The Free Ports Opportunity

How Brexit could boost trade, manufacturing and the North

RISHI SUNAK MP

Centre for Policy Studies

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THE AUTHOR

Rishi Sunak is the Member of Parliament for Richmond (Yorkshire). He was elected in 2015 and is a member of the Environment, Food and Rural Affairs Select Committee.

Before entering Parliament, Rishi spent his professional career in business and finance, living and working internationally. He co-founded a large investment firm, working with companies from Silicon Valley to Bangalore. He then used that experience to help small and entrepreneurial British companies grow successfully.

Rishi holds a degree in Philosophy Politics and Economics from Oxford University and was a Fulbright Scholar at Stanford University where he studied for his MBA. He is the co-author of *A Portrait of Modern Britain* (Policy Exchange, 2014).

Acknowledgements

With grateful thanks to my researchers Isaac Delestre and Philip Naylor. Their intellect, hard work and innovative thinking made this report possible and turned a woolly idea into real substance.

ISBN No. 978-1-910627-40-2

Printed by 4 Print, 138 Molesey Avenue, Surrey

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SUMMARY

Brexit will provide the UK with new economic freedom, and the Government should take the opportunity to create Free Ports across the nation. Free Ports will simultaneously: increase manufacturing output, create employment regionally where it is most needed, and promote trade. Using Free Ports to drive economic growth will also re-connect Britain with its proud maritime history as a trading nation and act as a beacon of British values, signalling the country's openness to the world.

What is a Free Port (also called a Free Trade Zone)?

- An area inside the UK geographically, but legally outside of the UK customs territory. Goods can be imported, manufactured or re-exported inside the Free Trade Zone without incurring domestic customs duties or taxes. These are only paid (often at reduced rates) on goods entering the domestic economy.
- As well as benefits to customs taxes and duties, Free Trade Zones often also support economic activity through financial incentives like Research and Development (R&D) tax credits, regulatory flexibility, and tax reductions.
- There are approximately 3,500 Free Trade Zones worldwide, employing 66 million people across 135 countries. There are no Free Trade Zones on the UK mainland today.
- The United States is home to over 250 Free Trade Zones, which employ 420,000 people and handle $750bn of merchandise. They have played a major role in retaining, re-shoring and growing domestic manufacturing activity and boosting trade.

Why can't we create Free Ports as a member of the Single Market and Customs Union?

- As a member of the EU Single Market and Customs Union, the UK does not have control over its trade policy. The UK is not able to set its own tariff/customs duties and administration.
- EU regulations would make it difficult to create US-style Free Trade Zones in the UK. The United Nations has concluded that: "Free Trade Zones as originally conceived do not exist anymore in the EU."

- The EU's Union Customs Code allows any Member State to challenge attempts to provide UK Free Trade Zone incentives. This allows any of a thousand or more special interest groups from across the continent to block the policy in Britain.
- Furthermore, EU State Aid rules are much more restrictive than global World Trade Organisation rules. As a result, the EU excessively limits the ability of British governments to financially support manufacturing activity in Free Trade Zones. These EU constraints have already limited the financial support available in UK Enterprise Zones.

Why would Free Ports work in the UK?

- Ports are already a vital strategic asset for the UK economy, accounting for 96% of all trade volume and 75% of trade value.
- A Free Ports programme would build on an existing UK strength: Britain's port infrastructure is world class, and the UK ports sector is already the second largest in Europe.
- Unlike many other countries with often just a single (taxpayer-funded) super port, the UK contains dozens of successful, large-sized ports; all privately financed. These are spread around the country and are already home to manufacturing clusters.

How would Free Ports help an Industrial Strategy to rebalance the UK economy?

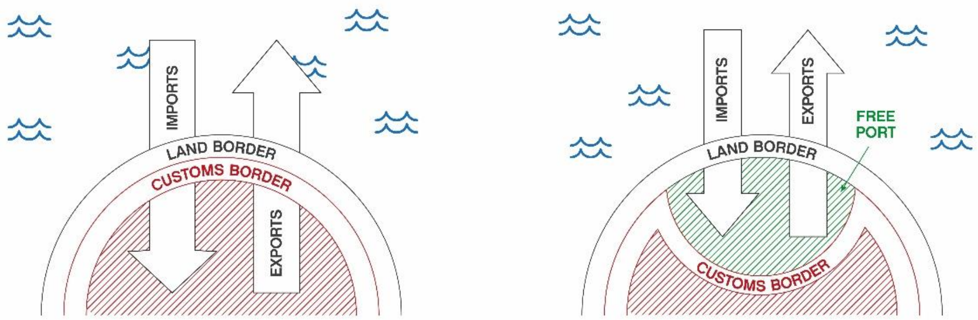
- Free Ports could create as many as 86,000 jobs for the British economy if they were as successful as the US' Foreign Trade Zone programme.
- Free Port jobs would be created in areas outside London where economic need is higher. Of the UK's 30 largest ports, 17 are in the bottom quartile of Local Authorities when ranked by the ONS' Index of Multiple Deprivation and three quarters are in 'below average' Local Authorities.
- Manufacturing accounts for just 10% of UK GDP, among the lowest out of all OECD countries (30th out of 35). Increasing the share of manufacturing in UK economic activity would have positive effects on productivity, wage levels, employment, the current account deficit, and research and development.
- Free Port employment would disproportionately be created in manufacturing rather than services. Experience abroad shows that Free Ports incentivise domestic manufacturing and processing activity. This is especially seen in sectors like pharmaceuticals, vehicle production, and chemicals, and in global companies where supply chain components move back and forth.

1. WHAT IS A FREE PORT?

Around 2,500 years ago the triremes[*] of the ancient Mediterranean – 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.

Today, a Free Zone or Foreign Trade Zone (as today's Free Ports are generally known) refers to an area that although *inside* the geographic boundary of a country, is considered *outside* the country for customs purposes. This means that goods can enter and re-exit the Zone without incurring usual import procedures or tariffs, which are only incurred when products enter the domestic economy. Typically, Free Trade Zones enjoy lower tax, trade tariff and duty environments than the rest of the domestic economy and are created with the explicit aim of attracting investment, promoting trade and boosting domestic manufacturing activity and local employment.[1]

Figure 1: A Free Port is inside a country's land border but outside its customs border



Today, Free Zones are used throughout the world and account for $500bn of direct trade related value added activity globally.[2] There are 3,500 of the

* An ancient Greek or Roman maritime vessel with three banks of oars.

1 Congressional Research Service Report, U.S. *Foreign-Trade Zones: Background and Issues for Congress*, 2013, p. 2.

2 McMaster Institute For Transportation & Logistics, *Maximising the Potential of the Foreign Trade Zone Concept in Canada*, 2013, p. 15.

Zones, employing 66 million people, and located in 135 countries, ranging from highly developed advanced economies to emerging markets.

Table 1: The growth of free and special Zones globally

	1959	1970	1985	1990	1997	2006
Countries	2	10	46	60	*NA*	135
Free Zones	4	20	175	200	845	3,500
Employees ('000s)	*NA*	50	1,300	2,500	22,500	66,000

Source: Congressional Research Service, U.S. Foreign Trade Zones, 2003, from ILO and United Nations data

Although the use of free Zones is widespread, they are a diverse concept and if you were to ask a European, an American, a Chinese, and a North African what defines a Free Zone, you would be unlikely to receive the same answer.

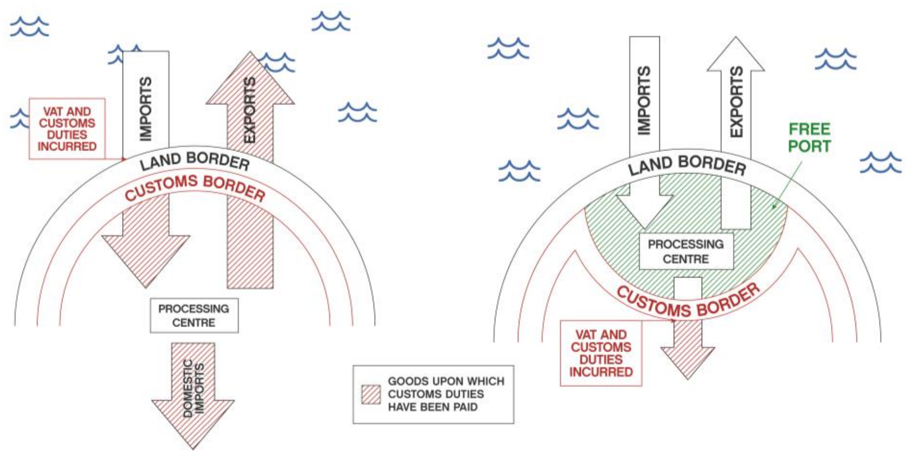
However, despite this variation in how Free Zones are structured and administered, the key tangible benefits they can offer are broadly consistent and fall into four main categories: Duty Exemption; Duty Deferral; Tariff Inversion; and Tax Incentives.

(i) **Duty Exemption.** Products enter the Zone without incurring import tariffs or duties. This allows the products to be processed and perhaps combined with other products or engineered into finished goods (all stimulating domestic activity), for eventual re-export to a third country.

The most famous Free Port in the world is Jebel Ali in the United Arab Emirates. A man-made port and Free Zone created in 1985, it is now one of the world's largest ports, home to thousands of businesses from 100 countries and with 135,000 employees. Although the domestic UAE market is relatively modest, global companies use Dubai as a processing and manufacturing hub in order to take advantage of its infrastructure, duty savings and strategic location. The Zone now accounts for 20% of UAE's foreign direct investment.[3]

3 Jebel Ali Free Zone, *Why Dubai, Why JAFZA*, 2016.

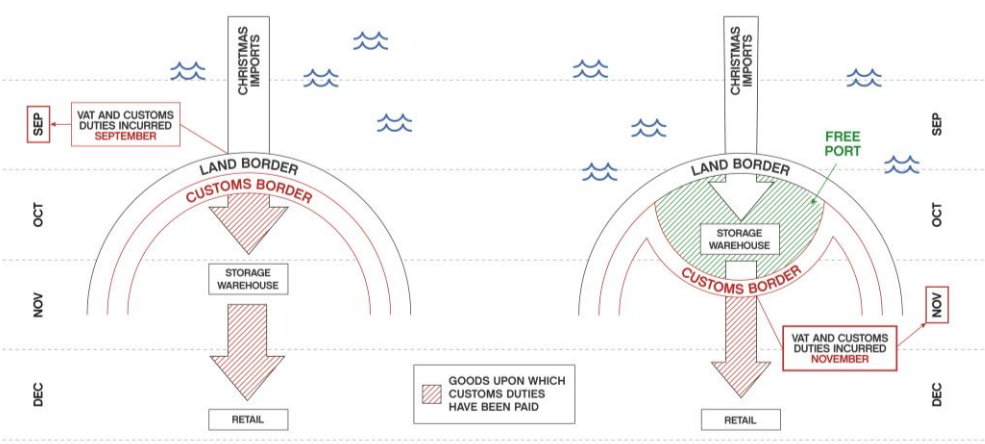
Figure 2: Duty exemption permits products to enter a free Zone without incurring import tariffs or duties



(ii) Duty Deferral. For goods that ultimately enter the host country, duty is deferred and payable only when the goods leave the Zone, not when they first arrive. This allows companies to warehouse and process goods in the Zone before incurring duties, improving cash flow cycles and making just-in-time inventory management* easier.

