of freeports. He said that 'Freeports will unleash the potential in our proud historic ports, boosting and regenerating communities across the UK'. One recent proposal for 'supercharged freeports' claims they will bring a £9 billion boost to the economy and will be of particular benefit for the north. The Government published a consultation paper on freeports in February 2020: 'Boosting Trade, Jobs and Investment Across the UK'. Its opening lines are almost poetic:

> In the Ancient World, Greek and Roman ships – piled high with traders' wines and olive oils – found safe harbour in the Free Port of Delos, a small Greek island in the waters of the Aegean. Offering respite from import taxes in the hope of attracting the patronage of merchants, the Delosian model of a 'Free Port' has rarely been out of use since.
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> Because freeports still offer that same story of trade and prosperity across the modern world. From the UAE to the USA, China to California, global freeports support jobs, trade and investment. They serve as humming hubs of high-quality manufacturing, titans of trans-shipment and warehouses for wealth-creating goods and services.
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> The UK will recreate the best aspects of international freeports in the brand-new, best-in-class, bespoke model set out in the following pages.

In October 2020 the Government published its response to the consultation setting out its vision for freeports as 'the hubs of enterprise [which] will allow places to carry out business inside a country's land border but where different customs rules apply'. Bids were invited in November 2020.

So freeports are happening. This report examines both the rationale for them and the existing evidence on them. We conclude that, in an advanced, relatively low-tariff country like the UK, freeports are unlikely to be a magic bullet. Their main impact – and any associated reductions in regulation – are likely to be to relocate rather than create economic activity and jobs. That said, freeports in the UK could be a part of a broader industrial and regional policy, drawing on recent experience with enterprise zones.

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WHAT ARE FREEPORTS?

In the early days, freeports were areas around docks - ports - where goods were brought in tariff free, further work was done on those goods to add value, and then they were exported. Nowadays freeports can range from secure warehouses, as in Luxembourg and Geneva, to sites where considerable added-value manufacturing occurs before the goods are re-exported.

Freeports are one type of 'special economic zones' (SEZs). SEZs are areas within a country where business activity is subject to different rules from those prevailing in the rest of the country. SEZs can include tax incentives for investment within the geographical area of the freeports, flexible regulation, and investment in infrastructure.

The UK is now proposing to set up a new generation of freeports which brings together manufacturing and science and technology. The Government intends that the UK model will establish freeports as 'national hubs for global trade and investment across the UK', to promote 'regeneration and job creation' and to create 'hotbeds for innovation'. These freeports will not just be at docks but around airports.

In its consultation paper, the Government defines freeports as:

> secure customs zones located at ports where business can be carried out inside a country's land border, but where different customs rules apply.

It notes that freeports can 'reduce administrative burdens and tariff controls, provide relief from duties and import taxes, and ease tax and planning regulations'. Typically, importers bringing goods into a freeport do not have to pay duties until the goods leave the freeport and enter the domestic market (in this case, the rest of the UK). If raw materials are brought into a freeport from overseas and processed into a final product before entering the domestic market, then duties will be paid on the final good and not on the raw materials, thus making the final good cheaper. No duty at all is payable if goods come into the freeport and are then re-exported (that is, they come into the freeport and then leave again without entering the domestic market).

So businesses operating in freeports or free zones benefit from:

- simplified customs procedures;
- relief on customs duties relating to handling and processing of goods destined for re-export;
- cash-flow benefits of not having to pay duty until the goods are released for free circulation in the domestic economy (or used or consumed within the free zone).

There are infrastructure benefits too: within a fenced industrial estate, tenants are provided with good quality office space, utilities, logistics services, business services and other facilities. Business regulations can be flexible too. For example, customs services are streamlined and red tape is kept to a minimum, often through a one-stop shop for permits and investment applications.

The UK and freeports

The UK had freeports until 2012 when the relevant legislation lapsed. The reasons for this lapse are not clear but there was a suggestion that freeports were of limited use, that they made no difference to Government revenue or customs reliefs, and that they introduced unnecessary complexities regarding customs. It was also suggested that alternative customs regimes had been brought in – customs warehousing and more sophisticated means of tracking cargo – which meant that the same benefits as provided by freeports could be attained by other means.

