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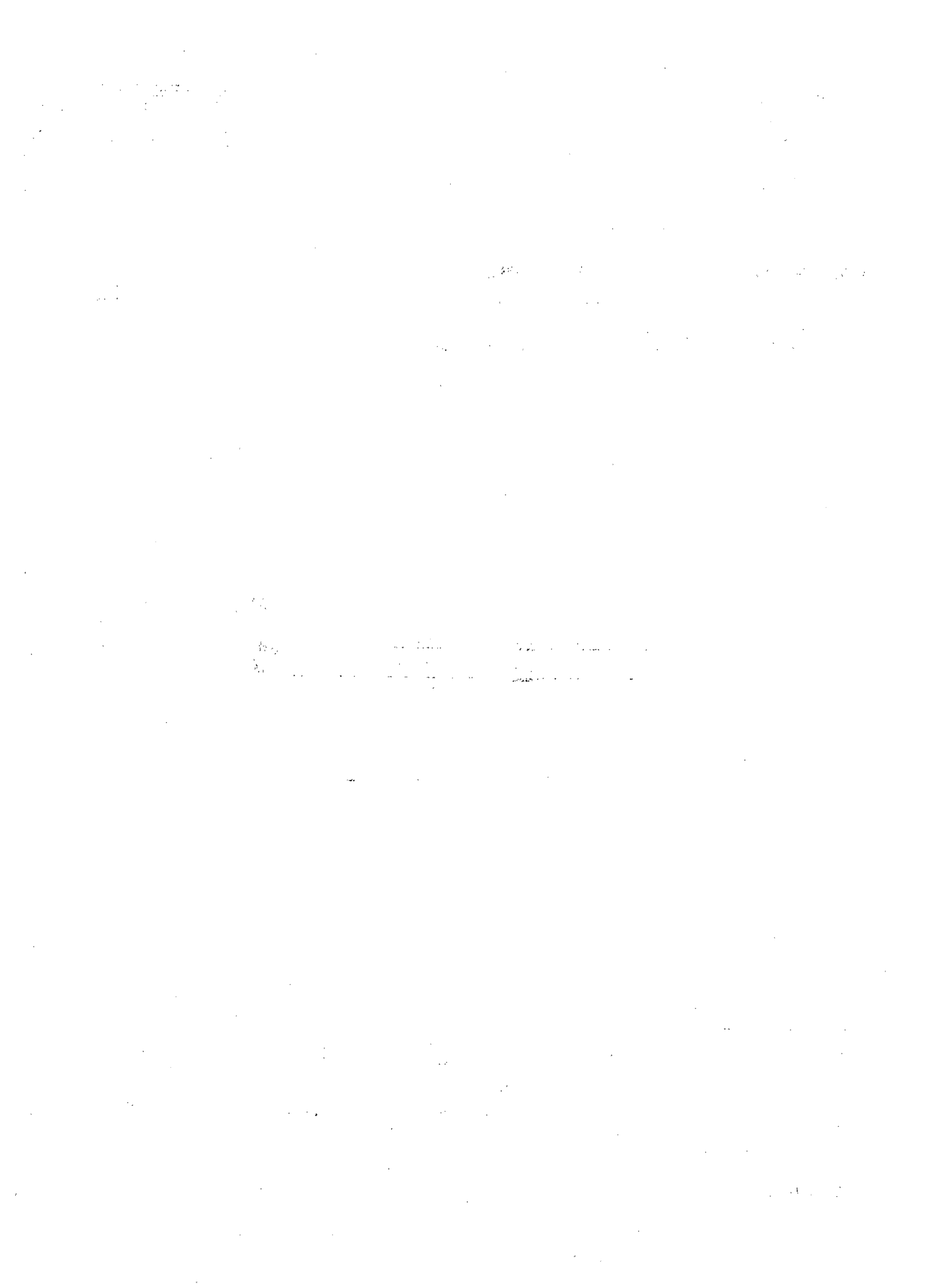
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FREE TRADE ZONES AROUND THE WORLD AND THEIR USE FOR
EXPORT-ORIENTED INDUSTRIAL OPERATIONS

INTRODUCTION

The purpose of this training workshop is to discuss the use of free trade zones as incentives to the establishment of export-oriented industries. It is a response on the part of UNIDO to an increasing interest in the use of customs exemptions as a means of inducing foreign capital investment. Among the general objectives in the interested countries are the creation of job opportunities, the increase of foreign earnings, the training of labour and management, and the improvement of the national industrial and technology base.

