



TOGETHER
for a sustainable future

OCCASION

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1. The question is more and more frequently asked "why are Free Zones established?" There is even concern in some quarters that too many such zones will produce harmful effects by causing unnecessary competition between zones, either for potential investors or for the same export markets.

2. Firstly, providing developing countries take proper professional advice, they are not likely to start an "incentives war". This advice, however, is not very widely obtainable, except from a very few operating Free Zones themselves (most are too busy to spare staff as consultants), from the UNIDO on Industrial Free Zones and the UNCTAD as commercial zones, a few consultant firms who have undertaken contracts to assist established free zones in certain aspects of management, re-organisation or market research, are also able to provide assistance, usually in collaboration with UNIDO or operating Industrial Free Zones.

3. Secondly, the total exports of existing and predictable free zones are unlikely to reach such large proportions in most categories that long-term action is likely to be taken to protect the markets of developed countries against such exports. There are of course, well known exceptions of quotas on "sensitive" items.

4. Perhaps the most significant factor is the number of free zones which already exist under the names of "off shore operations", "free ports", "free industrial zones", "border free zones" and so on.

5. Before defining the various types of non-industrial free zones, we should explain that at UNIDO we are receiving a growing amount of requests for technical assistance on industrial free zones. We therefore know that the tendency towards this method of industrial development is increasing, although there are some doubts expressed in certain quarters, which we shall deal with here.

6. It is feared that free zones could become artificial enclaves within countries, with no relation to the economy, and based on import of all components and export of all finished goods. Free Zone Authorities try to establish domestic suppliers and encourage their investors to buy locally. Encouraging forward linkage is more difficult, as usually no Free Zone products are allowed on the local market. If, however, local producers have to re-import such components to complete their product, an exception should be made.

7. Another fear largely due to ignorance of Free Zone legislation is the general fear of "exploitation". In short, legislation lays down investment terms and controls investors operations in a way that general investment cannot. The investor is bound by his contract to observe the Zone regulations.

8. Another anxiety is over the number of free zones now developing. First, it should be pointed out that in many countries more Zones open as existing ones fill up. In Malaysia eight are planned, in Colombia at least five and so on. This shows that such zones are limited in size and output and often are specialized in one field only. Their total production is nearly always confined to light industry, and is unlikely to become a large percentage of the imports in any one industry in any one importing country, simply because developing countries and therefore their free zones, are relatively small compared with the industrial production of most developed countries. (One exception to this is electronic components which benefit from US Tariff Schedule 806.30 and 807.00 which are produced in large quantities in Industrial Free Zones and exported to the USA).

9. Finally, reservations are sometimes expressed on the situation which would arise if several industrial free zones in one area all competed for the same investors and markets (This is actually the situation in electronic components in Asia. Demand is so large, however, no harmful effects have been observed). Usually, planners are wise enough to see such dangers and provide for them by ensuring that their free zone will specialize in a different type of industry or industries than those in the region. One purpose of this meeting in Barranquilla is to point out the possible dangers of lack of co-ordination between free zone planning authorities. This could result in free zones trying to attract investors in the same industry in a market, which, unlike electronics, could not support too many producers. Solutions will be offered during the meeting by officials from operating zones.

10. On the question of nomenclature, many economists are unaware of the difference between the different categories and tend to lump all such operations as tax-havens, mere storage "free zones" or "zones franchises" together with commercial and industrial free zones. Some definition is required to eliminate those operations of less interest to developing countries whose main interests are in creation of employment and the encouragement, with suitable controls, of export-oriented foreign manufacturing operations.

11. Tax-havens. These operations, very often based on small islands, are mainly aimed at tax-avoidance often without any investment or more than nominal clerical employment. Multinational companies and shipping companies often use this device to lower tax liabilities.

12. Storage Free Zones. These zones are often set up at frontiers, or at port areas so that importers of largely consumer hardware; automobiles, trucks, domestic machinery, etc., can build up stocks free of import duty or other taxes. Little employment is created except for the staff who make out invoices, security guards and similar jobs on a small scale.

13. In some developed countries such zones are, however, developing to quite large operations, for example at airports where large-scale storage facilities are available. This enables manufacturers to speed up domestic distribution, especially by air, and two large operations are expanding fast at two airports in Texas, USA.

