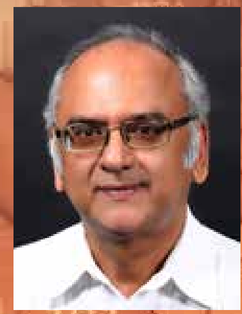
“Free Zones of the Future” as Opportunity to Reposition Free Zones in Global Value Chains



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"changing macro-economic context provides both opportunities and challenges for Free Zones as hubs within a global value chain"

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"Free Zones help accelerate, redefine global value chains", an article in "The Gulf Today" published on October 11th, 2015[1] . The article summarized the presence of the World Free Zones Organization's (World FZO) chairman Dr. Mohammed Al Zarooni at the American National Association of Foreign Trade Zones (NAFTZ) 43rd Annual Conference and Exposition in Los Angeles. In his speech, Dr. Al Zarooni addressed how the changing macro-economic context provides both opportunities and challenges for Free Zones as hubs within a global value chain (GVC) and how these may be leveraged into sustainable economic growth.

Since the theme of the World FZO's 2nd Annual International Conference and Exhibition revolves around opportunities and challenges for Free Zones in Global Value Chains (GVC), it is worthwhile to further explore the position of Free Zones in these GVCs.

In order to understand the role Free Zones currently play within GVCs, it is critical to consider the relationship between Free Zones and GVCs from a historic perspective. The integration of Free Zones within GVCs started in the late 1970s and was fueled by a number of developments in the global economy that altered the way multinational enterprises (MNEs) operated.

The most prominent of these developments was the increased integration and liberalization of economies and markets, a process often named "globalization". To a certain extent, global markets have always been integrated due to international investment and, largely, trade (e.g. Roman Empire and along the Silk Route) but the volume of global investment and trade accelerated particularly during the 1980s and 1990s. This is particularly true for cross-border investment or foreign direct investment (FDI). FDI really took off after the second World War between the United States, United Kingdom and continental Europe. During the 1960s and 1970s, FDI was focused on export and mainly directed to the Asian Tigers (e.g. South Korea). Especially from the 1980s and 1990s onwards, the volume of FDI – largely driven by market-seeking motives due to the emergence of regional trading blocs (e.g. NAFTA, EU and Mercosur) and increasing

market commonalities (i.e. standardization of products and demand across the globe such as credit cards and phones) – accelerated MNEs started to further expand their GVCs. Examples of such GVCs include production facilities in China, non-core activities and outsourcing (e.g. IT services) in India and headquarters and research and development activities in MNEs' home markets.

The expansion of GVCs can be linked with a second development which changed the global environment of investment and trade. From the 1980s onwards, governments actively abolished protectionist policies, removed trade and investment barriers and opened up their domestic markets for international trade and investment. This development, generally referred to as "liberalization", set the political and economic agendas throughout the 1980s.

Finally, improvements in transport technology (e.g. in shipping) and communications (e.g. computer, internet and digitalization) further encouraged a rapid globalization as the enhanced transport technology reduced transportation costs considerably. Lower transportation costs added to liberalization in that it further eases the process of moving goods and services across borders. Improvements in communications reduced or completely removed barriers to enter markets or, as argued by Friedman, resulted in a "flat" world[2], leading to increased exposure to international competition.

Together, these developments shaped the conditions which enabled MNEs to develop GVCs. Due to the increasing scale, volume and efficiency of global investment and trade as a result of these developments, MNEs could both vertically (i.e. subsequent operations in their value chain) as well as spatially (i.e. across border) expand their production networks and operations[3].

As a means to rationalize and mobilize their corporate structures, MNEs started to re-locate and fragment their assembly, manufacturing, logistics and distribution activities to countries with a comparative advantage in these activities. Examples of such comparative advantages include relatively lower labor costs

1 The Gulf Today (2015), Free Zones help accelerate, redefine global value chains

2 Hart, J. (2010), Globalization and Digitalization
3 Farole, T. and Akinci, G. (2011), Special Economic Zones: Progress, Emerging Challenges, and Future Directions

(e.g. Southeast Asia) and economies of scale (e.g. China). This global offshoring, a direct consequence of globalization as the re-location of production activities of MNEs to emerging and developing countries contributed to the "new international division of labor". In this new international division of labor, developing and emerging countries do not primarily focus on supplying natural resources such as metals, wood and oil (i.e. "old" international division of labor) but are more activity integrated in the global economy because of the production and manufacturing activities of MNEs located in these countries, of which mostly Asian countries. The result of this expansion of MNEs is a network of activities spanning across the globe: GVCs.

