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ZONING IN

With a multitude of free trade zones now touting for business across the globe, investors need to be able to spot the differences.

Increasing global trade, the development of infrastructure and advancing technology are driving the proliferation of free trade zones (FTZs) like never before. With more than 3500 FTZs in various guises now dotted across the world, these enclaves of preferential commercial treatment are responsible for about 68 million jobs and the generation of US$500 billion in annual trade.

FTZs are designated areas that typically eliminate traditional trade barriers and minimise bureaucratic regulations.

Importers and exporters based in such zones may benefit from the deferral or elimination of customs duties, exemption from certain taxes, as well as inverted tariff relief. Many FTZs also offer operational benefits such as indefinite storage opportunities, increased security and insurance on goods, and state-of-the-art operating facilities.

Free trade zones come in all shapes and sizes: free, foreign, economic and export processing zones all fall under the FTZ umbrella. The distinction between each term may depend on the zone's location, whether it generates mostly imports or exports, and what kind of trade-manufacturing mix is present.

SHANGHAI SURPRISE

China's Shanghai Pilot Free Trade Zone (SH PFTZ), which opened its gates in September 2013, has been in focus recently. With special economic zones having played a major role in China's economic development over the last 25 years, Beijing is clearly a big advocate of controlled, zonal commerce.

The Shanghai area is the first of a series of new trade zones on the Chinese mainland, where Beijing is experimenting with financial reform. And as China is pushing hard to internationalise the renminbi (RMB), it's no surprise half the companies in the zone are now connected to financial services.

Many Chinese companies use this zone for overseas launches because it is easier to borrow money at lower interest rates within the FTZ. Many overseas companies, however, have been critical of the zone's progress, especially as they're expecting >

Reports on the success of free trade zones (FTZs) across the world are mixed but in some developing nations FTZs have kicked off industrialisation. Policies in the Shanghai Pilot Free Trade Zone, set up in 2013, may be rolled out across the rest of China.

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a relaxation of China's current restrictions on financial activity to come soon.

In a recent interview with *The Wall Street Journal*, Fredrik Hähnel, general manager of merchant banking at the Shanghai branch of Nordic lender Skandinaviska Enskilda Banken AB, expressed his disappointment. "I still don't find the SH PFTZ as a physical entity very exciting," he said, "because one year on, I would expect more to have happened."

But others take a more philosophical view.

"You can't expect the zone to be a second Shenzhen after a year," says Richard Cant, a Shanghai-based regional director for law firm Dezan Shira & Associates. "Everything is relative. To create a subsidiary company in mainland China can take three to four months and cost upward of US$10,000. You can drown in paperwork. In the SH PFTZ those figures are cut in half. So things are better, but we're not talking streamlined just yet."

According to Eunice Kuo, a tax partner of Deloitte China, the slow progress is hardly surprising as many of the pilot policies within the zone will be rolled out across China.

Companies want improvements such as a shorter negative list – the list of Chinese industrial sectors from which foreign companies are banned from investing – and a bigger zone area, along with better coordination between government departments.

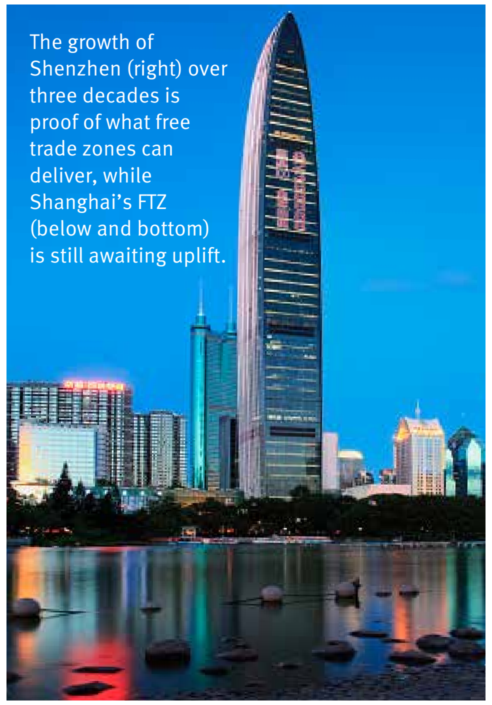
US SUCCESS STORIES

On the other side of the Pacific, foreign trade zones in the US are much further along the evolutionary scale. Nearly 300 FTZs and "sub-zones" have been authorised since 1934, including at least one in every US state and major port of entry. A growing number are now acting as hubs for the re-shoring of manufacturing, and are a valuable platform for US exports.

While physically located on US territory, each FTZ is considered outside US territory for the purposes of import inspection and duty collection. For companies operating inside an FTZ, this means that duties are only collected when imported goods leave the zone to enter US commerce, not when goods are admitted to the zone from abroad. Products and parts can be stored in a zone indefinitely and are exempt from state and local inventory taxes.

The FTZ program's usefulness was boosted with the 2009 introduction of the Alternative Site Framework (ASF). This allows a FTZ "grantee" – typically a local port authority – to confer FTZ status on companies operating nearby.

According to a recent United States Foreign-Trade Zones Board report, presented to US Congress, the 177 active zones in the US received US$835 billion in merchandise in 2013, with almost two-thirds of this domestically



The growth of Shenzhen (right) over three decades is proof of what free trade zones can deliver, while Shanghai's FTZ (below and bottom) is still awaiting uplift.

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sourced. Exported merchandise reached a record value of US$79.5 billion over the same period.

"In recent years FTZ exports have grown far faster than overall US exports," says Dan Griswold, president of the National Association of Foreign-Trade Zones (NAFTZ) in Washington, DC. "This clearly demonstates the competitive benefits of locating inside one of these zones."