Often used for goods around the Christmas period. Duty deferral allows manufacturers and retailers to import and build inventory in September without incurring duties. This cost deferral is helpful as goods are not sold until months later at Christmas. Duty deferral encourages more domestic processing and storing of goods rather than importing finished goods closer to the date of consumption.

Figure 3: Duty deferral allows for customs duties to only be paid when goods leave a free Zone, not when they arrive

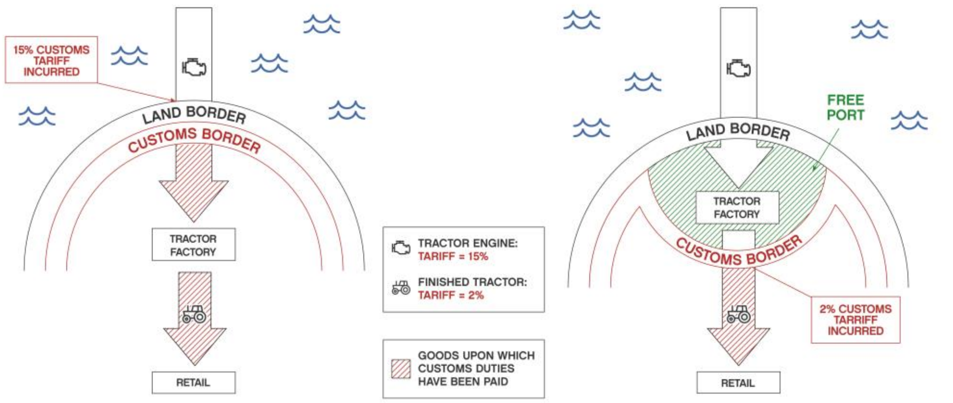


* Just-in-time is an inventory strategy companies employ to increase efficiency and decrease waste by receiving goods only as they are needed in the production process, thereby reducing costs by eliminating warehouse storage needs.

(iii) Tariff Inversion. The complexity of modern tariff regimes means that finished goods often command a lower tariff rate than their component parts. This incentivises importing finished goods rather than importing high tariff components and using domestic manufacturing to create the actual product. A Free Zone allows a company to import components tariff free, manufacture the final product in the free Zone, and then pay a lower duty rate on the finished product when it enters the host economy.

Duties on auto parts like radios are often higher than the duties on the finished car itself.[4] *This makes domestic manufacturing of cars less competitive with imports of the finished vehicle. Using a Free Zone enables auto manufacturers to import the components without incurring duty, manufacture domestically and then pay the lower duty rate on the finished cars when they are sold locally.*

Figure 4: Tariff inversion allows for intermediate input goods to be imported tariff-free



[4] Tiefenbrun, Susan U.S. Foreign Trade Zones of the US, Free Trade Zones of the World, and their Impact on the Economy, Journal of International Business and Law, Vol. 12 Issue 2, 2013.

European Union Inverted Tariffs

The EU exhibits a wide range of examples where the tariff for raw materials exceeds that of a processed good, which incentivises countries to import the final product rather than manufacturing the goods locally. Examples include:

- Cables and batteries (4% import tariff) used to make computers (0% import tariff).
- Plastic or glass containers (6.5%) used to make bottled water or perfume (0%)
- PVC materials (8.3%) used in to make film screens (2.7%)
- Textiles (8-12%) used to make car seats or sofas (0%)
- Frozen orange juice (e.g. 33.60% to 33.60% + 20.60 EUR/100kg) and oranges (16%) used to make intermediate soft drink concentrate (0%)

Source: Private analysis, conducted by leading international accountancy firm.

(iv) Tax Incentives. This generally consists of temporary financial support to incentivise beneficial and genuinely new economic activity. Typical examples include: lower VAT rates on goods brought in through the Zone, reduced rates of corporation tax for companies located within it, tax credits for local R&D activity, and lower rates of employment tax for new employment created. Some regulatory flexibility can also be offered, for example simplified planning processes.

China's Special Economic Zones are areas with lower tax, less regulation and easier planning processes than the domestic economy. Local property taxes, corporate income taxes and employment taxes were all lowered, as well as customs duties, in order to attract Foreign Direct Investment (FDI). The programme is 40 years old; the Zones account for 20% of China's GDP, 30 million jobs and around half of all FDI.[5]

5 World Bank, *Global Experiences with Special Economic Zones - With a Focus on China and Africa*, 2015, p. 4.

2. FREE TRADE ZONES AROUND THE WORLD

There are approximately 3,500 Free Zones located in 135 countries across the world.[6] While often associated with high-tariff, high-regulation emerging markets in Asia, the potential benefits of Foreign Trade Zones (FTZs) in developed western economies remain significant. Whereas in emerging markets Free Zones are typically focused on exports, in developed nations they can also service the domestic economy. The US is a case in point. Home to a considerable number of advanced and well-developed Zones, it provides ample evidence of their power in encouraging economic activity. Put simply, by championing FTZs, the UK would be joining a host of other countries actively supporting both domestic manufacturing and trade.

US Foreign Trade Zones

"The programme has proven its effectiveness by attracting new investment in the US manufacturing sector from abroad and the 're-shoring' of US manufacturing."[7]

Daniel Griswold, Former President of the National Association of Foreign Trade Zones

Modern Free Zones can be found in the US' Foreign Trade Zone programme. Launched during the Great Depression, these Zones allowed US companies to bypass the high tariffs in place at the time. The programme, initially, grew slowly.

However, a marked acceleration began when a change was introduced that meant there would no longer be any duty on FTZ value-added activity. Specifically, if a domestic company used a Free Zone to manufacture a product for the domestic market, no duties would be payable on labour costs, profit or domestic parts used in manufacturing.[8]

As a result the use of FTZs in the US has increased significantly in recent years, as has the value of goods processed within them. In 2014, exports from

6 OECD, *West African Challenges - Are Economic Zones Good for Development?*, 2011, p. 3.

7 US National Association of Foreign-Trade Zones, *US Foreign-Trade Zones Offer Attractive Harbour for Global Companies*, 2015.

8 KPMG, *Comparative Review of Select Free Trade Zones Around the World*, 2009.

FTZs reached $69.9bn, representing an increase of more than 66% since 2009. 420,000 people are employed in a FTZ (most but not all in manufacturing), and there are now over 250 of the Zones across the US, used by more than 2,500 organisations.[9] There is at least one FTZ in every US state and the evidence shows that both employment growth and export performance within these Zones have outpaced the country as a whole.[10]

Activities carried out in US FTZs broadly fall into two categories:

(i) **Production/Manufacturing** – 70% of FTZ activity, receiving $536bn in merchandise. The majority of goods entering FTZs are of US origin, but domestic manufacturers then combine these with components imported from abroad to manufacture a finished good.

Manufacturers, such as those in the car industry, are able to make substantial savings through inverted tariffs situations. For instance, Volkswagen's assembly plant in Tennessee's Chattanooga FTZ was found to be able to save as much as $1.9 million in component tariff costs on the 150,000 cars it produces each year.[11]

(ii) **Warehousing/Distribution** – 30% of FTZ activity, accounting for $235bn of merchandise. Companies take advantage of the liberalised warehousing arrangements to assist either with cash flow concerns or save administrative costs by bundling multiple shipments into a bulk weekly customs declaration. While being responsible for more than 10% of US imports annually in terms of dollar value, companies in the FTZs account for less than 1% of import filings due to the less burdensome and less frequent customs reporting system.

US Customs Processing Fees are capped $485 per shipment. A large company with 10 warehouses and hundreds of individual shipments a week would pay almost $2 million per year in administrative fees. Using the flexibility of the FTZ's consolidated weekly declarations, the total customs declaration cost for the company drops to $25,220 per year (52 weeks X $485), a considerable saving.[12]

9 Ibid.

10 US National Association of Foreign-Trade Zones, *US Foreign-Trade Zones Offer Attractive Harbour for Global Companies,* 2015.

11 Congressional Research Service, *U.S. Foreign-Trade Zones: Background and Issues for Congress*, 2013, p. 12.

12 Ibid.

Success Story: The Wabasha Motor Company and Minnesota Foreign Trade Zone

Wabasha Motor Company (WMC) is a US manufacturer of small engines for use in lawnmowers and garden products, and is reliant on foreign suppliers for goods.

In order to make its engines, WMC had to import $25 million of engine parts from overseas, which carried an average customs duty of 3% ($750,000 in cost). However, the engines themselves were not subject to any customs duty if imported into the US. Overseas manufacturers of small engines could import their products into the US and it was hard for WMC to compete as it was saddled with $750,000 of incremental cost in customs duties.

WMC applied for its facility to become a subZone of an FTZ. They were then able to save on the $750,000 duties, helping ensure that the company was able to remain in the US, maintain domestic manufacturing employment and stay profitable.[i]

[i] *Minnesota Foreign Trade Zones, Competing Globally with Inverted Tariffs.*

Success Story: Automotive Manufacturing

"[FTZ] SubZone status played an important role in Nissan's decision to shift production from overseas to Tennessee."[i]

Susan Tiefenbrun, Author of Tax Free Trade Zones of the World and in the US

"The US FTZ programme is a major factor behind the record export of 2.1 million American-made cars and light trucks in 2014."