So how did Free Zones successfully position themselves within these GVCs? Free Zones successfully tapped into these rapidly expanding GVCs in the 1980s and 1990s by attracting a large share of foreign investment. Offering a conducive environment for doing business complemented with sources of competitiveness including infrastructure, generous fiscal incentives and preferential market access to large consumer markets through preferential trade agreements[4] (e.g. United States and European Union), Free Zones attracted a vast portion of investment typical for GVCs.

This is particularly the case for assembly and manufacturing in industries like automotive, electrical goods, electronics, garment, textiles and apparel[5]. Activities at the lower end of the GVC are located in the low-wage countries whilst activities that are more up the GVC have been located in medium-income countries. Examples of the former include textiles and garment manufacturing in Bangladesh whilst electronics assembly in Malaysia and automotive assembly in Mexico are examples of the latter.

During the NAFTZ 43rd Annual Conference and Exposition, Dr. AL Zarooni highlighted: "Free Zones have rapidly expanded because they offer a proven investment and economic development tool for the global value chain[6]." Indeed, because of their competitiveness, Free Zones attracted a large share of mobile investment in these industries and activities in the last decades of the 20th century.

However, as also emphasized by Dr. Al Zarooni and indicated by the theme of the World FZO's 2nd Annual International Conference and Exhibition, Free Zones currently face a number of challenges that are related to their position within GVCs. As a matter of fact, if these challenges sustain, they may effectively undermine the competitive position of Free zones as hubs within GVCs.

A number of recent developments have affected the competitiveness of Free Zones for attracting investment from GVCs:

- Global economic recession: the development which certainly has had the largest impact on how MNEs operate, was the global financial crisis of 2007 and 2008, which subsequently led to the global economic recession that lasted until 2012. Not only have these crises dampened the pool of mobile investment as MNEs postponed their investment. They also altered the way MNEs organize their corporate structures. In search for reducing operating expenditures to "survive" the crises, MNEs started consolidating their GVCs by concentrating their activities in a limited number of countries[7]. This implies global investment has been concentrated and scaled up in a limited number of Free Zones at the expense of a much larger number of Free Zones from which GVC investments have been withdrawn and relocated. Free Zones in Asia have done particularly well, mostly due to their massive economies of scale and competitiveness in light manufacturing[8].

- Regionalization: in addition to the global macro-economic downturn, a political force which has eroded the traditional sources of competitiveness of the Free Zones, most notably the preferential market access through preferential trade agreements, is the ever-increasing process of regionalization. The world has seen an increasing number of bilateral and regional trade agreements that, to a certain extent, replace preferential market access, which has functioned as a traditional source of competiveness. As more countries have such agreements in place, more countries obtain "preferential" market access, which undermines the exclusiveness of preferential market access. In addition, due to customs regulations and the exclusion of products and goods manufactured in Free Zones from trade agreements, such agreements could potentially damage the companies currently based in Free Zones and using the Free Zone as platform for regional exports.

- Standardization and uniformity of incentives and World Trade Organization (WTO) agreements: another challenge for Free Zones concerns incentives offered within their jurisdiction. Firstly, fiscal incentive packages offered in Free zones have become increasingly standardized and uniform across the globe (e.g. most Free Zones offer corporate income tax holidays, preferential duty treatment and other tax exemptions). Furthermore, the WTO's Agreement on Subsidies and Countervailing Measures (SCM) has been designed to phase out subsidies on export performance and use of local contents. The implication is that the options to differentiate by providing fiscal incentives within a Free Zone have become limited.

