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Incentives Awarded across Free Zones:

Confirming the Transition to "Free Zones of the Future?"

By:

Mr. Laurens Van der Schoor, Free Zones & Incentives Advisor, Investment Consulting Associates (ICA)
Dr. Mohan Guruswamy, Chief Knowledge Officer, World FZO

Over the last decades, Free Zones have taken on a wide variety of names, concepts and designs, ranging from the more "traditional" models of Export Processing Zones (EPZs) and Free Trade Zones (FTZs) to "new generation" models such as diversified Special Economic Zones (SEZs) and cluster-based Specialized Zones (SZs). The common denominator among all of these Free Zone concepts, however, is that companies investing and locating in Free Zones enjoy a privileged status in terms of customs practices and regulations. Zone-based companies are typically exempted from import and export duties, value-added tax (VAT) and other (local) taxes which, in combination with simplified and streamlined customs and administrative practices, considerably reduce their operating costs.

In addition to this preferential treatment, zone-based companies often are eligible to take advantage of other fiscal and financial benefits that may be awarded in the form of incentive packages. Incentives provided to companies in Free Zones may have different objectives. Traditionally, incentives have been awarded as generous full or partial exemptions on corporate income and profit taxes (i.e. tax holidays) to directly increase the net profit of export-orientated companies. More recent, incentives seek to compensate for particular weaknesses of the Free Zone's competitiveness (e.g. grants to train and educate the local workforce), reduce operating and investment expenditures (e.g. business support and cash grants to offset capital expenditures for materials and equipment) or mitigate the regulatory burden (e.g. exemption from national or sub-national rules and regulation).

A number of observations with regards to incentive packages awarded within Free Zones can be made according to a number of international studies on Free Zones (e.g. World Bank, Facility for Investment Climate Advisory Services and the Organization for Economic Cooperation and Development). Firstly, Free Zones, especially in developing and emerging countries, seem to be biased towards providing fiscal incentives, particularly tax holidays, complemented with import duty exemptions, exemption from local taxes, unlimited repatriation of profits and capital as well as personal income tax exemptions. From a political perspective, it is more tempting to provide fiscal incentives as opposed to other forms of incentives such as cash grants, credits and funds as fiscal incentives do not directly require spending tax-payers' money but rather result in opportunity costs in the form of revenue foregone.

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Secondly, it is claimed the scope of incentive packages provided by Free Zones has become increasingly similar and standardized across the globe. This has been spurred by two recent developments. The implementation of the World Trade Organization's (WTO) Agreement on Subsidies and Countervailing Measures (SCM), which has been designed to phase out incentives on export performance and the use of local contents, restricts the provision of classical fiscal incentives contingent on export requirements. In addition, the proliferation of regional trade agreements (RTAs) and, subsequently, the formation of regional trade blocks have limited the scope of incentives as a national policy instrument. Regulations and clauses on the provision of (future) incentive packages for Free Zones may increasingly become incorporated within RTAs resulting in regionally harmonized and uniformed incentive practices that potentially affect Free Zones. Also, the further intensification of RTAs and the implementation of the WTO's SCM have led Free Zones with fewer options to differentiate their incentive packages, which may lead to an increased commonality of Free Zone incentive packages.

However, this shift of Free Zone incentives policies away from the classical fiscal incentives reflects a larger trend where "traditional" Free Zone concepts evolve into more "new generation" concepts (e.g. SEZs and SZs). It is often claimed the more "traditional" Free Zone models primarily focus on attracting new greenfield investment undertaken by foreign export-orientated companies engaged in labor-intensive manufacturing, warehousing and logistics through awarding fiscal incentives to support capital investment. "New generation" Free Zones, on the contrary, typically target a wider variety of industries with special attention for high-end and high value-adding sectors (e.g. R&D, headquarters). Such zones rather provide non-fiscal incentives aimed at, for instance, improving the local labor force through skills and human resource development. Also, these "new generation" Free Zones do not discriminate between foreign and domestic investors and extend their incentives and services package to existing investors rather than a focus exclusively on new investors.

This research paper seeks to identify whether incentive packages that have been awarded to zone-based companies reflect this move to "new generation" concepts of Free Zones and whether Free Zone incentives have indeed become similar and uniform. Identifying trends concerning the recipients of Free Zone incentives (e.g. industry, sector, foreign or domestic, greenfield or expansion) helps to explore what type of investors Free Zones currently desire and target, which may or may not be in line with the "new generation" concept of Free Zones. Of course, such targets may vary considerably across countries and even across Free Zones within a country so caution is required when generalizing cross-country data. However, data on Free Zone incentives is scarce and this research study rather functions as point of departure as it explores unique Free Zone incentives data.