14. Free Ports. Such zones are very often a part of a harbour area where both imports and exports are stored without incurring any tariffs or taxes. As customs free areas develop and the cost of land near harbours increases, however, it becomes less and less economic to use such areas to manufacture or even assemble.

15. Some free ports are in fact trans-shipment points where goods are temporarily stored before onward or inward shipment.

16. Offshore Operations. This term is vague, and is used to cover free ports, commercial zones, and also real manufacturing industrial free-zones. It is a somewhat suspected phrase, especially by Revenue officials as it implies tax-evasion if not exploitation of low-cost labour as well. Essentially, it refers to operations carried out in an area exempt from normal taxes and tariffs.

17. Border Free Zones. Such zones have mushroomed in areas where a developed country (with high cost labour) borders a developing country. Manufacturers with labour-intensive processes take advantage of the lower wages to establish subsidiaries, and often tax advantages are given, sometimes without proper planning for control.

18. Smuggling is also an unfortunate feature of such zones, since evasion of duties on goods taken into the developing country's domestic market is all too easy.

19. So far, such border zones have more often spring up spontaneously than been carefully established following suitable legislation.

20. Commercial Free Zones. These zones often contain only trans-shipment and storage facilities with no manufacture. Some do combine trans-shipment and bulk breaking operations with manufacture.

21. Again, unfortunately some such zones are notorious as centres of smuggling, which has given an air of illegality to the phrase "free zone". The reason is that the owners of the goods stored are usually not nationals of the country operating the zone and are therefore not scrupulous about paying import duties. Not only do goods "leak" on to the domestic market, but orders are often accepted for export "duty-free" and are shipped so marked, to evade import duties in the customer's country.

22. By no means all commercial free zones permit such manipulations, and where manufacture takes place as well, the Customs controls are usually more thorough. This is because the host country must keep some check on raw materials imported in order to ensure that they are properly exported.

23. This raises another point of concern to Revenue officials. Where zones are "mixed", i.e. part commercial part industrial, it is more difficult to ensure that all imported raw material is exported. In a purely Industrial Free Zone, it is usual that all imported raw materials, imported duty-free, must be re-exported. No sales are allowed to the domestic market, except under exceptional circumstances, and after paying duty.

24. Very often the products are mainly unsuitable for sale in the domestic market, e.g. semi-conductors, electronic parts, etc., for which there is little or no local demand.

Definition of Industrial Free Zones

25. Industrial Free Zones are those established since 1958 for the declared purposes of creating employment, and attracting foreign investment by offering a "package" of incentives. Investors main activities are manufacturing or industrial assembly. Income does not usually cover the cost of such zones which often require a subsidy. However, the host government eventually recoups the investment in terms of employment, contributions to the balance of payments, and taxation on wages, salaries and profits.

26. In effect the successful zones are export promotion incentives which are effective.

27. The creation of zones is the result of several demands; from developing countries for employment, foreign exchange and technology; from developed countries, for economic labour in stable, organized circumstances. The resultant demand force is very strong in labour-intensive industries, particularly electronic components, and to a lesser degree in garments, textiles, toys, metal products, and so on.

28. Information on the types of industry which are attracted to industrial free zones is only now being researched and analyzed.

29. Such industry is usually labour intensive and often resembles subcontract operations in that only a part of a sophisticated machine is assembled in the industrial free zone. In some industrial free zones, the bulk material, e.g. textiles are shipped in, made up in the industrial free zone and continue on to their export market.

Industrial Free Zones in Asia

30. So far most industrial free zones are located in Asia and vary in type. Some are "mixed", in that they are basically industrial estates serving the local market, but have a section which contains often foreign owned, export-oriented producers.

31. Many of these producers are joint ventures, depending on the host country's policy.

32. Although industrial free zone development in Africa, the Middle East, Central and South America is likely to be different in form, certain indications can be taken from the experience in Asia. This experience can be a guide for other developing countries.