Daniel Griswold, Former President of the National Association of Foreign Trade Zones

The automotive industry is one of the primary users of FTZs, and the industry as a whole exports more than $10 billion from FTZ production facilities. Established in 1983, the Nissan Vehicle Assembly Plant in Smyrna, Tennessee is a prime example of how the industry has capitalised on the FTZ programme.

By using tariff inversion, Nissan can elect to make customs entry on the rate of the foreign components or finished goods, whatever is lower, encouraging domestic manufacturing by making substantial savings on duty.

As the plant and the surrounding FTZ has expanded, production at the site has increased significantly – one expansion in the 1990s increased production to 450,000 cars a year, up from 250,000.[ii]

Today, the plant continues to have a huge impact on local employment, with a workforce of 8,400 who have a combined annual payroll of $399 million. 640,000 vehicles are now produced each year, and in total $6 billion has been invested in the site.[iii]

By locating the factory in the US, Nissan Smyrna has had a remarkable impact on the wider area. For instance, its truck manufacturing operation uses 83 suppliers based in the US.[iv] Nissan also later incorporated a second site into the FTZ, an engine manufacturing facility, which in turn employs 2,000 people.

The State of Tennessee has actively supported the development of the plant, assisting with road infrastructure, training grants and Industrial Development bonds, which has played a large part in Nissan's decision to continue to make considerable investments in Smyrna.

[i] Tiefenbrun, Susan, *Tax Free Trade Zones of the World and in the United States*, 2012, Pp 345-347; [ii] The New York Times, *Trade Policy Test at Nissan's Tennessee Plant*, 1993; [iii] Nissan Smyrna, *Nissan Manufacturing in Tennessee*, 2016; [iv] Tiefenbrun, Susan, *Tax Free Trade Zones*

Republic Of Ireland – Shannon Free Zone (Part I)

"If you want to try something new… you want to introduce new ways of doing business…having a Zone, having an area that is ring-fenced and set aside from the rest of the economy, is key to pilot-testing and making it work and attracting new business opportunities before extending nationally."

Kevin Thompstone, former CEO, Shannon Development Corporation

After Ireland joined the EU, the country's ability to continue its successful free Zone programme was significantly curtailed (see Chapter 3).

However, in 1959, the pioneering Irish Government had established the first modern Free Trade Zone in the small town of Shannon in rural County Clare. In the 1940s, most transatlantic flights had to stop to refuel in Ireland, thus supporting significant economic activity at Shannon Airport. However, improvements in aviation technology meant planes could go non-stop and bypass Shannon, throwing the region's economic prospects into doubt.

To counter this, the Irish Government launched the Shannon Free Zone with the intention of using low tax, duty-free incentives to stimulate economic activity. In addition to the usual benefits of a Free Port, such as deferred tax arrangements, further incentives for business were offered. Imported goods were exempted from VAT, which extended for goods used for production if 75% of the products manufactured were then exported. There were also grants available for R&D and staff training.

While many of the benefits conferred upon Shannon have since been eroded as a result of Ireland's accession to the EEC in 1973, at the time the Free Zone proved a major success, attracting a host of global companies and by the 1960s accounting for a third of Ireland's exports of goods.[13] Over time, consultants from Shannon went around the world as the model was copied by growing economies in Latin America and Asia. Indeed, a 2005 visit to Shannon by Premiere Wen Jiabao is often credited as sparking the now highly successful Free Zone programme in China.[14]

While many of its benefits have been phased out by the EU, the business cluster that the Free Zone established remains the biggest multi-sectoral business park in the whole of Ireland, and outside of Dublin it is the Republic's largest target of Foreign Direct Investment.[15] The Zone employs over 7,000 people while generating more than €3.3bn in trade annually.[16]

Manaus, Brazil

Head 800 miles upstream from where the tropical currents of the Amazon basin disperse into the cold Atlantic and you will find yourself in the colourful streets of Manaus. The capital city of the Brazilian State of Amazonas, Manaus was once known as the 'Paris of the Tropics' thanks to the booming rubber industry which made the city Brazil's richest during the late 1800s.

As rubber profits dwindled during the 20th century Manaus became increasingly notorious for the trade in timber logged, often illicitly, from the surrounding rainforest. After an initially unsuccessful attempt in 1951, Brazilian president Castello Branco signed a law declaring the establishment of a Manaus Free Trade Zone with a radius of some 10,000 km.[17]

Heralded as a counter-intuitive solution to deforestation, the Zone not only provided the usual customs benefits to goods imported by air and river but also offered generous tax breaks to encourage industrial development in the area and, with it, urban jobs for workers who might otherwise be tempted by illegal logging or farming.

The Zones tax incentives include:[18]

- A reduction of up to an 88% on import tax.
- Exemption from the excise duty, which can reach 35%.

13 Shannon Chamber, *Shannon Free Zone.*

14 The Guardian, *Story of cities #25: Shannon – a tiny Irish town inspires China's economic boom,* 19 April 2016.

15 Shannon Commercial Properties, *The World's First Free Trade Zone.*

16 Ibid.

17 The Brazil Business, *Manaus Free Trade Zone.*

18 Financial Times, *Manaus: Free Trade Zones in Jungle Capital's Passport to Success*, 2011.

- Reductions of 55-100% in VAT.
- A 75% reduction on Corporate Income Tax for profits made within the Zone.
- Land provided by Government at virtually no cost.

In recent decades, manufacturers from around the world have flocked to Manaus to benefit from these incentives. Today, approximately 100,000 jobs in western Amazonia are directly related to the Manaus Free Trade Zone with a further 400,000 estimated to have been indirectly created outside the Free Trade Zone.

The success of the Manaus Free Trade Zone has transformed the jungle city into an unlikely hub of motorbike and electronics manufacturing with the likes of Harley-Davidson, Honda, Siemens, LG, and Samsung all setting up substantial operations in the area.[19]

The dynamics of emerging economies are clearly distinct from those of their more developed counterparts. Even so, Manaus provides a striking example of the success that FTZs have already had in providing targeted manufacturing employment to areas dependent on industries no longer capable of generating high quality jobs.

Canada

> *"The marketing and marketability of FTZ-like programs in Canada is rather poor with their fragmented and somewhat esoteric nature shouldering a good share of the blame"*

McMaster Institute for Transport & Logistics

Canada's concept of Free Zones is unusual in that they are geographically flexible – they are not focused on a specific designated area.[20] Programmes including the Duty Deferral Program and the Export Distribution Centre Program can be accessed by businesses regardless of where they are in the country. A company could for example create a duty-free customs bonded warehouse in part of their office building. Goods could be stored without import duty or taxes, reducing up-front costs.[21]

Although theoretically offering the benefits of flexibility, the more dispersed nature of Canadian free Zones has been criticised as being less effective than the US. The programme is harder to sell to international

[19] Brazilian Ministry of Development, Industry & Foreign Trade, *Manaus Free Trade Zone: Business Opportunity and Investment in Amazon*, 2008

[20] Canadian Department of Finance, *Foreign Trade Zone*, 2013.

[21] Government of Canada, *Enjoy the Benefits of Foreign Trade Zones… Anywhere in Canada!*, p. 5.

businesses who are more used to the idea of geographically specific FTZs around transit hubs.[22]

Furthermore with the smaller, more dispersed, Zones, it is more difficult to co-ordinate promotion. Indeed marketing of the programme has been directly criticised and Canada was remarkably omitted in a purportedly comprehensive French encyclopaedia published on the topic entitled "*Free Zones of the World*."[23]

The lessons from Canada's experience is that a country's free Zone concept must be marketed properly internationally and secondly, that the flexibility suggested by removing the geographical constraint of a free Zone is in practice offset by less effective co-ordination and promotion of the concept.

22 McMaster Institute For Transportation & Logistics, *Maximising the Potential of the Foreign Trade Zone Concept in Canada*, p. 48.

23 Calgary Region, *A Review of Canada's Foreign Trade Zones*.

3. BREXIT PROVIDES AN OPPORTUNITY

"Brexit represents a unique opportunity to revisit customs procedures and other trade policy measures."

Head of Customs, Leading international accountancy firm

The success of Foreign Trade Zones in stimulating manufacturing, employment, and investment in other developed economies such as the US begs the question as to why policy makers in Britain – one of the developed world's most consistent advocates of free trade – have not followed suit.

The answer lies in Brussels. As a member of the EU, the UK does not have sovereignty over its trade and customs policy. While the European Commission does allow member states to create customs Free Zones within its territory (it actually lists 85 such Zones established within EU[24]), the highly regulated environment demanded by the Commission makes these Zones a pale imitation of their international counterparts and limits their ability to operate in practice.

"The conclusion is that FTZs as originally conceived do not exist anymore in the EU. The Commission does allow the establishment of free Zones within its territory, but its definition of free Zone is a very narrow one."[25]

United Nations Economic and Social Commission,
Free Trade Zone Development

The reasons for this can be considered in two distinct categories: the EU Single Market regulations contained in the Union Customs Code[26] and the EU's State Aid laws (which are more onerous than those of the World Trade Organisation, of which the UK is also a member). Together, these rules have ensured that modern EU Free Zones amount to little more than storage and warehouse facilities with simpler customs formalities[27] – denying European economies the opportunity to stimulate economic activity in a meaningful way.

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[24] European Commission, *Free Zones in Existence and Operation in the Community*, 2015.

[25] United Nations Economic and Social Commission for the Asia and the Pacific, *Free Trade Zone and Port Hinterland Development*, 2005, p. 74.

[26] European Commission Taxation and Customs Union, *Free Zones*.

[27] McMaster Institute For Transportation & Logistics, *Maximising the Potential of the Foreign Trade Zone Concept in Canada*, p. X.

The impact of EU constraints is stark: within the UK today, there is just one free Zone, based on the Isle of Man, compared to over 250 in the US.

Outside the EU, Single Market, and Customs Union, Britain will maintain its own schedule of tariffs and customs duties, in common with all other nations and World Trade Organisation members. Crucially, Britain will also have much more flexibility to pursue an ambitious Free Zone policy, using its sovereignty over customs issues and compliance to drive economic growth, employment and investment in specific areas.

"In terms of Free Zones, Brexit has the potential to be a very interesting opportunity for the UK. That could make it far cheaper for manufacturers to base their operations in Britain. It could mean a significant number of jobs being created in Britain."[28]

Dr Alexandre Lavissiere, Professor in International Business, Ecole de Management de Normandie

EU Single Market Regulations

One of the key benefits of FTZs in the US is so-called tariff inversion. This involves firms manufacturing products within an FTZ for which the customs duty on the component parts is higher than that of the finished product (see Chapter 1).