The choice of customs free zones as a tool for helping accomplish this involves an evaluation on a country-by-country basis as to its potential effectiveness. Usually it will be found that customs privileges are productive only in conjunction with other incentives because businessmen making substantial capital investments will consider the overall climate for investment regardless of the attractiveness of a specific programme. Thus, such matters as guarantees against nationalization, treatment of earnings, exchange rates, income and property tax treatment, and the country's general attitude toward foreign business will be looked at in addition to customs considerations. My point here is that generally we cannot expect a programme based on customs privileges alone to generate the establishment of desired industrial operations on a significant scale. But, neither can we ignore the fact that in some cases the customs exemptions may make the difference.

Once it has been decided to use customs privileges, the question becomes one of picking the appropriate type and determining the scope of its application. A decision should not be made until there has been an overall review of the national customs system, taking into account its objectives and how it is administered.

Where controls exist primarily for raising revenue, duty exemptions would be considered essentially as a form of tax relief. On the other hand, if the controls are intended to protect domestic industries, other more complex considerations follow.

If I may generalize, in choosing a means of granting customs privileges the use of free zones would be appropriate where the benefits are to be limited to certain types of industries and where it is desired to have the operations located in specific areas for purposes of port or regional development, or for customs control. In some cases it might be found appropriate to add customs privileges to other exemptions already available under existing economic development programmes.

CUSTOMS PRIVILEGES - GENERAL

The use of customs privileges as a means of stimulating desired economic activity is by no means new. It is as old as customs controls themselves, for the human mind naturally and inevitably seeks to avoid constrictions on its conduct. Thus, as long as there have been limitations on the right to enter the goods of one country into another, there have been efforts to avoid the controls by legal and illegal means. Needless to say, any programme that seeks results through legal exemptions assumes the existence of effective controls against achieving the same results by illegal means.

Customs exemptions have been effectively used as economic stimulants throughout the history of commerce. The prosperity which unrestrained trade, fostered by free port status, brought the Hanseatic cities is described in just about every textbook on commercial history. Of course, the complexities which the industrial revolution imposed on world trade brought an end to the widespread use of the "free port" concept, though the idea has continued on a more individually limited, but more widely used, basis in the form of "free trade zones."

Before talking about the various types of customs privileged zones that are in existence today, I perhaps should briefly cover some common procedures for customs exemptions that have no geographic characteristics. By that I mean those that are available as an inherent part of national customs administration and not limited to specific areas or zones.

Rebates on Exports

Particularly in those countries whose customs duties exist for the purpose of protecting domestic industries, we usually find a procedure for the rebate of duties paid on raw materials and components used in products that are exported. In the United States this procedure is referred to as "drawback". Many feel that duties in such cases should be reimbursed as a matter of equitable right.

A problem with drawback, as with any rebate procedure, is that, to protect against fraud, detailed record keeping is required and a lot of "red tape" is involved, making lengthy delays common.

Bonded Procedures

Another way of providing exemptions from normal customs requirements is a bonded procedure that permits the storage, manipulation or manufacture of foreign merchandise prior to formal entry. A security bond is posted under this procedure to insure that duties are paid if and when goods enter the domestic market. Customs officials approve the bonded facilities and supervise certain operations. This procedure makes Customs exemptions available on a country-wide basis. Regulatory provisions as to the types of operations permitted and procedures to be followed are specific enough so that the programme can be administered with minimal policy-level involvement. Importers feel that such procedures are called for in a customs system designed to protect domestic industries, as there is no real import impact until foreign goods actually enter the domestic stream of commerce. In the United States bonded procedures are limited primarily to storage

and certain manipulations, through manufacturing under bond is permitted if the product is to be exported. Goods may be stored in bond for up to one year, though extensions can be requested in some cases for up to two more years.

Bonded procedures are also used in connection with the transportation of foreign merchandise after it reaches a country in which it will not be formally entered immediately upon arrival, either because it is in transit to a third country, or destined for a bonded warehouse or free trade zone. When goods arriving from abroad cannot be directly unloaded at a zone, a bonded procedure is used by customs to supervise transportation from the arrival point to the zone. The cargo is sealed by Customs upon arrival and the seal broken under Customs supervision when it gets to the zone.

In addition to the exemption procedures I have just referred to, some countries have administrative licensing provisions for exempting foreign materials from duties based upon their end-use.

FREE TRADE ZONES

Free trade zones, which can be considered decedents - or remnants, if you will - of the "free ports" of the pre-industrial age, are the most common type of customs privileged areas found in use today. There are about 70 in operation around the globe.

Before talking in more detail on such zones, I would like to briefly allude to some other kinds of customs privileged areas presently in existence.