So after 2012 the UK focused instead on Enterprise Zones, which had previously been introduced by the Thatcher Government. Enterprise Zones do not usually handle cargo but are focused on regeneration more broadly (such as the London Docklands) including improving infrastructure and connectivity.

Serwicka & Holmes define Enterprise Zones, of which there are 61 in the UK, as 'designated areas that provide tax breaks and Government support, aimed at increasing new business start-ups and creating new jobs.' They identify three specific benefits provided by the Government in recent years:

- business rates discounts (worth up to £275,000 per business over a five-year period)
- enhanced capital allowances for companies investing in new plant or machinery
- location-specific amenities (such as rail, ports, high-speed broadband) and simplified planning process.

However, a radical change to the recent enterprise zone model was the ability for local government to finance new investment in infrastructure via Tax Incremental Financing (TIF) powers. These allowed local authorities to use the future uplift in the value of their zone's business taxes (rates) to finance new infrastructure. This feature has, according to Hooton and Tyler (2019), enhanced the ability of local areas to invest in the physical fabric and infrastructure in their area, thereby enabling them to restructure their local economies.

WHAT IS THE CASE FOR FREEPORTS?

Proponents of freeports argue that they provide four main advantages.

Job creation. First, they argue that freeports provide the opportunity for job creation, with estimates ranging from 86,000 to 150,000 potential new jobs being created in the UK as a result of businesses moving their manufacturing and logistics hubs into freeports. These figures have been calculated by applying a US framework to the UK situation, but accounting for population differences, and assuming that all jobs created in freeports are 'additional' to existing employment.

Economic benefits. A report published by Mace suggests that the introduction of 'Supercharged Freeports', which would be primarily based in the north, could boost annual trade by £12 billion, adding £9 billion to the UK economy annually.

Benefits to business. Businesses stand to gain financial benefits provided by the Government, as inducements to relocate their operations to UK freeports. This greater business activity could, in turn, boost the economy of the surrounding areas.

Tariff inversion. Businesses might benefit from tariff inversion. Tariffs can be higher on component parts than on the finished product; tariff inversion is where companies bring component parts into a freeport tariff free, build a finished product within the freeport, and then import or export the finished product, thereby only paying tax on the finished product and not the component parts. So, for example, if tariffs on car components are 10% but on the final car only 5%, then a car built in a freeport would have to pay only 5% tariff when it entered the domestic market.

Case Study: United Arab Emirates

Success through extensive liberalisation. The Jebel Ali Freeport in Dubai, one of the largest in the world, has had success as a hub through its highly liberal approach to taxation: as Davidson notes '0% corporation tax, no VAT, no income tax, no taxation at all.' Further, 100% foreign ownership is permitted along with no restrictions on repatriation of profits or controls on foreign currency exchange. There are no import or export duties relating to the zone except for sales made into the UAE. It is also relatively easy to obtain work permits for foreign nationals, and there are guarantees of no corporate or even personal income taxes for between 15 and 50 years from set up.

Applicability to UK. It is doubtful that the UK could apply such a liberal approach to freeports. A no tax zone would create huge incentives for existing UK businesses to relocate to within the freeport; non-freeport areas in the UK would suffer a loss of business activity. There are also issues with the compatibility of any such proposals with the OECD's approach to digital taxation and tax havens and to the level playing field provisions in the UK's agreement with the EU

WHAT IS THE CASE AGAINST FREEPORTS?

Opponents to freeports point out four main disadvantages:

Job relocation as opposed to creation. Do freeports add to economic activity within a country, or merely move it around? The estimates referred to above, based on US statistics, assume that all jobs are additional - but this is not credible, and is contradicted by the available evidence. Meanwhile, existing evidence for the UK is at best mixed: one study by Larkin and Wilcox, cited by Serwicka & Holmes, concluded that 'up to 41% of the 58,000 jobs created in the enterprise zones of the 1980s were relocated from elsewhere in the UK' (and even the 'new' jobs might have been created elsewhere if enterprise zones had not existed). Another study found a positive effect of enterprise zones on employment - but some also found either mixed or no effects and some impact evaluations found evidence of displacement. The study also found mixed evidence on the impact of enterprise zones on wages.