This kind of tariff inversion is theoretically possible in the EU through the provisions of Union Customs Code (UCC), which came into force in May 2016. This allows EU companies to apply to process goods under what are known as 'special Procedures for Inward Processing'. Once granted, this status allows a firm to pay duties only on the finished product – effectively offering one of the key benefits of a Free Zone on a company-by-company basis. While this may seem straightforward, the hurdles to achieving special status are considerable.

In order to use the Inward Processing Procedures, the UCC requires a UK company to first obtain authorisation from HMRC. This wouldn't be a problem were it not for the fact that, in making its decision, HMRC is legally required to establish that "the essential interests of Union producers would not be adversely affected" before granting authorisation.[29]

What this means in practice is that if a single EU Member State believes that tariff inversion in the UK is likely to harm businesses in their country they are able to immediately lodge a complaint with the EU Commission. At this point the Commission establishes "an expert group, composed of the representatives of the Member States" to "advise the Commission on whether the economic conditions are fulfilled or not".[30]

28 Transcript of private interview, October 2016.

29 EU REGULATION No 952/2013, Article 211 (paragraphs 4-6), 9 October 2013.

30 COMMISSION IMPLEMENTING REGULATION (EU) 2015/2447 (paragraph 4), 24 November 2015.

The reality of fulfilling these "economic conditions" is that it becomes extremely hard for manufacturers to reap the kinds of benefits enjoyed by producers based in US FTZs. After all, given the vast diversity of commercial interests across the EU – from French wine-makers to German car manufacturers – the opportunities for "adversely affect[ing]" domestic production in one of the Union's member states are almost limitless.

As a customs expert at a leading global accountancy firm explains: "If an UK company were, for example, seeking to import fruit juice (a high tariff product) in order to make a soft-drink concentrate (which attracts a zero tariff) you would receive complaints from Spain and Italy immediately because they want you to use their fruit. Ultimately, you wouldn't be able to do it."[31]

Furthermore, under the UCC, the specific recordkeeping, movement controls and other administrative burdens are extremely numerous and potentially costly to comply with. When compared to the limited tax and other incentives allowed under EU law, Free Zones are often just not viable under a basic cost/benefit analysis.

This highly regulated approach taken by the EU also affects the ability of smaller companies to take advantage of the kinds of benefits associated with Free Zones. For example, in order to use Inward Processing Procedures firms are generally required to provide a bank approved guarantee or certificate of insurance that they will be able to meet any future customs obligations if for whatever reason the customs reliefs are later revoked. As well as being an onerous and costly process in itself, this requirement has sometimes seen smaller firms unable to obtain the banks' blessing, putting them at a disadvantage to their larger competitors.

31 Transcript of private interview, October 2016.

Expert View: Free Zone Regulation in the EU

Head of Customs Services
Leading international accountancy firm

The European Commission defines Free Zones (FZs) as "special areas within the customs territory of the Community."

Although the European Commission states that "there may be special reliefs available in free Zones from other taxes, excises or local duties" in practice these are rather limited and more often than not FZs have operated as simplified versions of customs warehouses (CW) (see below).

Uptake of Free Zones within the EU has been significantly less than in some other WTO members (e.g. US, China, Middle East). In the case of the UK, there used to be six FZs. Four UK FZs were located at certain ports of entry and controlled principally on the basis of the requirements of CW procedures and there were no special reliefs from other taxes, excise duties or local authority rates. Due to the limited benefits of using a FZ, the UK ceased to renew the licenses for the FZ in 2012.

Whilst uptake of these types of programmes have been hugely successful in many WTO member countries, the uptake of the EU's programmes are generally less widespread. Some of the reasons for this are outlined below:

Complexity

The EU sets a comparatively high bar to access the kinds of procedures associated with FZs. The EU's framework requires application, approval and compliance with each of the various programmes to be used. For example, to try and replicate some of the benefits of a Free Zone a company has to apply for at least three different programmes: Inward Processing Relief, Outward Processing Relief, and Customs Warehousing. Each procedure has different approval criteria, time constraints, record-keeping and return requirements under EU law. This means there can be significant compliance barriers to accessing these reliefs which prevent take up even where there is limited risk.

Lack of legal certainty

The rules have to cater for the whole range of goods available and operations which may be performed on them, which means that there are wide interpretations of the law by each member state. This leads to a lack of certainty and a fear that simple technical breaches can lead to major costs. An example of this is in the Caterpillar/Terex ECJ case where the litigants were potentially subject to millions in duty on the basis that incorrect codes were entered on the customs declarations. Companies which have done their best to comply can be caught out.

Economic test

For some programmes, particularly Inward Processing Relief for more sensitive goods,[i] the EU requires that the applicant passes an economic test.

This can be a long administrative process which requires the applicant to prove why approval for the procedure will not affect the economic interests of other EU operators. The process often enables operators in other member states to object to applications. With operators in 28 member states able to object, many applications fail or are so drawn out that the applicant gives up.

Cultural Approach

There is a sense of mistrust in the EU, with trade facilitation being seen as somehow associated with international tax avoidance. The default position has become that it should be allowed only in exceptional circumstances rather than actively promoted. We have had many examples of applications and decisions taking so long that the applicant gives up or where the bar is placed so high that it is not worth applying. For example:

- An application refused because the goods were not typically sold within three months, even though there was no question they would eventually be exported.
- An application held up for months until it could be proven that the net weight of each pair of shoes can be reported accurately.
- An application delayed for a year whilst the authority decided who could make a decision on the application.

[i] See Regulation (EU) 952/2013 Article 211(5) and Commission Delegated Regulation (EU) 2015/2446 Regulation 166-7 and Annex 71-02.

EU State Aid Laws

While easing the financial and administrative burden of trade tariffs is the primary function of an FTZ, this is not the only opportunity they can offer. In many jurisdictions, enhanced trade conditions have been further supplemented by financial support geared towards activities such as R&D, employment, and exports with the aim of attracting and supporting dynamic manufacturers. However, due to EU State Aid rules, the UK is limited in its ability to implement these initiatives compared to countries outside the EU, which operate in line with the more flexible World Trade Organisation (WTO) State Aid rules. This issue with EU State Aid rules has been long documented:

"There are certainly problems with EU State Aid rules, which need reform."[32]

Rt Hon. Jeremy Corbyn MP, Leader of HM Opposition

"A number of State Aid block exemptions could be reformed to make them more flexible so that cities can more effectively support economic growth."[33]

Sir Richard Leese, Leader of Manchester City Council

"…some expressed concern about [State Aid's] limits, about real or apparent extension of EU competence into areas of domestic policy, and about the way State Aid controls are exercised."[34]

Consensus of responses to Government Balance of Competences Review

Under Article 87 (1) of the 2007 Treaty on the Functioning of the EU (originating as the Treaty of Rome), EU member states agree that:

"[A]ny aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market."[35]

The general aims of the provision are noble ones, essentially seeking to ensure that governments are not able to subsidise inefficient industries at the expense of European competitor firms. Indeed, from a British perspective, this has often been beneficial thanks to the UK's comparative reticence towards using public money to support its private sector. However, there is sometimes a fine line between creating a level playing field for European business and hobbling the ability of states to compete innovatively for international investment or strategically supporting areas or industries.

Outside of the EU, Britain's ability to offer State Aid would be governed by the WTO, of which it would remain a member. There are two main reasons why WTO rules are considered by legal practitioners, academics[36] and economic consultants to be less restrictive to governments.[37] Firstly, WTO State Aid rules are narrower in scope than EU rules, capturing less activity under their umbrella. For example, under WTO rules, only export subsidies and import substitution are prohibited *per se*, and otherwise adverse effects need to be proven. The

32 Jeremy Corbyn, State Aid Aspects, Speech to UK State Aid Law Association, 2016.

33 Report of North West Regional Leaders Board, 2016.

34 HM Government, *Review of the Balance of Competences between the United Kingdom and the EU: Competition and Consumer Policy Report*, Summer 2014.

35 Treaty on the Functioning of the EU, Article 107.

36 Ehlermann and Goyette, *The Interface between EU State Aid Control and the WTO Disciplines on Subsidies*, European State Aid Law Quarterly, 2006.

37 Oxera Consulting, *Brexit: Implications for State Aid rules*, 2016.

threshold for breaching EU rules is much lower, requiring a state to show that support "demonstrably distort[s] competition and trade".[38]

Secondly, and more significantly, there are major procedural differences. In the EU, states are required to notify and then gain *ex ante* approval from the European Commission for any kind of support. No such mechanism exists under WTO rules where any issues can only be brought up after support has already been provided.

Similarly, when it comes to enforcement, the hurdles are higher in the WTO system. Private companies have to convince their national governments of the merits of their case as only the state can bring a WTO action. However, in the EU system any private company can bring a dispute action if they feel aggrieved. Lastly, there can be no retrospective penalties imposed under WTO rules unlike EU penalties which do stretch back in time adding to costs.

An informative case study is the Free Enterprise Zone policy implemented in 2012 by the Coalition Government. Created with the intention of stimulating business creation in what the then Chancellor George Osborne termed "the parts of Britain that had missed out in the last ten years"[39] the Zones have had remarkable success. Indeed, by August 2015, the Department for Communities and Local Government was reporting that Enterprise Zones had created 19,000 jobs after attracting £2.2 billion of private investment and around 540 new businesses.[40]

Despite this crop of rosy figures, the restrictions imposed by Europe's State Aid laws put a dampener on Britain's ability to scale up these successes. That's because, while special permission was attained from the EU to provide enhanced capital allowances to firms in the Zones, the UK Government has little scope to provide tax incentives large enough to attract big employers. Unlike its non-EU competitors, Britain is limited to providing €200,000 of tax breaks over 3 years to any one business (an allowance that Free Enterprise Zones currently provide in business rate relief). This precludes the UK from being able to offer the kind of targeted R&D or export focused incentives being provided in the US.

"It is important to acknowledge that EU State Aid rules introduced since the E[nterprise] Z[one] era significantly limit the extent to which member states can offer incentives to businesses to attract investment to a particular area or support business growth."[41]

Highlands and Islands Enterprise, Scottish Government's Economic Development Agency

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[38] David Unterhalter SC and Thomas Sebastian, *After Brexit: State Aid under WTO disciplines,* Monckton Chambers, September 2016.