Summing up, to remain competitive as hubs for GVCs, Free Zones need to move away from the traditional sources of competitiveness mostly based on cost advantages (e.g. overgenerous fiscal incentives, exclusive focus on low wages and preferential market access). These low cost and low tax business environment strategies are easy to copy and replicate. Recently, a trend has been witnessed where new Free Zones have been developed as a location for multi-use, more complex manufacturing, professional services and commercial activities requiring a more educated and skilled workforce[9].

However, the challenge a number of Free Zones face is that, because of their narrow focus on traditional sources of competitiveness, they are situated in a "lock-in" situation due to

overreliance on assembly, light manufacturing activities and a limited number of industries. To achieve diversification and socio-economic upgrade, a "role reversal" is required, where Free Zones need to move beyond the traditional sources of competitiveness and look for alternative and sustainable sources of competitiveness. Ideally, Free Zones do not only deliver short-term static gains (e.g. job creation, attraction of investment and increased exports and revenues) but also long-term dynamic gains (e.g. structural transformation of the economy).

4 Farole, T. (2011), Special Economic Zones in Africa: Comparing Performance and Learning from Global Experiences
5 Akinci, G. and Crittle, J. (2008), Special Economic Zones: Performance, Lessons Learned, and Implications for Zone Development
6 The Gulf Today (2015), Free Zones help accelerate, redefine global value chains
7 Farole, T. (2011), Special Economic Zones in Africa: Comparing Performance and Learning from Global Experiences
8 Farole, T. (2011), Special Economic Zones in Africa: Comparing Performance and Learning from Global Experiences
9 Akinci, G. and Crittle, J. (2008), Special Economic Zones: Performance, Lessons Learned, and Implications for Zone Development

To maximize the dynamic benefits, this shift to a "new generation" of Free Zones should be aligned with so-called "new generation" investment policies[10], which put a high priority on inclusive growth and sustainable development while strengthening or maintaining the competitiveness of the investment climate. The approach for Free Zones addressing these challenges and achieving dynamic gains may be twofold:

1. Focus on alternative sources of competiveness: move beyond overgenerous fiscal incentives, preferential market access and relatively low wages to better respond to actual business needs and the evolving global market, thereby improving the overall economic competitiveness of the Free Zone for MNEs and their GVCs.

2. Focus on sustainable sources of competitiveness: the shift to other sources of competitiveness provides an opportunity for positioning and structuring Free Zones as hubs of socio-economic growth by providing cost-effective infrastructure and good support enabling socio-environmental practices and compliance[11].

Recognizing the role of the national investment climate is critical in the search for alternative sources of competitiveness. Free Zones should not operate as "enclaves" or "islands" and should be integrated with the national investment climate. This relates not only to the physical aspect (i.e. infrastructure) but also to labor, economic and fiscal policies to ensure linkages between Free Zones and the local economy are developed.

Critical is to place the Free Zone in the economic context of the country by aligning the target industries with comparative advantage of the national or local economy. This makes the Free Zones relevant to the economic context of the national investment climate whilst it simultaneously leverages the comparative advantages as alternative sources of competitiveness to attract companies to the Free Zone.

Responding to current market signals also requires a focus on the quality of the investment climate within the Free Zones rather than the amount of incentives provided. This includes, amongst others, high-quality infrastructure, soft incentives (e.g. skills development and training centers) and regulatory incentives (e.g. streamlined and simplified administrative procedures).

When it comes to sustainable sources of competitiveness, MNEs have increasingly started to implement their corporate social responsibility (CSR) standards. Implementing these throughout their GVCs is particularly effective as these usually include corporate activities in developing and emerging countries. It nevertheless remains a challenging task to implement CSR standards in a cost effective manner and with local suppliers at the lower ends of a MNE's GVC. Because MNEs are geographically clustered within Free Zones and offer pooled resources, Free Zones have the potential to offer a regulatory infrastructure (e.g. trained inspectors) and physical infrastructure (e.g. waste treatment facilities), which otherwise may be expensive to implement, at a manageable and cost-effective scale. Consequently, Free Zones function as hub of sustainable development in line with international socio-environmental standards and contribute to realizing environment and social policy objectives.