33. This breaks down into:

I. TYPES OF INDUSTRY.

II. TYPES OF INVESTMENT REGULATIONS.

III. PATTERN OF DEVELOPMENT - FORWARD + BACKWARD LINKAGES.

I. TYPES OF INDUSTRY

34. A new industrial revolution has taken place almost unnoticed in Asia in the production of products for the electronics industry in industrial free zones. The semi-conductor industry alone is evidence of this, due to its enormous value, and to the fact that such labour intensive work is required to assemble the semi-conductors, for which demand increases at a staggering pace.

35. This factor alone justifies the prediction that industrial free zones will spread from Asia to many developing countries in Africa, the Middle East, Central and South America. Already over twenty US firms assemble semi-conductors in the Caribbean area.

A. Semi-Conductors

36. These are used in a wide range of electronic products: industrial - computers, telephones, military equipment; consumer- television, radio..

37. Now worth billions of dollars every year, much of it produced in free zones, the industry began only in the 1950's in the USA with transistors and diodes. The first industrial free zone was established at Shannon, Ireland, only in 1958. Others followed mainly in Asia, in the 1960's, but few achieved real success except in Hong Kong, Puerto Rico, Korea, Singapore and Taiwan. In the 1970's, industrial free zones have spread to Malaysia, Mauritius, Mexico, the Philippines, Singapore and India. Plans are far advanced for industrial free zones in Cyprus, the Arab Republic of Egypt, Fiji Islands, Indonesia, Senegal, the Caribbean and Central America.

38. In many other locations interest is being revived and commercial free zones and free ports are being converted to industrial free zones. largely because of the huge increase in demand for semi-conductors and electronic parts.

39. There are already three "generations" of semi-conductors, although all three are still in use:

a. Discrete: transistors, diodes, rectifiers;

b. Integrated Circuits (IC) = sets of discrete devices e.g. monolithic digital IC, linear IC;

c. Large scale integration (LSI) = hundreds of IC together.

40. Basically they enable manufacturers to miniaturize, to shrink a product like

a radio to cigarette pack size or to increase computer speeds and flexibility a thousandfold.

41. Why is this enormously profitable industry carried on to often in industrial free zones and not in the plants in the USA and Japan, from where the technology stems?

42. The answer lies in the steep increase in labour costs since the 1960's in the USA and Japan and in the factor that in this industry it is vital to obtain a market share quickly by using "marginal costing" i.e. pricing below cost in anticipation of volume sales.

43. Thirty-two US companies are now producing semi-conductors in Asia alone. (In 1971 only 14 were producing). This represents over 70,000 jobs. Nineteen Japanese and four other firms employ 20,000 more. Thus, in three years, this industry alone has created over 90,000 jobs in Asia alone.

44. Another significant fact is that employment in Hong Kong has not increased much, due to its higher wages, and as a concomitant, producers are searching for low cost labour in more developing countries and looking for industrial free zones to achieve this.

45. The danger here is that developing countries may not be ready to accept and control this influx of investment and may even allow excessive privileges by being unaware of the demand for low cost labour.

46. Geographically, in 1971 most investors were producing in Hong Kong, Taiwan, Singapore and (mainly Japanese firms) in Korea.

47. (Other locations are now mainly the Caribbean, Ireland, Italy, Mexico, Portugal and Scotland.)

48. Who are these investors?

49. The market is dominated by US and Japanese multinationals with European firms increasingly active.

50. Texas Instruments, Fairchild and Motorola control between them about 2/3 of the US market, although they have over 30 competitors. Basically US laws view "off shore operations" i.e. production in industrial free zones as a domestic operation rather than a separate (foreign) company.

51. For approximately the same reasons almost all Japanese investment is in Korea.

The future of the Semi-conductor Market

52. Electronic News, New York, May 1973 figures are:

1973 (Billions/US Dollars)	1976	1980
2.9	3.9	6.2

53. Growth is assured but the growth of local support industry in host countries has to be encouraged by shrewd legislation otherwise exports continue to be mainly parts only. Forward and backward linkages must be planned at the time when investment is permitted since otherwise the multinationals who control the industry will naturally continue to export non-finished goods which attract lower import duties in their own countries.

54. This is a very important field in which UNIDO has a vital part.

55. Many governments in developing countries are not sufficiently aware of the above factors, which are more complex than described above.

56. Even when investment terms are well negotiated, safeguards are needed to avoid the infant local industries being exploited by being forced to re-import parts from abroad which were originally produced in their own country.