[39] House of Commons Library, *Enterprise Zones*, 2016, p. 3.

[40] Department for Communities and Local Government, *Enterprise Zones Boom with Thousands of New Jobs Attracted this Year,* 2015.

[41] Highlands and Islands Enterprise, *Review of Enterprise Areas in Scotland*, December 2015.

Expert View: State Aid Law In The EU

Ross Denton, Partner (EU, Competition and Trade Practice)
Baker & McKenzie LLP

The UK is subject to two similar but different controls on aid granted by public bodies. As a Member of the World Trade Organisation (WTO), whether individually or through the EU, the UK is subject to the Agreement on Subsidies and Countervailing Measures ("SCM Agreement"), and through its membership of the EU, the UK is subject to State Aid rules. When the UK leaves EU, then unless the UK agrees to continue to apply the EU's State Aid rules (which it is unlikely to do unless it seeks access to the Single Market), then the UK does not have to apply State Aid rules, but will still be subject to the SCM Agreement.

If the UK does not apply State Aid rules after Brexit, what will change? There are a number of key differences between the SCM Agreement and State Aid rules:

1. The State Aid system is, in effect, the internalization of the SCM Agreement into a domestic scenario. So, for example, the US does not have an equivalent of EU State Aid rules applicable to and binding upon its States. This means that the EU Member States have accepted much more detailed and onerous obligations vis-a-vis each other on subsidies, than they have in respect of their global trading partners.

2. The State Aid system applies more clearly to a much wider range of measures covering a selective advantage, offered in any shape or form. So for example, the recent Decisions on tax rules undertaken by the European Commission against certain US companies would be unlikely to be brought or be successful under the SCM Agreement.

3. The State Aid system also starts from a presumption of illegality (i.e. State Aid is prohibited unless approved) and as a consequence, Member States cannot implement State Aid without approval (standstill obligation). Neither feature is present in the WTO system.

4. The SCM Agreement provides a loose framework of rules, subject to adjudication through the WTO Dispute Settlement Agreement. The State Aid system, meanwhile, has highly developed procedures and processes administered by a single body, the European Commission, and adjudicated upon by the European Courts of Justice. The State Aid system also has many thousands

of pages of guidance and regulations, much of it dealing with sectors or categories of subsidies that are permitted under EU rules, such as regional aid or aid for R&D.

5. The State Aid system gives the European Commission a monopoly on the approval of aid provided by EU Member States, while the SCM Agreement does not have any system for approval of either prohibited or actionable subsidies.

6. The State Aid system requires recovery of all the aid paid directly from the EU Member State, i.e. the payer. This obligation of recovery is enforced rigorously by the European and national courts. Under the SCM Agreement, the remedies are either (i) a Government to Government action against the paying Government, or recovery of the aid via a countervailing duty imposed on a trader importing the goods into a particular WTO member, but in that case, only to the extent that the subsidy has caused damage.

7. The State Aid system permits third parties to bring private actions concerning use of State Aids, including recovery. The rights and obligations under the SCM Agreement can only be enforced at the WTO level by Governments.

Unrealised Potential at the Free Port of Trieste, Italy

"The only Free Zone in the EU that enjoys a more favourable special regime than the more restrictive one laid down by the Community Customs Code"[i]

Trieste Free Port Authority

The Free Port of Trieste occupies a unique position in the EU due to its historic circumstances.[ii] As part of the provisions of the Treaty of Paris, the treaty which negotiated the settlement with minor Axis powers at the end of the Second World War, the UN Security Council guaranteed the independence of The Free Territory of Trieste.[iii] As the EU Treaty obligates Member States to respect agreements concluded before 1958,[iv] Trieste has a special status and is theoretically able to offer incentives that are unique to Free Zones in the EU.

However, due to its position in the single market, Trieste still remains bound by many EU regulations. Tax incentives, which could be offered to companies relocating to the Zone, are not allowable on the grounds that they may distort competition.

Another limitation on the Free Port is the sort of value-added activity that can take place in a free Zone while still being able to make use of the incentives on offer. Only basic activity is permitted before the Union

Customs Code applies, unlike in the US where manufacturing a product or transforming it is actively encouraged. Despite Trieste being the most incentivised Free Zone in the EU, the Free Zone has not been able to attract a large number of manufacturers to the Port.

[i] Trieste Port Authority, *Free Port* and conversation with Dr Trampus, October 2016; [ii] Ibid; [iii] Treaty of Peace with Italy, 1947; [iv] Treaty Establishing the European Community, Article 307, 1957

Shannon Free Zone Part II

"It would be difficult to replicate the original Shannon Free Zone within the EU today. The rules are more restrictive these days. Shannon Free Zone is a global brand and today is more a marketing tool for a classic business and industrial park."

Kevin Thompstone, former CEO, Shannon Development Corporation

Chapter 2 illustrated how Shannon became a successful Free Zone in the 1950s. However, after Ireland joined the EU in 1973, the benefits of the Shannon Free Zone were progressively removed as Ireland had to comply with EU customs and State Aid rules. The 0% corporate income tax rate was increased to 10%[i] (and eventually had to be set at same the level of the rest of country). Similarly, the customs advantages were curtailed and extra administration required.[ii]

Helen Downes, Chief Executive of the Shannon Chamber of Commerce, has emphasised that although Shannon has remained an attractive place to invest, "the original tax and customs benefits have been eroded since EU membership".[iii]

[i] Library of the European Parliament, *Establishing Free Zones for Regional Development*, 2013, p. 4; [ii] The Guardian, *Shannon - A Tiny Irish Town Inspires China's Economic Boom*, 2016; [iii] Transcript of private interview, October 2016

4. CAPITALISING ON BRITISH PORTS INFRASTRUCTURE

While FTZs can be set up almost anywhere, the emphasis that they place on facilitating trade makes ports (or indeed airports) one of the most common locations. This is another reason to embrace a UK Free Ports programme. The UK already possesses world class port infrastructure that is capable of handling and capitalising the new opportunities a Free Zone programme would create. UK ports are large enough, competitive enough, and have access to the private capital needed to make the policy a success.

Beyond this practical fit, embracing an ambitious Free Ports programme would re-connect our economic growth with our proud maritime history, signalling strongly to the world our openness to trade. And, while there is nothing to prevent FTZs also being created around other transport hubs such as airports, this chapter will argue that pairing FTZs with ports is, in a variety of ways, a particularly appealing prospect for the UK economy.

Due to Britain's island geography, ports play a unique role in the UK economy. With approximately 96%[42] of all UK trade by volume, and 75%[43] by value, passing through the country's ports, the sector's success relies heavily upon the continued willingness of UK companies to export and import. At the same time, however, access to cutting-edge shipping infrastructure is a powerful draw for export and import focused manufacturers to invest in UK operations. Creating FTZs around ports would give both port operators and businesses the confidence to continue investing in the sector.

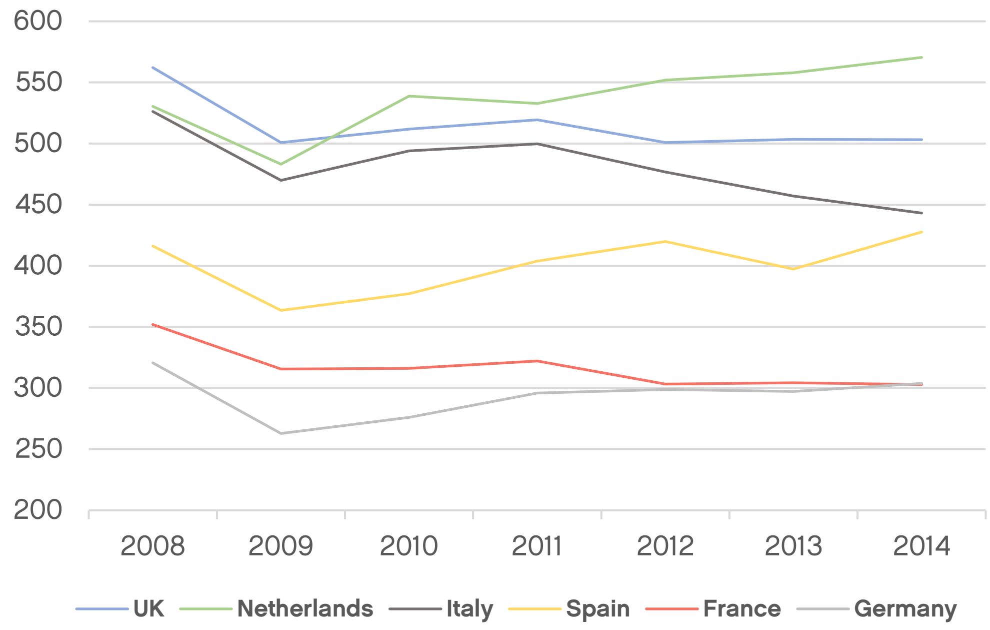
In 2010 Britain still boasted Europe's largest ports industry and, while a combination of recessionary pressures and oil market changes have seen the UK fall behind the Netherlands in recent years, it remains the continent's second largest.[44]

42 UK Trade & Investment, *The UK Ports Sector*, 2013, p. 10.

43 British Ports Association, *UK Ports Industry*.

44 Eurostat, *Gross Weight of Seaborne Goods Handled in Ports*, 2014.

Figure 5: Sea transport of goods, millions of tonnes



Source Eurostat, *Gross Weight of Seaborne Goods Handled in Ports,* 2014

In addition to the formidable volume of the British market, its efficiency – a vital component to keeping down carrier's costs in a globally oversupplied market – is also impressive. According to the Journal of Commerce's index of berth productivity (a measure of the speed at which ports unload their vessels), Southampton is Europe's third most productive port, outdoing both Hamburg and Antwerp.[45] Southampton is also Britain's largest exporting port (£40 billion in value, £36 billion of which is exported outside of the EU).