Zones that are preused to handle goods destined for third countries which are inaccessible to ocean ports of entry are referred to as "transit zones" or "entrepots." There are about 15 of these in operation, mostly in Africa and Latin America.

Another type of customs privileged area that is used by countries wishing to attract business investment to vast isolated or undeveloped areas is the "free perimeter". A number of these are found in Latin

America in the countries of Argentina, Chile, Colombia, Mexico and Peru.

Mexico has a unique programme that makes a 30-mile strip along its northern border a customs free area to encourage industrial and assembly operations. This programme benefits from the provisions of U.S. Customs law that permit domestic goods assembled abroad to be returned with duties paid only on the foreign value added.

The "free port" concept is still in use, but on a limited scale where special geopolitical factors exist. Examples are Hong Kong, Singapore, and Gibraltar.

Customs control is obviously a greater problem in administering free port or free perimeter programmes as these areas cannot be as physically secure as free trade zones.

FREE TRADE ZONES - CHARACTERISTICS

A typical "free trade zone" is an enclosed facility, under Customs security supervision, situated in or near an international port and into which foreign merchandise, not otherwise prohibited, may be brought without being subject to formal Customs requirements. The merchandise can usually be stored, exhibited, processed, or used in zone manufacturing operations, without being subjected to duties and quotas unless and until the goods or their products enter the Customs territory of the zone country. A zone might occupy only a warehouse building, but more often it is a fenced-in industrial park type facility covering a few or many acres.

Sometimes zone customs privileges are extended to capital equipment and machinery brought into a zone for use therein. Rarely are they extended to consummables.

Ordinarily the consignee of foreign merchandise can choose between having duties and quotas imposed on the goods in the condition in which they arrive in a zone or in the condition they enter customs

territory. When the former choice is made under United States zone procedures the lot is classified as "privileged" merchandise. If the goods are altered in manufacture or another process, a calculation is made as to the amount of the original merchandise that turns up in the finished product and a duty is paid on that amount at the originally fixed rate. Provision can be made to have any waste destroyed under Customs supervision. If anything that is salvagable is entered into the domestic market, duties are paid on its value as scrap.

The zone privilege would not ordinarily extend to retail transactions. These are normally carried on under separate procedures referred to as "duty-free shops".

Some zones permit the establishment of supporting activities related to the conduct of international trade such as consulting and financial operations, exempting them from regular national licensing requirements. This is more likely to be the case in zones that function as large-scale industrial parks primarily for manufacturing and assembly operations for export.

Of the general purpose free trade zones in operation today, the ones at Copenhagen and Hamburg have probably served as models more than any others. This is likely because of the historical role of these cities in international trade and the longevity of their zone programmes. At the present time, however, the zones at these two cities are not primarily involved with manufacturing operations.

MANUFACTURING IN ZONES

Thus far I have talked about customs exemptions and the free trade zone as one means of granting such privileges on a limited geographic basis. Now I would like to focus on manufacturing in zones.

The zone concept offers a means of providing customs privileges on a restrictive basis to desirable industries willing to locate within the zone and to produce under certain conditions that are

designed to negate the threat of economic injury to domestic industries not located within the zone and to help fulfill economic development objectives.

Where the locational requirement is not important there is, of course, the alternative of using special bonded procedures instead of zones, so that the privileges are available wherever plants are located. It appears that a number of countries, including the Benelux countries and Japan, have used this means of granting customs exemptions to manufacturers rather than zones.

Naturally, the more industrialized countries are more restrictive in permitting manufacturing in their zones. This is apparent from an examination of the zone laws and regulations of European countries, which either prohibit zone industrial operations altogether or require special permits on a case-by-case basis.

Developing countries, on the other hand, tend to have general guidelines as to the types of industries that may be established in their zones so that ad hoc approvals are not required at a high government level.

Manufacturing in U.S. Free Trade Zones.

In the United States manufacturing is permitted under both zone and bonded procedures, but, as I noted earlier, under the bonded procedure all primary products must be exported.

Under U.S. zone law, manufacturing was not permitted in zones until 1950. Incidentally, U.S. zones are called foreign-trade zones. While there are no specific limitations concerning types of industries and restrictions against importation, the Foreign-Trade Zones Board which administers the zone programme, is responsible for considering the impact on domestic industry of zone manufacturing operations. The Board is chaired by the Secretary of Commerce and the Secretary of the Treasury is a member so that the business and

balance of payments impact of zone operations is naturally taken into account in the consideration of applications for new zones and zone operations. Obviously, export-oriented operations are encouraged. Ongoing operations are reviewed periodically, as the Board retains the authority to halt any zone operation that it finds against the public interest.