Data on investment incentives which have been exclusively awarded to companies locating in Free Zones has been retrieved from the IncentivesMonitor.com database. This data functions as ideal proxy for exploring how and to whom incentives have been awarded by Free Zone authorities and/or (local) governments as it captures both quantitative indicators (e.g. number of jobs created and value of capital investment invested by the incentive recipient) as well as qualitative characteristics (e.g. nationality and industry of the incentive recipient). Based on the IncentivesMonitor.com data, a sample of 966 awarded Free Zone incentives has been constructed.

Trends of Free Zone Incentives

These 966 incentives have been awarded across 24 countries from January 2010 up to and including March 2016. As the table below shows, a total of US$421.2 million has been spent by governments and Free Zone authorities on incentive packages awarded to zone-based companies. This implies an average value of US$0.95 million per incentive package. In turn, companies in Free Zones that received these incentives invested for a total value of US$22.79 billion, thereby creating over 204,000 new jobs. As such, an average Free Zone investment project that received incentives equaled a value of US$26.6 million and created 212 new jobs.

Over 2015, the database recorded 118 incentives that had been awarded in Free Zones, which, together with 2011, is the lowest annual number so far. Despite this low number, the average value of incentive packages has not decreased. On the contrary, with an average value of US$1.57 million and US$1.89 million in 2015 and 2014, respectively, incentive packages remain relatively generous. Thus, governments and authorities award fewer incentive packages but spent more money on these incentive packages. This may be a reflection of the fact that governments and authorities are more selective in awarding (larger) incentive packages due to budgetary and strategic reasons.

Table 1: Overview of key Free Zone incentive statistics

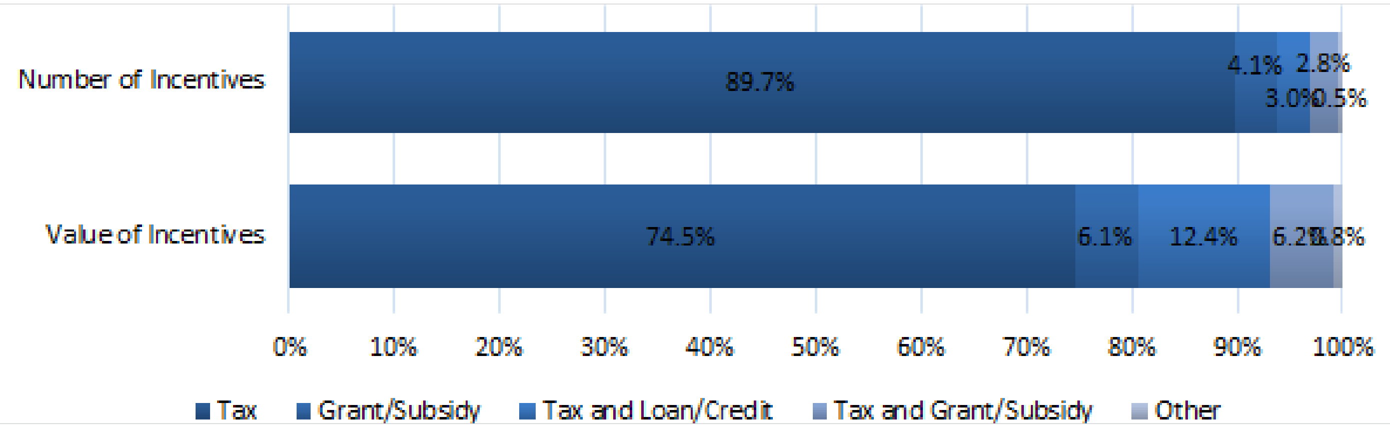
Year	Number of Awarded Incentives	Value of Awarded Incentives (US$ mln.)		Value of Capital Investment (US$ mln.)		Number of Newly Created Jobs	
		Total	Average	Total	Average	Total	Average
2010	146	$130.9	$1.03	$2,708.0	$22.0	17,890	123
2011	115	$73.0	$1.55	$1,649.2	$16.7	41,053	357
2012	215	$49.1	$0.41	$4,051.7	$22.0	34,421	160
2013	185	$90.7	$0.93	$4,276.9	$24.9	45,391	245
2014	144	$62.4	$1.89	$2,696.4	$19.7	23,993	167
2015	118	$11.0	$1.57	$6,961.1	$62.2	29,308	248
2016	43	$3.9	$3.06	$449.4	$14.5	12,360	287
Total	966	$421.2	$0.95	$22,792.7	$26.6	204,416	212

Source: IncentivesMonitor.com (2016) Date range: 2010-2016

Type of Free Zone Incentives

As mentioned, international studies highlighted the reliance of Free Zones on fiscal incentives, particularly tax holidays. Indeed, across the sample of 966 incentives, the vast majority continues to take the form of tax incentives. Nearly 90% of the incentives has exclusively been awarded in the form of a tax incentive. However, in terms of the budget spent on incentives, disproportionately more money has been spent on an incentive package consisting of a combination of tax advantages and a loan or credit (i.e. 12.4% of the total budget spent on incentives against just 3.0% on the total number of incentives).