Table 2: European port productivity

Port	Country	Berth Productivity
Bremerhaven	Germany	86
Rotterdam	Netherlands	86
Southampton	UK	81
Hamberg	Germany	81
Algeciras	Spain	76

Source JOC Group, *Berth Productivity: The Trends, outlook and Market Forces Impacting Ship Turnaround Times,* 2014

45 JOC Group, *Berth Productivity: The Trends, outlook and Market Forces Impacting Ship Turnaround Times*, 2014.

In a world of rapidly burgeoning ship sizes, the provision of longer, deeper berths is also a crucial element of success. Fortunately, the track-record of British ports investing to meet the challenge of larger ships is strong. Three of Britain's ports (Felixstowe,[46] London Gateway,[47] and Southampton[48]) are already capable of handling Maersk's 400m Triple E class container ships – the largest in the world. The Liverpool2 container terminal expansion at the Port of Liverpool, meanwhile, will see the port able to handle two 380m post-Panamax[*] vessels simultaneously.[49]

More impressive still is the fact that, unlike its continental rivals, the British port sector has achieved its success without recourse to the public purse. While 80% of EU ports are state owned[50] the UK sector underwent sweeping privatisation in the 1980s meaning that, today, the private sector operates 15 of the largest 20 British ports by tonnage and around two-thirds of the UK's port traffic.[51]

To put this in context, the recent upgrades to the ports of Rotterdam and Antwerp cost Dutch and Belgian taxpayers €1.1 billion and €680 million respectively, while upgrades to the UK ports of Felixstowe and Southampton have been successfully upgraded without any cost to the Exchequer.[52] Put simply, the structure of the UK sector has successfully mitigated the need for substantial government subsidy without compromising industry performance.

The fruits of these successes for the wider economy are plain to see. In 2013, the UK ports sector directly employed an estimated 118,200 workers, contributed £2 billion in taxation, and made a £7.7 billion value-added contribution to UK GDP. In other words, its contribution to Britain's economy is only marginally less than that of the UK's world-renowned advertising industry.[53] A UK Free Ports programme would provide this successful sector with a further opportunity to grow.

46 Shipping TV, *Triple-E Marstal Maersk Sails From Felixstowe*, 2016.

47 DP World London Gateway, *Maersk Triple-E Vessel Becomes Largest On River Thames Ever During London Gateway Call*, 2015.

48 Daily Echo, *New Port Service to Bring Some of World's Biggest Ships to Southampton*, 2015.

* Post-Panamax describes the category container ships which are too large to fit through the Panama Canal.

49 Peel Ports Group, *Liverpool2.*

50 *Centre for Policy Studies, Economic Bulletin Number 74, European Commission Proposals Threaten UK Ports Industry*, 2016.

51 UK Trade & Investment, The UK Ports Sector, 2013, p. 10.

52 Freight Transport Association, *UK Port Development.*

53 Oxford Economics, *The Economic Impact of the UK Maritime Services Sector: Ports*, 2015, p. 2.

5. FREE PORTS CAN HELP REBALANCE THE ECONOMY

There is a clear political desire to rebalance the British economy away from London towards the regions, and away from the services sector towards manufacturing. A British Free Ports programme would directly expedite both these policy objectives. Free Ports would boost economic activity in exactly the areas and sectors where more growth and high-productivity jobs are needed.

Growing the Regions

In 2015 the average contribution of a London worker to the UK economy was £42,666. Outside of the South East, no other region averaged above £25,000. In Northern Ireland, one of the poorest performing regions, the figure was just £17,573.[54] This stark divide between the economy of London and that of the North remains one of the most pressing policy challenges facing the UK.

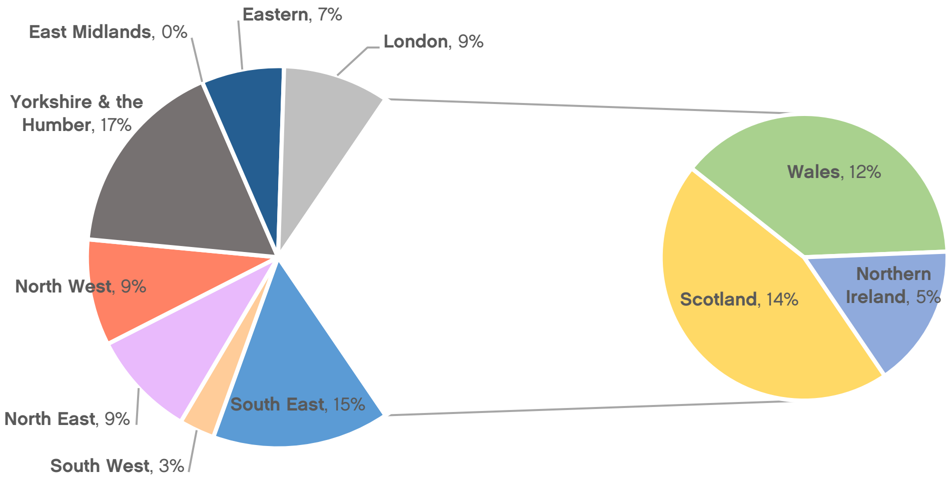
Foreign Trade Zones built around Britain's ports are particularly well suited to addressing this gap. Unlike continental markets where emphasis is placed upon monolithic super-ports, the UK's maritime activity extends over a much larger number of smaller ports across a relatively diverse geographic area. One glance at the map below illustrates well the geographic breadth of the UK port sector. By creating port-based free Zones and thereby boosting economic activity in these areas, jobs and investment would arrive where they are needed.

Not only are ports widely distributed across the country, but the North of England punches well above its weight in the sector. While the region is home to around 24 per cent of the total population, and contributes about 20 per cent of total GVA it accommodates 35 per cent of total port throughput.[55] A Free Ports programme would disproportionately benefit the North and help make a reality of aspirations to create a 'Northern Powerhouse'.

54 Financial Times, *UK North-South Divide Widens*, 2015.

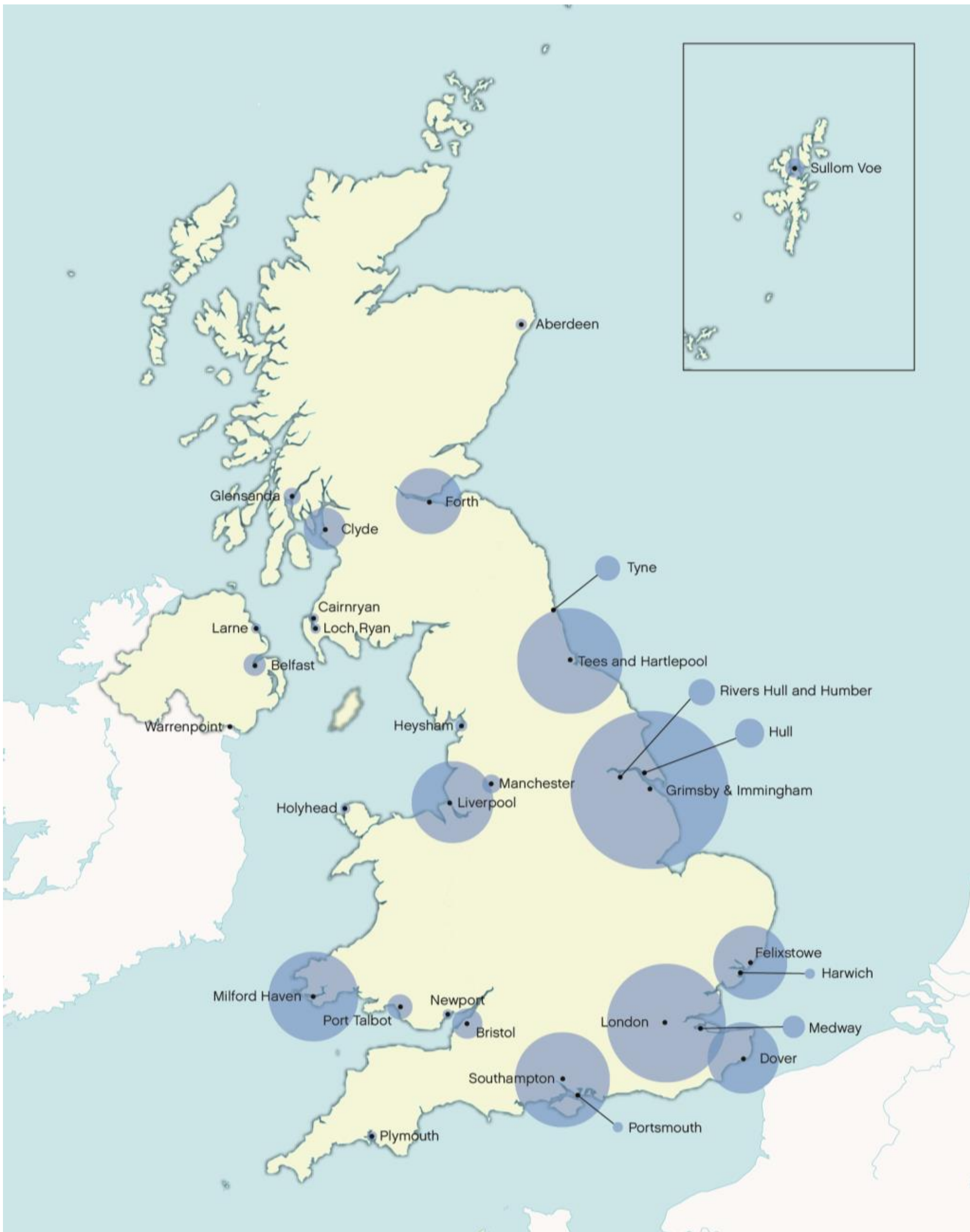
55 Institute for Public Policy Research, *Gateways to the Northern Powerhouse: A Northern Ports Strategy*, 2016, p. 4.