Establishment and maintenance costs. Freeports require considerable infrastructure to protect their status as extraterritorial zones, though these costs may be mitigated through the use of existing ports. The UK intends to invest in infrastructure, construction and machinery in freeports to 'raise productivity' and 'cut costs associated with processing goods'. Nonetheless, these ongoing costs offset the economic benefit of job creation. For example, Serwicka & Holmes report that 'final evaluation of the enterprise zones found that the public sector cost per additional job created in the zone amounted to £17,000 per job in 1994-95 prices.' Freeports can force local areas to expand provision of roads, schools, hospitals without any compensating increase in tax revenue to provide these services. On the other hand, some would argue that those disadvantaged regions will benefit from this sort of Government investment.

Money laundering / tax evasion risk/ other illegal activities. Some worry that the secrecy and extraterritorial nature of freeports means that they can host money laundering and tax evasion, to the detriment of the national economy. In a report for the European Parliament, Korver says 'the goods in freeports [...] are technically 'in transit' even though in most freeports of this kind, there are no time limits. This system allows the stored goods to gain value and it allows for tax-free sales. Goods can enter a freeport, stay there indefinitely and trade an unlimited number of times without ever having been taxed.' The Financial Action Task Force report that this lack of scrutiny can 'facilitate' trade-based money laundering, through 'relaxed oversight, lack of transparency, trade data and systems integration.' Others, however, argue 'goods are under customs supervision and thus are often more controlled than elsewhere because traceability is one of the logistical services offered'.

There is a particular issue with art and archaeological treasures. By its own admission, the Geneva freeport has been used in the past by 'undesirable tenants' to conduct illicit archaeological trafficking, a fact that was made public when Italian police were given access a couple of years ago because they suspected stolen treasures might be stashed there. It also stores over a million paintings including a thousand Picassos which belong to 'an unaligned group of art dealers, collectors, freight forwarders and offshore companies (generally with opaque ownership), who appreciate the anonymity and prison-like security provided by the Swiss facility.'

Deregulation. The most successful freeports exist in countries with minimal regulation (see case study: UAE). There are several countries bordering the EU that have a liberal approach to regulation, environmental and labour standards (see case study: Serbia).

Case Study: Serbia

Competitiveness. According to Kostadinović and Petrović-Randelović (2015), 'the free zones in Serbia have much greater benefits than the neighbouring countries, which is the result of favourable geographical position and possession of cheap labour.' The monthly minimum wage in Serbia is €307.67.

Conditions in Serbia. As reported by the Development Agency of Serbia: 'import into and export from these zones is free of VAT, customs and clearance. If goods are produced within zone using a minimum of 50% of domestic components, they are considered to be of Serbian origin and are therefore eligible to be imported into Serbian territory or exported without customs, pursuant to free trade agreements.'

Domestic economic benefit. The Free Zones Administration of Serbia report that the 15 free trade zones in Serbia have created 35,279 jobs, €3 billion in investments (since 2008), and €5 billion in turnover in 2018. However, the OECD is more sceptical of the benefits of the free zones: 'In Serbia, there are fewer advantages of operating in the zones and so it is not as obvious if the zones themselves are really making a difference in attracting FDI into the economy. Serbia has a fairly broad range of tax incentives independent of the presence in the zones.'

Applicability to UK. Serbia's economic success in tandem with its status as a candidate country for EU membership highlights the potential for the UK to effectively align with EU rules, thereby facilitating trade, while acting as an entry-point for businesses to the EU. However, the UK has refused to commit to regulatory alignment and it cannot offer cheap labour to the same extent as Serbia, though the UK provides a more favourable investment environment due to the financial sector in London.

THE UK'S VERSION OF A FREEPORT 2.0

The UK government wants its freeports to be 'national hubs for global trade and investment', 'promote regeneration and job creation', especially high skilled jobs and 'create hotbeds for innovation'. The innovation agenda is particularly emphasised: 'The Government intends for freeports to be dynamic environments which enable innovators, start-ups, businesses and regulators to generate and test new ideas and technologies across a range of sectors, from customs, to the aviation, rail and maritime sectors. This agenda could also see innovative solutions developed which could regenerate local areas or help deliver the UK's decarbonisation agenda.'

