THE FUTURE OF FREE ZONES IN THE UK

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Since the EU referendum, there has been a growing interest in the reintroduction of free zones in the United Kingdom. Those advocating free zones believe that they will help to boost British trade after Brexit and promote economic growth.

WHAT ARE FREE ZONES?

Free zones (alternatively known as free ports or free trade zones) are designated areas of a country, which are inside the geographic boundary of that country but are considered to be outside of that country for the purpose of import duties. Free zones facilitate trade by allowing fewer customs formalities for goods from the rest of the world. Goods that are imported into the free zones do not incur usual import procedures on entry and exit, and import duties are not payable until these goods are released for free circulation in the domestic economy (or used or consumed within the free zone). Businesses operating in free zones are offered the following benefits:

- Savings in tariff inversion when intermediate goods can be imported tariff-free to a free zone, processed and sold as a final product that incurs lower tariff rates;
- 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);
- Simplified customs procedure;
- Added security from the perimeter fence enclosing the free zone.

FREE ZONES IN THE UK AND EU

UK free zones were in operation from 1984 – when areas of Birmingham, Belfast, Cardiff, Liverpool, Prestwick and Southampton were designated to become the UK's first free zones – until July 2012, when the UK stopped renewing the licenses for free zones. Prior to 2012, there were five free zones in the UK located in Liverpool, Prestwick, Sheerness, Southampton and Tilbury. Technically not part of the UK nor the EU, a free zone is currently in operation on the Isle of Man.

Within the EU, there are currently 80 free zones located across 21 EU Member States. These pertain to 'control type I free zones', which are an enclosed geographical area (with a perimeter fence) instead of a building or premises, and where goods placed within the area are checked by the customs authorities upon entry and exit.

In the EU, there also used to be 'control type II free zones' – where physical control of goods placed within the zone was done on the basis of stocktaking (rather than at entry and exit points to the zone) and additional physical inspections. But as of 1 May 2016, these were re-classified as customs warehouses (also called bonded warehouses) due to the application of the EU's Modernised Customs Code (see Article 288(2) of the Union Customs Code).

RULES ON THE OPERATION OF FREE ZONES

Operations of free zones must be compliant with EU state aid rules. This is because tax exemptions and financial incentives offered to businesses choosing to locate in these zones can, in principle, be considered as a state subsidy that distorts competition – and would be in breach of the Treaty on the Functioning of the European Union (TFEU).

The requirement for compliance with EU state aid rules constrains the options for free zone operations, but exemptions may be granted under Article 107(3)(a) and (c) of TFEU, whereby the use of state aid is considered beneficial to the economic and social development of underdeveloped regions of the EU (for example, aid for regional development, promoting innovation, improving environmental standards and assistance to small and medium-sized enterprises).

Even free zones in non-EU countries operate under some form of state aid control. First, free zones are bound by the obligations in the WTO Agreement on Subsidies and Countervailing Measures. Second, free zones located in countries that have preferential trade agreements with the EU are often subject to EU state aid rules. This is because EU trade agreements usually contain some provisions on state aid control, as a condition for improved access to the EU Single Market, particularly for accession countries.

POSSIBLE FREE ZONES SAVINGS

Free zones are often driven by the desire to avoid higher tariffs on inputs than final outputs (i.e. tariff inversion savings). US automotive is one industry sector where tariffs on inputs are higher. For example, due to inverted tariffs, a Volkswagen plant in Tennessee was estimated to save $1.9 million – or $13 per car – on producing 150,000 cars annually in Foreign-Trade Zones [1].

This issue is less significant for EU tariffs or likely UK tariffs. For example, in the motor vehicle sector EU tariffs are not inverted: importers of automotive parts face lower tariffs (4.5%) than importers of final cars (10%). The EU is, in fact, more often accused of tariff escalation rather than inversion.

The possible savings in tariff inversion will be eroded further if the UK Government was to go ahead with its proposal to liberalise most MFN tariffs to zero in the event of a 'no-deal' Brexit. The UK Government proposal would see 87% of UK imports (by value) enter the UK duty free.

Alongside possible savings there is also a question of costs: will it cost businesses more to store goods in a free zone? On the one hand, storage costs will be incurred by businesses regardless of whether goods are stored in a free zone or elsewhere. On the other hand, it is possible to argue that storage costs will be higher in a free zone: because of the added security.

CONCLUSION

Free zones should not be seen through the prism of post-Brexit opportunities as a tool that – unfettered by the EU state aid rules – can deliver a major boost to economic growth potential after Brexit. This is for the following reasons.

First, when tariffs are low the direct benefits of free zones are small. Although there are potential benefits and savings that businesses can accrue from simplified customs procedures, plus relief on customs duties and tariff inversion, we believe that such benefits will be limited in the UK context. Second, after Brexit has occured, free zones in the UK would still be subject to WTO Subsidies Agreement rules and to any commitments to EU state aid rules under 'level playing field provisions' and UK free zones would certainly be included in any post-Brexit trade deal. Third, policy impact evaluations often suggest that the net benefit of free zones is limited. The US experience is not very illuminating: while there are many jobs in the US Foreign-Trade Zones, there is little evidence of how many are net creations.

The overall conclusion would seem to be that while some form of free zones could help with shaping export-oriented and place-based regional development programmes, policymakers should devise measures that (i) counteract possible diversion of economic activity from elsewhere, and (ii) offer a set of incentives wider than just free zones, while keeping within the WTO and any 'level playing field' obligations that arise from our trade agreements.

REFERENCES

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ABOUT THE ORGANIZATION

The UK Trade Policy Observatory (UKTPO) is a partnership between the University of Sussex and Chatham House. Created in June 2016, the UKTPO is an independent expert group that initiates, comments on and analyses trade policy proposals for the UK and trains British policy makers, negotiators and other interested parties through tailored training packages.

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