B. Other types of assembly industry

57. In addition to electronic parts, there are several other types of labour intensive industry which are already predominant in existing industrial free zones, with garments leading. Others are optical goods (lens-grinding), diamond processing, wigs, toys, plastic goods, leather working.

Garment Industry

58. The reasons for the predominance of this industry in free zones is obvious. By far the most expensive element in garment production is labour for cutting out, stitching seams and fitting button, zips, tapes, etc. Buyers sometimes calculate costs largely on seam lengths.

59. One big advantage this industry has for many developing countries is that basic raw materials are locally available, giving a higher added value and less imported content.

II. TYPES OF INVESTMENT REGULATIONS

60. A main purpose of an Industrial Free Zone is to control foreign investment to ensure that the host country derives the maximum advantage.

61. Special legislation is required to establish the usually state-owned Authority and govern the operations of the investors. Such regulations have to be clear, unequivocal and brief, to encourage investment.

62. In a paper of this length it is not desirable to go into detail, and a legal draughtsman experienced in such legislation is required.

63. Basically, the host country must offer incentives both fiscal and physical to override the disincentives. These can include lack of sophisticated infrastructure, geographical position, climate, the necessity to train labour and management, lack of credit facilities and the lack of a well established industrial atmosphere.

64. Physical incentives are basically the provision of rentable standard factory bays with all services at standard prices.

65. Fiscal incentives include duty-free import of machinery and raw materials, usually providing the latter are all exported in finished products.

66. Freedom from corporate taxes must be carefully calculated on a realistic basis, and not overdone. Some IFZ offer no tax exemption at all, e.g. India.

67. The experience of operating Industrial Free Zones management is essential for the development of a properly balanced set of incentives and their active promotion overseas. The latter is an extremely important and specialized activity, as Industrial Free Zones are in competition with the incentives of many developed countries who encourage foreign investment.

III. PATTERN OF DEVELOPMENT - FORWARD AND BACKWARD LINKAGES

68. An Industrial Free Zone is not an end in itself. It leads to other investments in the host country, by producing an industrial atmosphere.

69. The development of linked industries must also be carefully planned to avoid the host country remaining as only a supplier of low cost labour.

70. Backward linkage means the development of satellite industries or services to supply the factories in the zone. Legislation may be required to ensure that not all raw materials are imported indefinitely, and that local services are free to develop. Local bank credits may also be required to encourage entrepreneurs to become zone suppliers.

71. Forward linkage means the use of the products made in the zone as components to establish more sophisticated finished articles for manufacture and export by firms outside the zone.

72. Failure to plan for this may result in components made in the Zone being re-exported back to the host country at higher prices. It may also result in the continued import of products into the host country which could be produced there with some practical encouragement given to local firms.

73. This is not to say that the main principle, the export of 100 per cent of the Free Zone production need be infringed. The components needed by local producers outside the zone should be allowed on to the domestic market only as an exception and after paying the normal dues and tariffs paid on all similar imports.

74. Thus, the development of export-oriented industry is assisted by the Zone; and the import bill consequently reduced in the long run.

UNIDO TECHNICAL ASSISTANCE

75. The future of the development of industrial free zones is assured. World demand for manufactures increases annually at over 10 percent, and skilled labour is at an increasing premium, and increases everywhere in cost.

76. UNIDO's objective is to assist the normal processes of industrial development, and guide developing countries to create new industry and therefore employment.

77. However, expertise in the establishment of Industrial Free Zones is in very short supply at present, and is really only available in cooperation with operating Industrial Free Zones management.

78. UNIDO recognizes this fact, and is prepared to offer technical assistance in a realistic manner by fielding specialized teams from operating zones as well as by providing advice and guidance from its headquarters wherever possible.

79. New problems require new solutions, and the establishment of industrial free zones in many developing countries is going to require expertise from many sources. One of these is the growing number of consultant firms who have had experience of feasibility studies in the field. The traditional form of long-term experts giving guidance on export development questions supplements such technical assistance, but cannot replace the experience of Industrial Free Zone Management staff.

80. UNIDO acknowledges its debt to the cooperating Industrial Free Zone managements and looks forward to cooperating with many more in the years to come.