The Government wants to select up to 10 freeports across the UK, with one in each of the four nations. Freeport sites could be located inland as well as adjacent to ports, increasing the range of options for sites and potentially allowing existing manufacturing plants to be designated. There will be planning liberalisation to help bring more land forward for development, speed up the planning process and allow ports to respond more rapidly to new demands, for example by building new facilities.

The UK envisages that the freeport sites must usually be secure areas with perimeter fences. Facilities must be available so that Government agencies can inspect goods if necessary. Goods entering and exiting a site would need to be tracked via a records management system which can be viewed remotely by Government agencies. The key elements of a freeport will be as follows:

- Duty suspension: No tariffs, import VAT or excise to be paid on goods brought into a freeport from overseas until they leave the freeport and enter the UK's domestic market.
- Duty inversion: If the duty on a finished product is lower than that on the component parts, a company could benefit by importing components duty free, manufacturing the final product in the freeport, and then paying the duty at the rate of the finished product when it enters the UK's domestic market.
- Duty exemption for re-exports: A company could import components duty free, manufacture the final product in the freeport, and then pay no tariffs on the components when the final product is re-exported.
- Simplified customs procedures: The Government intends to introduce streamlined procedures to enable businesses to access freeports.

The Government is also exploring the creation of 'regulatory sandboxes' which can help to facilitate the trialling and testing of new technology and processes. The Government also acknowledges the need to prevent illicit activity. It mentions the OECD guidance on Countering Illicit Trade and Enhancing Transparency in Free Trade Zones and the Fifth Anti-Money Laundering Directive, both implemented in the UK, and proposes bringing art market participants including freeports into the scope of the Money Laundering Regulations for transactions exceeding € 10,000. The Government says it remains committed to tackling tax avoidance and evasion, aggressive tax planning and non-compliance.

CONCLUSIONS

Many economists would argue that the case for freeports is by definition a second best one. If tariffs are too high or regulations too burdensome, they should be lowered for the whole country. If, on the other hand, the level of tariffs or regulation is justifiable, why would they be lowered for one part of the country? In practice, therefore, the real case for freeports is in developing countries where either the customs administration is chaotic or regulation is too high/ dysfunctional, and there are political economy reasons why governments cannot change that for the whole country. That isn't the case for the UK.

In particular, the practical benefit of tariff inversion is likely to be minimal in the UK. When the Government's initial freeport consultation started in February 2020, it was not known what post-Brexit tariffs the Government was planning to introduce. Now that these tariff schedules have been published, it appears that the benefits of tariff inversion are likely to be negligible, because there are very few cases where tariffs on components are substantially higher than the tariffs on the final goods made with them. Put simply there is no tariff wedge to invert and so little economic case for US-style freeports.

The only groups that are certain to benefit from freeports in the UK are businesses (presuming they decide to relocate operations to the freeports) and high net-worth individuals. The disadvantages of freeports, by contrast, will be experienced more broadly in the UK due to the public cost of maintaining them, which will be exacerbated by the necessity of providing financial incentives for businesses to relocate to UK freeports. Proponents of freeports point to job creation as a justifier for these costs. But the capacity of freeports to create additional jobs is unclear.

The main impact of freeports - and any associated reductions in regulation - is therefore likely to be to relocate rather than create economic activity and jobs. That said, freeports in the UK could be a part of a broader industrial policy drawing on recent experience with enterprise zones. For example, they could be used to solve specific problems - perhaps attracting jobs to a lagging region, or focusing them on a specific sector which is particularly struggling due to tariffs, or in opening up new financing models for local authorities. But, as a general policy tool, it is doubtful that they can lead to the sort of transformation that the Government seems to be hoping for. And some key problems with freeports need to be borne in mind in designing the policy framework around them.

Since freeports are very much on the agenda, for areas of deprivation being awarded a freeport would be a boost. But the more the Government advocates the benefits, the more disappointment there will be for those regions which miss out - and the more they risk losing out to areas which are awarded a freeport.

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