More than 3000 companies now participate in the US FTZ program, including high-profile corporations General Electric (GE), Apple, Rolls-Royce, Airbus and BMW. GE recently invested US$800 million in a huge manufacturing facility with FTZ status in Kentucky, while appliance manufacturer Whirlpool has just opened a facility inside a FTZ that it calls the largest washing machine plant in the world. The benefits that FTZ status confers mean that Whirlpool is now shifting production of washing machines back to the US from Mexico.

Some experts question how much the FTZ program in the US benefits the broader American economy, but recent figures suggest it has a positive impact.

Employment in US FTZs reached a record 390,000 workers in 2013. While that's not many compared to the overall US workforce of about 156 million, it's worth noting that most of this employment is in the manufacturing sector, which has suffered significantly from layoffs over the past few decades.

"The purpose of the US FTZ program is to encourage economic activity in the US that might otherwise be conducted elsewhere," says Greg Jones, the co-founder and vice president of the Free Trade Zone Corporation based in Alabama.

"When calculated on a macro-economic basis, the customs duty savings realised by FTZ participants are dwarfed by the federal, state, and local taxes that they contribute as a result of their location inside the US. This comes on top of job provision."

FTZs come in various shapes and sizes. In 2010 Norwegian outdoor apparel retailer Helly Hansen established a so-called "usage-driven" FTZ. This remote zone in the city of Auburn, south of the port of Seattle, was created under the Alternative Site Framework for use by a single company. This single site now meets most of the company's storage, logistics, accounting, customer service, marketing and sales operations needs for the American and Canadian markets.

In the four years since establishing the Auburn FTZ, the financial benefits have allowed Helly Hansen to double its on-site workforce and handling capacity.

"Before we set up the FTZ we had to pay duties immediately upon importation," explains Scott Sutherland, Helly Hansen North America's director of finance. "Delayed payment of duty is very useful because duty rates are a significant part of our inventory costs and seasonal apparel can sit around in our warehouse for many months."

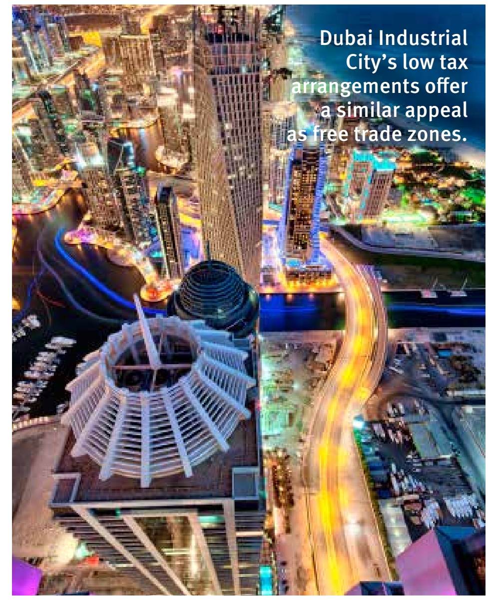
CROWDED MARKET

Over the last 15 years, Middle Eastern countries have been as active as any region in setting up FTZs. Yet while these FTZs offer similar fiscal and financial incentives, their performance has differed widely. Many FTZs, including those in Jordan, Syria and Egypt, have failed to attract much foreign investment and are little more than storage and warehousing areas.

On the other hand, the growing number of FTZs in the United Arab Emirates (UAE) are attracting foreign investment, job provision, export levels and backward linkages with the UAE economy.

The Jebel Ali FTZ in Dubai, the first in the UAE, now boasts some of the most comprehensive business incentives in the world. Full foreign ownership of companies is permitted and there are no restrictions on the repatriation of profits or foreign currency exchange. There are no import or export duties except for sales made into the UAE, and corporate and personal income taxes are waived for up to 50 years from start-up.

However, FTZs are not the only option for investors in the UAE, as the country offers low tax arrangements more generally. For instance, Dubai Industrial City is not a free zone, but businesses here can export duty free to a number of countries as a result of free trade agreements (FTAs). The number of firms operating in the city has almost doubled from 259 at the end of 2011 to 471 at the end of 2012.



Dubai Industrial City's low tax arrangements offer a similar appeal as free trade zones.

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RAY O'DRISCOLL, SHANNON GROUP

With so many FTZs now operating in the Gulf, competition to attract business is on the increase. The Ajman Free Zone in the UAE, for example, lets investors pay their charges monthly or quarterly, with payment plans designed to attract small-to-medium enterprises (SMEs).

THE GOOD AND THE BAD

Over the last two decades many FTZs have had disappointing outcomes. Poorly conceived and managed, they have been criticised for their macro and micro level constraints on business, bad labour practices and poor environmental records. They have fallen prey to money launderers and drug traffickers, failed to increase exports, and provided little in the way of benefit to the host country.

But some FTZs have been spectacularly successful, creating huge wealth, significant numbers of jobs and becoming starting points for industrialisation, especially in developing countries. It only takes one look at Shenzhen, which over the last 30 years has grown from a sleepy coastal hamlet into a Chinese city of 10 million inhabitants, to see what can be achieved.

In the face of an ever-increasing number of global trade pacts, some experts predict the demise of the FTZ. Others disagree, pointing toward a trend in zone specialisation and innovations such as the ASF system in the US.

"Global trade liberalisation will continue to diminish the benefits of some 'classic' free trade zones," says Ray O'Driscoll, a director with the Shannon Group, which oversees Ireland's Shannon Free Zone – the world's first free trade zone.

"However, companies are attracted to free trade zones for multiple reasons not just one. The successful zones will be the ones that innovate with the business environment they provide." ■