Figure 1: Distribution of total number of incentives and total value of incentives per type of incentive



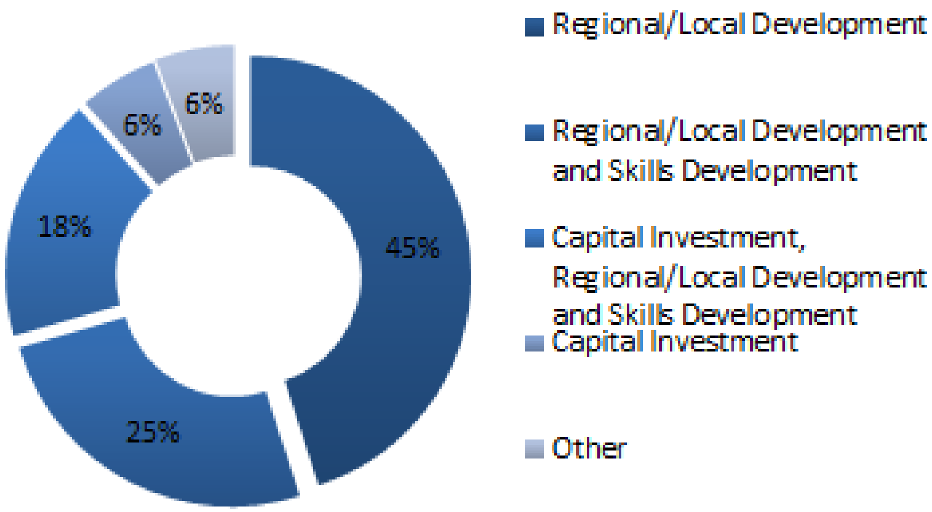
Source: IncentivesMonitor.com (2016) Date range: 2010-2016

Objective of Free Zone Incentives

Governments, authorities and policy-makers implementing Free Zones may have various motives for doing so. Frequently, "traditional" Free Zones are developed primarily to create static, short-term economic gains such as increased investment, employment opportunities, exports, foreign exchange earnings and tax revenues. On the other hand, the "new generation" Free Zones may have been initiated within a more dynamic and long-term strategic framework. In such cases, Free Zones may function as laboratories for testing and introducing new policies to contribute to economic diversification, structural transformation, sectoral upgrading, enhanced competitiveness and skills development.

Incentives granted to companies investing in Free Zones are usually aligned with such policy objectives in order to realize economic gains. It appears nearly half of all Free Zone incentives (or 45%) have been granted in order to create regional and local development by means of supporting investment attraction and employment generation. This thus reflects a focus on short-term economic gains typical for "traditional" Free Zones rather than dynamic and long-term economic gains. On the contrary, only 1% of Free Zone incentives is specifically aimed at supporting local labor force development through employment and human resource support, which rather is an indicator of the "new generation" of Free Zones. One out of four Free Zone incentives have been awarded to contribute both to regional and local development as well as to development of the local labor force whilst 18% of Free Zone incentives has been awarded to support multiple objectives (i.e. regional and local development, capital investment attraction and local labor force development).

Figure 2: Distribution of incentives per objective



Source: IncentivesMonitor.com (2016) Date range: 2010-2016

This implies Free Zone incentives have been initiated from a more or less short-term vision, geared towards contributing to attracting capital investment and generating employment opportunities, rather than from a long-term strategy contributing to economic diversification and transformation through the development of the local labor force.

Target of Incentive Packages

It may be the case various types of incentive packages are awarded to various types of investors in terms of their nationality, type of investment project (e.g. new or expansion investment) and industry and sector in which they operate. If Free Zones have indeed transitioned towards "new generation" concepts, their incentive packages should have been awarded to a wider variety of industries and sectors with special attention for high-end and high value-adding sectors (e.g. R&D, headquarters), both foreign and domestic investors as well as expansion and new investments rather than the narrow focus of "traditional" Free Zones and their incentive packages.