In administering zone programmes that permit manufacturing for import as well as export, it is important to take note of the special legal significance of zone manufacturing. In such cases the original foreign goods lose their identity and a new product emerges. The origin of the new product is the zone country and not the countries from which the raw materials and components were exported. Thus, to ensure that zones are not used to circumvent duties and quotes, it should be made clear in the regulations governing zone procedures that any merchandise coming into a zone is subject to both duty and quote restrictions either in its condition upon arrival in the zone or in its now manufactured condition, if and when it enters customs territory.

EXPORT MANUFACTURING ZONES

One approach that has been used in recent years by some developing countries to stimulate industrial development which does not compete with local industries is the establishment of industrial park facilities for export-manufacturing operations. In addition to making available general tax benefits on the basis of how desirable the manufacturing operation is to the national economy, the industrial park functions as a free trade zone providing Customs exemptions to all firms using the zone.

There are probably less than 10 of these special export-oriented zones presently in operation around the world, most of them located in Asia. The most well known probably are at Kandla, India, Kaohsiung, Taiwan, and Masan, Korea.

Kaohsiung's Export Processing Zone which is 5 years old, covers some 170 acres in the city's port area on the south coast of Taiwan. Over 42,000 workers are engaged in manufacturing and processing operations in over 150 factory buildings within the zone which is used mostly by foreign firms who exported \$180 million in goods last year. A tax relief schedule is set up based upon the contribution which different types of industries will make to the local economy. Besides customs-free access to foreign raw materials and semi-processed products, the zone users are allowed to bring in their capital equipment duty free.

The Kandla zone is located on a 342 acre tract about 6 miles from the port city on India's northwest coast. This zone is not yet fully developed from the standpoint of transportation, utilities, and other services. Expectations that zone users would help develop the infrastructure for the facility have apparently not been realized.

Korea's free export zone at Masan is intended to offer an attractive investment climate to encourage export manufacturing and processing operations. Port and servicing facilities are still under construction at the zone which covers some 440 acres. The usual zone customs privileges are provided and plant sites and buildings are available for lease or purchase. Zone firms are considered public utilities for purposes of handling labour disputes.

Another export manufacturing type zone is presently being established in the Philippine's island of Bataan at Mariveles.

There are some industrial park zones around the world that are not legally restricted to export operations, but which nevertheless are primarily involved in export oriented operations because of the workings of purely economic forces. This comes about, for example, in zone countries whose domestic market is surpassed by other larger nearby markets. During this training workshop you have undoubtedly heard much about two such zones: Ireland's Shannon Free Airport and Panama's zone at Colon.

Ireland's zone is unique in that most of its cargo comes and goes as air freight. Of the \$115 million in zone exports last year, over 90% were shipped by air; and 75% of the zone's imports arrive by air freight. Most zones, though, operate in conjunction with ocean transportation terminals.

In some countries we find industrial free trade zones that produce primarily for the local market. In such cases there can be a benefit to the local economy to the extent that the goods produced or assembled in the zone might otherwise have been imported as finished products. One example of such a zone is Colombia's Barranquilla Free Trade Zone. This industrial park zone covers 250 acres at the city's ocean terminal. Over 2,000 firms use the zone and 800 persons are employed. It has been in operation for 8 years. Until recently the zone was used mostly for the storage and processing of imports, but Colombia's present policy is to encourage manufacturing operations for export.

U.S. FOREIGN-TRADE ZONES

There is only one zone in operation under the U.S. zone system that functions entirely as an industrial park. This is the zone located at Mayaguez on Puerto Rico's south coast.* The zone is operated as a part of the Commonwealth's economic development programme. It is unique under the U.S. system because Puerto Rico, while within U.S. Customs territory, is not subject to federal taxes. Thus it can offer business firms tax benefits not available in the United States itself. The zone presently covers 35 acres, but there are plans for expansion to 50 acres. Firms either rent or buy standard industrial plants. Last year \$3 million in goods were shipped from the zone, most of them to the U.S. market.

In all, there are 8 zone sites presently in operation under U.S. law. Other than the zone at Puerto Rico, there are zones at New York, New Orleans, Toledo (Ohio), San Francisco, Seattle, and Honolulu. All but two of these facilities function primarily as staging area type zones having one or two warehouses with additional

fenced in open space. They are engaged in storage, repacking, inspection, processing, and some light manufacturing operations.

The only facility other than Mayaguez that is used solely for industrial purposes is a zone site at San Francisco, operated by a clothing manufacturer, and administered as a subzone to the City's general purpose zone. Two other subzones, so called, which are operated in conjunction with the New Orleans and Mayaguez zones relinquished their zone status during the past year.