Figure 6: Regional distribution of UK freight tonnage in 2013



Source: Oxford Economics, The Economic Impact of the UK Maritime Services Sector: Ports, 2015, p. 16

Figure 7: UK ports by cargo,* 2014



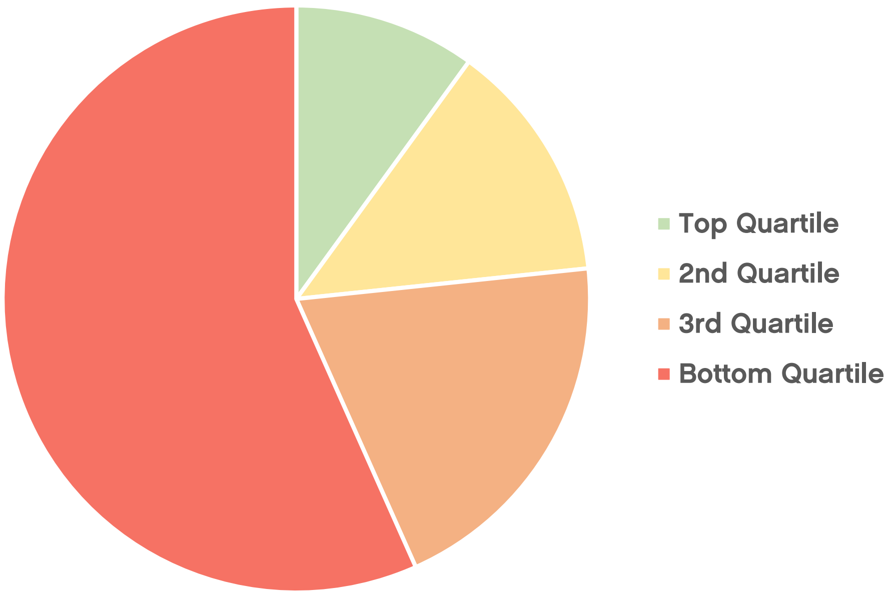
Source: Department for Transport, 2015

Furthermore, on a local level large ports are disproportionately located in areas that perform relatively poorly economically, meaning that a port-centred Free Zone programme would automatically be targeted to areas of higher unemployment and deprivation. Of the UK's 30 largest ports, 17 are in the bottom quartile of local authorities when ranked by the ONS's Index of Multiple Deprivation. In total, three quarters of these ports are located in 'below average' local authorities.[56]

* All ports marked on map handled over 2 million tonnes of freight in 2014.

56 Department for Communities and Local Government, *The English Indices of Deprivation*, 2015.

Figure 8: Top 30 UK ports by Deprivation Index quartile



Source: Department for Transport, Maritime and shipping statistics, 2016.

Table 3: Deprivation of UK ports by quartile (4 = most deprived)

Port	Deprivation Quartile
Grimsby & Immingham	4
London	3
Milford Haven	1
Southampton	4
Tees and Hartlepool	4
Felixstowe	2
Dover	3
Forth	4
Belfast	4
Clyde	4
Hull	4
Medway	3
Bristol	4
Rivers Hull and Humber	4

Port Talbot	4
Manchester	4
Sullom Voe	1
Glensanda	2
Tyne	4
Heysham	3
Harwich	4
Holyhead	3
Aberdeen	2
Orkney	1
Portsmouth	4
Warrenpoint	4
Newport	4
Larne	3
Cairnryan	2
Ipswich	4

Note: The deprivation quartiles associated with each port group refer to the Local Authority (LA) district in which each port group is located and its ranking in the Department for Communities and Local Government's Index of Multiple Deprivation. In the case of port groups spanning across multiple LAs, the LA in which the majority of activity occurs was chosen. For example, the Port of London extends across much of the Thames but the largest container docks (Tilbury and London Gateway) are located in the LA of Thurrock.

Indices of Multiple Deprivation published by England, Scotland, Wales, and Northern Ireland are not cross comparable. Therefore quartiles refer to the LA's deprivation ranking within that region. For example, Newport is located in the Welsh LA of Bristol Channel, the third most deprived of Wales' 22 LAs. Therefore, while Newport is in the most deprived quartile of Welsh LAs it does not necessarily follow it is also in the 4th quartile nationally.

Sources: Department for Communities and Local Government, 'English indices of deprivation 2015'; Welsh Government, 'Welsh Index of Multiple Deprivation, 2014 local authority analysis'; Scottish Government, 'High Level Summary of Statistics data for Social and Welfare trends'; Northern Ireland Statistics and Research Agency, 'Northern Ireland Multiple Deprivation Measure'.

The Free Zone jobs opportunity

While the *precise* impact of a fully-fledged UK Free Zone programme is not possible to quantify, an indication can be given by the job creation generated in the US:

US Free Zone Jobs	→ Adjusted for size of labour force[57]	UK Free Zone Jobs
420,000		**86,000**

Growing Manufacturing

Despite being the world's 5th largest economy Britain ranks only 9th for its manufacturing output, putting it behind both Italy and South Korea.[58] Manufacturing's contribution to the UK economy has been on a long-term pattern decline, falling from 30% of national output in the 1970s to just 10% of today, among the lowest of all OECD countries.[59] This decline has tangible negative impacts for the economy: lower productivity and wages, less overall job creation and reduced investment in R&D and the nation's ability to capitalise on future innovation.

As services are not traded in containers or subject to customs and duties in the same way as goods, a Free Ports programme, almost by definition, targets manufacturers handling tangible goods rather than the services sector. Thus, Free Ports can contribute to an economic rebalancing by encouraging manufacturing growth.

Manufacturing growth would help drive up UK productivity and thus wages. In 2014, UK productivity was 19% below the G7 average for per-worker output.[60] Part of the explanation for this is an over-reliance on the services sector where productivity is 20% lower than in manufacturing sectors. Furthermore, services productivity has historically grown less quickly.[61] Generally, the manufacturing sector has benefitted from advancements in technology in a way that other sectors, particularly the service sectors, have not. The lower productivity exhibited by services jobs means average wages fall as workers move from manufacturing sectors to employment in services.

57 US total labour force = 161.1 million, UK total labour force = 33.0 million (World Bank, *Total Labour Force Data*, accessed 14 October 2016).

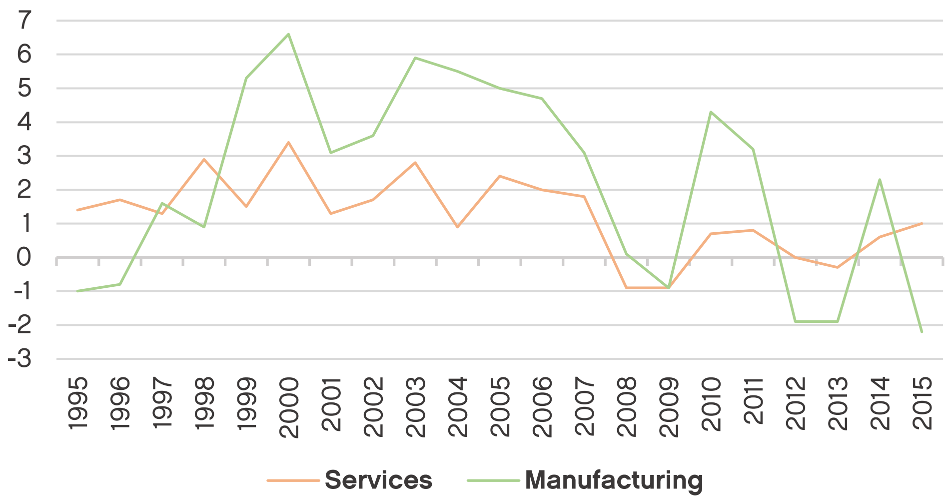
58 House of Commons Library, *Manufacturing: International Comparisons*, 2016, p. 4.

59 House of Commons Library, *Manufacturing: Statistics and Policy*, 2015, p. 4 and World Bank data.

60 Office for National Statistics, *Statistical Bulletin, International Comparisons of Productivity - Final Estimates: 2014*, 2016.

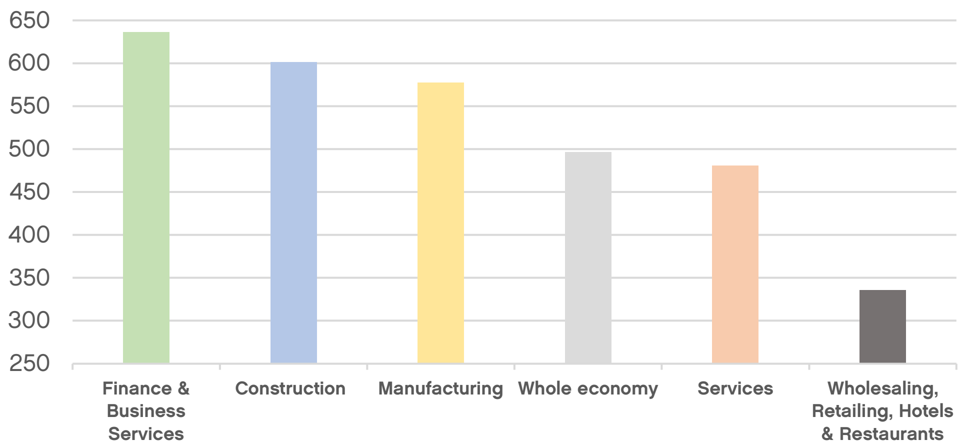
61 House of Commons Library analysis of ONS Statistics, 2015.

Figure 9: Productivity (output per hour), annual % change



Source Office of National Statistics, Statistical Bulletin, International Comparisons of Productivity - Final Estimates: 2014, 2016.

Figure 10: Average weekly wage (£s) for year ending May 2016



Source: Office for National Statistics, Earnings and Working Hours, 2016.

The manufacturing sector accounts for 70% of all UK R&D investment, despite accounting for just 10% of national output. Less manufacturing activity in an economy leads to less investment in discovering the new paths to prosperity. Furthermore, global companies are increasingly re-locating R&D activities to where manufacturing actually takes place so researchers can work closely with those responsible for putting ideas into practice. Even if the UK retains the headquarters of manufacturing companies, without retaining the physical manufacturing it is more likely to lose the highly skilled research jobs over time. It is worth noting that China is now home to over 1,200 R&D facilities established by foreign multinationals.[62]

62 Andrew Liveris (CEO of Dow Chemical), *Make it in America*, 2012, p. 48.

It is also anachronistic to view manufacturing as a 'traditional' industry of the past: from developing new chemicals that prolong the life of batteries in hybrid vehicles or building advanced robotics to aid complex neurosurgery,[63] manufacturing is key to our future prosperity and well-being.

There is clear research[64] demonstrating that investment in manufacturing has a much higher economic multiplier than investment in other sectors. In other words, a new manufacturing investment is likely to lead to many more other jobs being created up and down the supply chain and outside of the sector itself compared to a comparable investment in the services sector.

"Foreign trade Zone operations have the advantage of closeness of production and distribution to the marketplace. They represent a middle ground, which combines local advantages with low-cost foreign inputs. Thus, the manufacturing process does not have to be exiled to foreign countries."