One tool that may be at the disposal of Free Zone authorities, policy-makers and practitioners may be the "V-R-I-O" concept[12]. This concept is comprised of four key criteria by which capabilities can be assessed in terms of providing a basis for achieving sustainable sources of competitiveness and are therefore applicable to the context of Free Zones. These four key criteria include:

V – Value of strategic capabilities

Strategic capabilities are of value when they:

a. Take advantage of opportunities and neutralize threats.
b. Provide value to customers which are provided at a cost that still allows an organization to make an acceptable return.

R – Rarity of strategic capabilities

a. Rare capabilities are those possessed uniquely by one organization or only by a few others (e.g. a company may have patented products, have supremely talented people or a powerful brand).
b. Rarity could be temporary (e.g. patents expire, key individuals can leave or brands can be de-valued by adverse publicity).

I – Inimitability of strategic capabilities

Inimitable capabilities are those that competitors find difficult and costly to imitate, to obtain or to substitute:

a. Competitive advantage can be built on unique resources (a key individual or IT system) but these may not always be sustainable (key people leave or others acquire the same systems).
b. Sustainable advantage is more often found in competences (the way resources are managed, developed and deployed) and the way competences are linked together and integrated.

O – Organizational support

a. The organization must be suitably organized to support the valuable, rare and inimitable capabilities that it has. This includes appropriate processes and systems.

This concept is applicable to the operation of Free Zones and their necessary shift to sustainable sources of competitiveness. The strategic capability of Free Zones mainly revolves around the complete service proposition of the particular Free Zone. This service proposition encompasses all services, infrastructure, utilities, incentives and preferential regulatory and customs treatment that are provided to investors in a Free Zone. In this case, the Free Zone service proposition should provide value to its investors but should simultaneously be provided at a cost-recovery basis for the Free Zone authority.

Furthermore, to achieve a sustainable competitive advantage, the Free Zone service proposition should be unique and exclusive ("rarity") and should be complex and costly to duplicate or substitute by other Free Zones ("inimitable"). This would, for instance, include a service proposition in line with industries and sectors in which a Free Zone has local comparative advantages. This way, its service proposition does not function as a "blueprint" for other Free Zones, which most likely possess comparative advantages in other industries.

10 UNCTAD (2015), Enhancing the Contribution of Export Processing Zones to the Sustainable Development Goals: An analysis of 100 EPZs and a Framework for Sustainable Economic Zones
11 UNCTAD (2015), Enhancing the Contribution of Export Processing Zones to the Sustainable Development Goals:An analysis of 100 EPZs and a Framework for Sustainable Economic Zones

12 Barney, J. (1991), "Firm resources and sustained competitive advantage", Journal of Management, vol. 17 (1991), no. 1, pp. 99–120.

Is the service proposition of a Free Zone...				
Valuable?	Rare?	Inimitable?	Supported by Organization?	Scenario
No	-	-	-	Competitive disadvantage
Yes	No	-	-	Competitive parity
Yes	Yes	No	-	Temporary competitive advantage
Yes	Yes	Yes	Yes	Sustainable competitive advantage

Finally, the organization should be well-equipped to implement this service proposition and maintain its delivery and high-quality standards ("organizational support"). This element concerns a number of Free Zone stakeholders, including the Free Zone regulator administrating the zone, the developer who physically constructs the Free Zone and its infrastructure and the operator or administrator who is in charge of the day-to-day management of the zone.

If all four elements are in place, then the Free Zone has successfully achieved a sustainable competitive advantage and combines it attractiveness to investors and the global evolving market in a socio-economic and environmental sustainable manner.

Concluding, it is the shift to alternative and sustainable sources of competitiveness that in itself provides renewed opportunities for Free Zones to strengthen their position within GVCs. It is the Free Zone which is able both to respond to the needs in the evolving global market as well as to develop infrastructure and (after)care enabling socio-environmental practices that is ready to compete in the global arena in the nearby future. After all, the theme of the World FZO's next Annual Conference is "Global Value Chain: Opportunities for the Free Zone of the Future!"

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