The subzone is a unique evolvement under the U.S. zone statute that in a legal sense amounts to a form of noncontiguous expansion. A usual characteristic is that it involves the plant of a manufacturer. To get subzone status a strong case must be made that customs relief is necessary in the public interest and there is no other practical way of making it available. An example would be where an operation would be conducted outside the country were it not for the availability of the zone privilege.

While manufacturing operations do not presently constitute the major part of operations in U.S. zones, there are many projects under study that would involve the use of the zone privilege for manufacturing operations that would stimulate economic development in inland areas of the United States. Two of these areas are Kansas City, Missouri, and Little Rock, Arkansas.

CONSIDERATIONS IN ESTABLISHING A FREE TRADE ZONE PROGRAMME

It would be difficult, if not presumptuous on my part, to suggest a framework for zone systems wherever they are to be located, but there are, I think, some considerations that have general application.

First, the enabling legislation should clearly set forth the purpose of a zone programme and provide a clear delegation of authority to the administering agency, with guidelines that are rather specific with respect to permissible manufacturing operations. The statute should indicate under what circumstances, if any, imports are to be permitted from the zone into the zone country's customs territory.

Authority should be retained at a high level to review unusual proposals and those that might have an adverse impact on the domestic economy. The law ordinarily should not permit any rights to vest in zone users concerning the customs privilege itself.

The statute should indicate what limits there shall be as to the number, location, and type of zones. For example, the administering agency might be authorized to itself establish a zone or zones, or it may be empowered to authorize qualified corporations to establish zones under certain circumstances and in certain locations. Under U.S. law the Foreign-Trade Zones Board, instead of establishing zones itself, has the authority to license (grant) corporations, which have been qualified by the legislature of the state in which the zone would be located, to establish and operate zones. Zones have to be located in or near U.S. Customs ports of entry.

The administering agency should be one which has a function relating to the primary purpose of the zone. Thus, if a zone programme is designed to induce capital investment in the form of industrial operations, an agency concerned with economic development might have the primary administrative responsibility. The role of other agencies, such as the customs and transportation agencies should be set forth, though normally Customs would have broad authority concerning security and entry procedures.

The regulatory framework set up by the agency should favour those industries that will contribute most to the domestic economy. Thus judgments have to be made on such matters as whether the industries should be highly technological or labour intensive, whether they will be encouraged to use any domestic raw materials or components, whether local business participation is to be encouraged, and how much training there is to be for local management and labour.

Non-customs benefits for the facility have to be decided on and enumerated. There should, of course, be coordination with other agencies such as those involved with tax and labour matters.

In planning a zone there has to be thorough consideration given to physical requirements. Ordinarily a zone will not attract industry unless there is an adequate basic infrastructure. The transportation network, utilities, port facilities and services, zone structures, security and administration, are all factors to be considered. In some cases the zone users might be so attracted to the area for economic reasons that they will help develop the port and zone facilities. If they are allowed to put up their own facilities there should be standards and stereotype building plans available.

As with any programme of this type, of course, it is most important to provide for sound operational management and a good promotional programme.

Last, but not least, any country setting up a zone programme, especially one that will attract manufacturing, has to consider its international commitments. Clearances would probably be necessary where a country is a member of a free trade area that involves economic and monetary commitments as well as a customs union such as the European Community. It is not clear in my mind whether membership in the GATT or trade groups such as EFTA and LAFTA would require consultation prior to the establishment of a zone system such as we are discussing.

CONCLUSION

There are a few observations I would like to make in conclusion. We are concerned here about the use of zones for creating special privileges for selected industries. In return there should be a tangible public benefit. Otherwise we are placing the non-zone industries of the country in an unfair position.

The amount of special benefits given beyond customs privileges should be measured in terms of what is necessary to get the desired capital investment and keep it. Further, to insure that the operations become more than temporary camping treks, there should be an effort

To attract industries that will have a real comparative advantage in the international market as a result of their locating within the zone country. I need not dwell on a consideration that should underlie any industrial development programme and that is that the social goods should not be forgotten.

Finally, it is a good practice whenever one talks about free trade zones to make clear that these zones, when properly administered, are not loopholes in a customs system. Any foreign goods or products that enter customs territory from a zone are treated essentially as if they came directly from abroad. A zone can serve to attract commercial and industrial operations that a country would otherwise have lost for non-economic reasons relating to inflexible customs requirements.

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- * Another industrial park type zone was approved by the Foreign-Trade Zones Board in 1970 for McAllen, Texas, on the U.S.-Mexican Boarder. The project was financed in part with federal funds as a public works activity designed to stimulate economic development of the area.