Sean Lydon, Director, Sony Electronics Inc

Internationally, the clear experience has been that creating free Zones increases the incentives for manufacturers to establish operations, re-configure supply chains, and exploit new lines of business. Free Zones can also make existing manufacturing operations more efficient, improving international competitiveness and creating new profits which can be used for further investment. Manufacturers with global supply chains are ideally placed to capitalise on the opportunities provided by Free Ports.

"Direct Delivery" at Free Ports improves manufacturing efficiency

Due to more flexible customs formalities, imported parts can be used immediately on a production line with reporting to customs authorities done at a later date – shipping can occur 24 hours a day, even when customs officials are unavailable.

This "Direct Delivery" is enormously valuable to a manufacturer operating a 'just in time' inventory system. If a shipment arrives at midnight, it can be taken straight to the line for use and therefore realise the benefits of using imported components, reduce the need to carry so much inventory, and eliminate the risk of lines being shut down due to part availability.

This supply chain flexibility is used by auto manufacturers, pharmaceutical companies and food processors who are dealing with perishable products. These benefits are only enhanced when free Zones are located in ports where inbound shipments can be quickly transferred to the nearby plant, further reducing manufacturing cycle times.

63 Ibid

64 US Bureau of Economic Analysis, cited by Liveris, ibid p. 19.

Free Zones help reduce the costs of scrap in the manufacturing process

Scrap is one of the products of any manufacturing process. By locating a manufacturing plant in a free Zone, duty is never paid on the scrapped material from imports which is often re-exported or discarded and therefore disregarded for domestic duty purposes.

As well as the typical waste of a manufacturing process, scrap also refers to shrinkage, seepage and evaporation. For example, edible nuts imported from Brazil, India or other countries can be stored in free Zones until they dry out. Subsequently they can be presented to Customs for the payment of duties on a reduced weight since the water contained within them has since evaporated.

Free Zones can host 'show room' space for capital goods[i]

Whilst goods are in a free Zone, title remains with the seller/manufacturer and no duty is owed until the goods cross the boundary into the economy. Free Zones can therefore act as a manufacturer's show room where they can send their goods without incurring customs duties and potential buyers can inspect and sample goods before purchase.

Show rooms in free Zones allow the manufacturer to cost effectively market their goods without incurring multiple sets of duties. Many overseas firms claim that without a show room they would never have been able to capture such a large share of a domestic market.

[i] *Susan Tiefenbrun, U.S. Foreign Trade Zones of the US, Free Trade Zones of the World, and their Impact on the Economy, Journal of International Business and Law, Vol. 12 Issue 2, 2013.*

The dynamism of British ports has already played a key role in attracting high productivity manufacturing jobs to the UK and making ports Free Zones will further enhance their appeal. For Nissan, which represents one-third of all UK car manufacturing, the proximity of the Port of Tyne played a key role in its decision to invest in the North of England. Today, the Port of Tyne is the second-largest car exporter in the UK, and thirteenth largest in Europe.[65] The Port of Hull, meanwhile, recently received a £310 million combined investment from Siemens and Associated British Ports (ABP) to establish the area as an advanced manufacturing hub geared towards the North Sea's offshore wind industry. The investment is expected to directly create 1,000 new jobs in the area.[66]

65 IPPR, *Gateways to the Northern Powerhouse: A Northern Ports Strategy*, 2016, p. 22.

66 Siemens, *Siemens' Investment in Green Port Hull.*

North East Cluster 1: Tyne Port and Automotive Sector

The Port of Tyne supports a total of 14,000 jobs in one of the country's most deprived regions,[i] providing the logistical backbone to the manufacturers who have helped make the North East the only English region with a consistently positive balance of trade.[ii]

In addition to serving customers including Hitachi, VW Group and Hoegh, the Port of Tyne has played a key role in one of the UK's most notable manufacturing success stories: Nissan Sunderland. Producing a car every thirty seconds – 10,000 vehicles a week – Nissan Sunderland is reliant on the port for its export-focused manufacturing.

80% of the plant's production is exported to over 130 countries globally, and around a third of the cars are destined for markets outside of Europe. In fact, Nissan Sunderland is the sole global supplier of the new Infiniti Q30 for the American and Chinese markets. The success of Nissan Sunderland has enabled it to employ 7,000 people with an estimated 27,000 supported jobs in the regional supply chain.[iii]

As one former senior executive of Nissan International explained, the creation of FTZs in the Tyne Port area could be of crucial importance to retaining car manufacturing jobs post-Brexit:

"*Manufacturers like Nissan need flexibility to go out and source parts from around the world. However, if you have a means of getting components into the UK in a very favourable environment from a duties and taxes perspective, this would be major benefit and the manufacturer will be much more inclined to maintain a strong base in Britain.*

The same global vehicle model is often manufactured in different locations. For efficiency, auto manufacturers use a single high-volume, low-cost component supplier near one of the manufacturing plants, and then ship the parts to other assembly plants worldwide. For example Nissan's Qashqai is made in the UK, US and South Korea. This need for trade in parts increases the importance of free Zones in attracting global manufacturers."[iv]

The Port has also been able to benefit from regional businesses further afield. Based in County Durham, Hitachi Rail Europe, is currently producing 122 state-of-the-art trains for the use of the East Coast and Great Western Main Lines.[v] The project sees train body-shells weighing 28 tonnes brought in to the Tyne Port before being transported to the company's manufacturing facility in Newton Aycliffe.[vi]

[i] Port of Tyne, *About Us;* [ii] North East Local Enterprise Partnership, *Growth for North East Exports*, 2015; [iii] Port of Tyne, *Car Terminals;* [iv] Transcript of private interview, October 2016; [v] Hitachi Rail Europe, *The Intercity Express Programme (IEP) is a Project in Progress.*; [vi] Port of Tyne, *Current: Your Quarterly Update from The Port of Tyne*, 2015.

North East Cluster 2: Teesport and the Chemicals Industry

"The trade advantages of Free Zones sound like they could directly benefit chemical companies based in the North East, especially if they can be combined with other infrastructure support for the sector."[i]

Dr Stan Higgins, CEO, North East Process Industries Cluster

The North East is home to a cluster of businesses involved in chemicals and accounts for almost 60% of all UK chemicals production. The companies are involved in fine & speciality chemicals, petrochemicals, polymers and composites, pharmaceuticals, biotechnology, bio-resources, biofuels and renewable energy and low carbon materials.

There are more than 1,400 companies directly involved in the supply chain of these industries, generating £26 billion in annual sales, employing 190,000 people, and making this one of the only net-exporting regions in the UK.

Chemical companies are notably dependent of trade both for imports of raw materials and exports of finished goods. In general, 75% of the chemical cluster's product is exported and a large proportion of its raw materials are imported, often paying tariffs of up to 6.5%. Clearly, a free Zone that exempted raw material imports from tariffs, allowing them to be processed and re-exported, would be greatly beneficial to the industry.

The industry cluster is built up deliberately around the ports in Teesside, Hartlepool and the Tyne, which are key to the industry's success. Around 70% of the cargo handled at Teesport, the country's third largest port in terms of tonnage, is related to the chemicals industry.

Chemicals executives cite UK energy costs as a particular issue for their international competitiveness. Energy is a major cost input in many chemical processes. Freed from EU State Aid rules, the UK would likely have more flexibility to support the industry with specific policies to tackle high energy prices, including examining tariffs on internally (within a group of companies on a chemical park) generated energy.

[i] *Transcript of private interview, October 2016.*

CONCLUSION

Upon leaving the EU, Britain will find itself with more opportunities for economic innovation than at any time in almost 50 years. As the date of our departure draws closer, it will be the responsibility of government to ensure Britain is not timid in seizing those opportunities.

This report has argued that an extensive and ambitious network of UK Free Ports would not only provide domestic manufacturers with a wealth of tangible benefits, but also send a clear message to international markets that Britain's new global role will be open, innovative, and outward looking. It is therefore imperative that, if the recommendations of this report are to be implemented, the Government acts to legislate in the immediate aftermath of Britain's departure from the EU.

There will, of course, be those that argue that Free Ports do not go far enough. Some economists have advocated that Britain should adopt a unilateral 0% tariff.[67] Whatever the economic merits of this policy, the political reality is that this is unlikely. To the general public, the inherent unfairness of one-sided liberalisation and also the loss of bargaining chips needed to forge a new wave of trade deals upon exiting the EU, make this direction an unlikely path for politicians.

Free Ports, on the other hand, have the advantage of a broad ideological appeal that could be expected to command bipartisan support, allowing the policy to act as a rapid response in the event of British withdrawal from the Customs Union. It is easy to see Labour mayors of regional port cities partnering with a pro-enterprise, pro-trade Conservative Government to make Free Ports successful.

Another great advantage of a Free Ports policy is that its fundamental simplicity and the wealth of international precedent make implementation possible over a short timescale. While a more ambitious programme than the Enterprise Zones introduced by the Coalition Government in 2011, Free Ports have similar legislative requirements. It is therefore reasonable to suggest that a determined government could see the first Free Ports become operational within as little as a year of announcement, as was achieved with Enterprise Zones.

[67] Daily Telegraph, *Britain must ditch its protectionist EU trade agreement,* 2016.

The obvious, and probably the most effective, mechanism for deciding upon the locations of the first Free Ports would be a hybrid approach. A number of locations would be decided upon centrally in accordance with the government's industrial strategy priorities – Tyneport, with its importance for the UK car industry, being an example. The remaining locations, meanwhile, could be decided through a bidding process in which Local Enterprise Partnerships, Devolved Administrations and the ports themselves would be able to submit their case for participation.

This competitive process would see Devolved Regions 'bidding' for the right to gain government support, demonstrating what they will also do locally to support the Free Port's success.

What Brexit means for Britain will be determined as much by how we make use of our new freedoms as by the outcomes of the forthcoming negotiations. Free Ports are not a panacea, but, with decisive action, they have the potential to lay the foundations of a golden age of prosperity for a Britain connected by its trading and manufacturing businesses to every corner of the world.

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Around 2,500 years ago the triremes of the ancient Mediterranean – 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.

Foreign Trade Zones are now flourishing all around the world – except in the European Union. Post-Brexit they could play an important role in signalling Britain's openess to the world, as well as reconnecting the nation with its maritime history.

The potential benefits are significant, the costs minimal, the politics simple. When implemented, Free Ports would simultaneously: increase manufacturing output, encourage employment regionally where it is most needed, and promote trade.

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