Target Sector
In terms of the sector, manufacturing remains the most popular target sector by far. Over half of the Free Zone incentives (57.3%) has been awarded to companies undertaking manufacturing activities, followed by companies investing in construction (14.0%), business services (12.5%) and warehousing and distribution (6.2%). Target sectors typical for "new generation" Free Zones have been awarded with incentives only sporadically, as R&D and headquarter investments only represented 2.5% and 1.3%, respectively, of all awarded incentives.

Target Industry
The bias towards manufacturing is reflected by the target industries. Consumer goods (20.7%) is the most frequently targeted sector, followed by services (14.4%), industrial goods (11.8%), life sciences (8.0%) and food & drink and basic materials (both 8.0%). These industries are typical labor-intensive industries that are compatible with the manufacturing focus of "traditional" Free Zones. Notable exceptions include services and life sciences, which adhere more towards the sectoral focus of the "new generation" Free Zones.

Investors' Nationality
The distribution of incentives regarding nationality of investor is, quite surprisingly, favored towards domestic firms. Two out of three Free Zone incentives have been awarded to domestic investors, leaving a third of incentives granted to foreign investors. Therefore, it seems the traditional bias towards foreign investors and FDI has been partially overcome. However, it should be noted a large number of incentives has been awarded in US Free Zones to US companies. If these are omitted, the distribution between domestic and foreign companies is more balanced (52.0% against 48.0%, respectively).

Type of Investment Project
Finally, looking at the type of investment project that has been rewarded with incentives reveals a distribution similar to that of the investors' nationality. One out of three incentives has been granted to existing zone-based companies that are investing in an expansion project against two out of three incentives which have been awarded to companies undertaking a new greenfield investment.

Conclusions

The aim of this research paper was to identify whether incentive packages that have been awarded to zone-based companies reflect the observed move to "new generation" concepts of Free Zones. Typical for this concept is a wider industry and sector focus as opposed to the previous narrow focus on export-orientated manufacturing, whilst it also aims to attract both foreign and domestic investment through the provision of non-tax incentives. If indeed Free Zones have moved towards this "new generation" concept, their incentive practices should reflect these traits.

The dataset used in this study to investigate Free Zone incentive practices indicates that – as opposed to the "new generation" concept of Free Zones - the vast majority of the incentives awarded within Free Zones remain to take the form of fiscal incentives and target new greenfield investment in manufacturing operations.

Incentives within Free Zones have been awarded with the objective to achieve short-term economic gains (i.e. contributing to attracting capital investment and generating employment opportunities) rather than contributing to long-term economic diversification and transformation (i.e. development of the local labor force), which is more the objective of "new generation" Free Zones.

On the contrary, there is some preliminary evidence that supports the shift towards the "new generation" Free Zones. For instance, the distribution of incentives awarded to domestic and foreign investors is more or less balanced, coming from an exclusive focus on foreign investors in "traditional" Free Zones.

Also, as the number of incentives that has been awarded has gone down but the budget spent on incentives has gone up, it appears governments and authorities are more selective but simultaneously more generous when it comes to awarding incentive packages.

The data presented should be interpreted carefully due to its limitations and it should be highlighted this research paper functions as a starting point. Nevertheless, based on a global sample of Free Zone incentives, it does provide some empirical evidence that the transition of Free Zones from “traditional” concepts to “new generation” concepts is far from complete. The beneficiaries of incentives do not reflect the target companies typical for “new generation” Free Zones. Repeating and extending this research on a periodical basis may function as a monitor of the progress of the transition and whether Free Zones indeed move away from their “traditional” concepts, strategies and lay-outs.

Footnotes

[1] This database tracks information on all major types of financial and fiscal incentives awarded to corporate investors establishing new operations or expanding an existing operation in all industries. Minimum requirements for incentive packages to be incorporated in the database involve job creation and a minimum amount of capital investment.

[2] Australia, Brazil, Cambodia, Colombia, Costa Rica, Cuba, Dominican Republic, India, Indonesia, Jamaica, Macedonia, Moldova, Morocco, Myanmar, Nicaragua, Panama, Paraguay, Poland, Russia, South Korea, Tanzania, United Arab Emirates, United States and Uzbekistan.

[3] Based on 445 awarded incentives out of the 966 awarded incentives as the incentive value has been disclosed and registered for 445 out of the 966 awarded incentives.

[4] Based on 858 awarded incentives out of the 966 awarded incentives as the capital investment value has been disclosed and registered for 858 out of the 966 awarded incentives

[5] Based on 445 awarded incentives out of the 966 awarded incentives as the incentive value has been disclosed and registered for 445 out of the 966 awarded incentives

[6] Average of 12 awarded incentives only

[7] Average of 31 awarded incentives only