Seeing It Through

A Plan for 'Full Fat' Freeports

By Sam Ashworth-Hayes

BRIEFING PAPER

EXECUTIVE SUMMARY

- Some academic economists are sceptical of the ability of freeports to add value to the British economy, arguing that they primarily divert (rather than create) economic activity;
- Policymakers need not risk this being the case—freeports offer an exciting opportunity to create growth by addressing inefficiencies within the British economy;
- This paper sets out four ways this can be achieved;
    - Creating a light-touch planning regime, providing fast and certain planning permission for high value economic activities;
    - Providing significant packages of local investment to alleviate concerns about crowding of public services and infrastructure, with short run disruption smoothed by offering payments linked to the port's success;
    - Implementing a tax regime designed for growth, including full expensing for capital investment, the simplification of customs processes, and the elimination of property taxes;
    - Establishing a regulatory sandbox, allowing governments to trial regulatory changes across a sample of freeports, testing policy alternatives against one another and getting real world feedback on their performance.
- By tailoring the freeport model to address the UK's unique policy failures, these facilities can boost growth and provide a proof-of-concept for beneficial future reforms to the wider economy.

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INTRODUCTION

The creation of new freeports across Britain formed a central part of the Conservative party's 2019 manifesto.[1] Following the resignation of Boris Johnson, Liz Truss pledged to create "full-fat freeports" during her successful campaign for party leadership.[2] The early days of Truss's premiership have emphasised economic growth as one of the government's top priorities, with cuts to taxes and red tape, and boosts to investment lined up across policy fields.[3] The creation of 'full-fat freeports' fits directly into this agenda.

Some academic economists and trade experts, however, have proved less enthusiastic, noting that the sorts of customs-based barriers to trade which drive the success of freeports in developing nations are relatively absent in Britain.[4] This does not mean that freeports have no role to play in boosting growth; it simply means that they will need to target different distortions within the British economy.

This paper sets out how this could be achieved. The first section lays out why freeports alone are unlikely to be an appropriate policy tool for boosting UK growth. The second sets out four policies for generating growth through freeports. The final section presents a brief conclusion.

THE PROBLEM WITH FREEPORTS

The principal benefit of freeports is avoiding burdensome taxes and tariffs on imported goods which are used as inputs to a domestic production process, reducing the total cost of production for those firms situated within it, and in doing so reducing the deadweight loss associated with the use of tariffs to raise revenue.

Freeports constitute an area into which goods can be easily imported, incorporated into the production of other goods, and exported without paying customs tariffs or duties. These tariffs are only paid if the goods subsequently leave the freeport for the wider domestic economy. In effect, the freeport exists as a small area outside of the customs territory of the wider country, often with investor-friendly tax and regulatory policies added to sweeten the bargain.

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1 "Get Brexit Done: Unleash Britain's Potential. The Conservative and Unionist Party Manifesto 2019". Available online at: https://assets-global.website-files.com/5da42e2cae7ebd3f8bde353c/5dda924905da587992a064ba_Conservative%202019%20Manifesto.pdf

2 Swinford, S. "Liz Truss plans 'full-fat freeports' if she becomes prime minister", The Times, 25 July 2022. Available online at: https://www.thetimes.co.uk/article/liz-truss-plans-full-fat-freeports-if-she-becomes-prime-minister-xl3rnv62w

3 Elgot, J., "Focus on growth not fiscal discipline, Kwasi Kwarteng tells Treasury", The Guardian, 13 September 2022. Available online at: https://www.theguardian.com/politics/2022/sep/13/focus-on-growth-not-fiscal-discipline-kwasi-kwarteng-tells-treasury

4 Sam Lowe, "Any Port In A Storm? The Future For Freeports", The House, 31 March 2022. Available online at: https://www.politicshome.com/thehouse/article/any-port-in-a-storm-the-future-for-freeports-explained

These arrangements play a useful role in developing economies with significant barriers to trade. The problem for Truss's new freeport policy is that the UK is already a relatively low-tariff economy and the general direction of government policy is aimed squarely at making it lower still. Freeports benefit the economy by punching a hole in the tariff regime to let business flow unburdened. The post-Brexit UK Global Tariff policy—set out by Truss in her role as Secretary of State for International Trade—explicitly set out to remove these barriers across the UK economy broadly, aiming for a schedule which was "simpler, easier to use, and lower tariff" than the EU equivalent.[5] This was successfully achieved. The average tariff on imported inputs under the schedule is 2.8%, or 1.6% when weighted by trade. Some 59% of imported intermediate goods face no tariff at all, and another 20% face tariffs of under 5%.[6]

Those goods subject to high tariffs are not necessarily in areas associated with high growth potential; dog and cat food products, wheat, undenatured ethyl alcohol, and vegetable oils are among those singled out for unfavourable treatment, and account for around 0.6% of total UK intermediate imports.[7] While there would be welfare gains to lowering these barriers, they are unlikely to be very large; the high-wage, technologically-advanced economy the Conservative Party aims to build will not be based on dog food production.

Moreover, the UK already has policy levers for significantly reducing the distortions created by these taxes. Inward Processing Relief allows firms to reduce and delay payments on goods brought into the UK as part of the manufacturing process, paying tariffs only when the goods are released into free circulation.[8] This means that products destined for re-export outside the UK customs territory avoid Customs Duty and import VAT, while those released internally may face reduced rates based on that charged on finished goods. This scheme is not costless; the application process can take time to complete, and maintaining compliance puts new paperwork burdens on businesses. For an operation at sufficient scale, these costs will not erode savings.

Similarly, bonded warehouses allow for goods to be brought in without payment of duty or VAT until released into free circulation.[9] If goods are re-exported, then no payment is made.

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5 "Public Consultation: MFN Tariff Policy - The UK Global Tariff", Department for International Trade. Available online at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/885943/Public_consultation_on_the_UK_Global_Tariff_government_response.pdf

6 Holmes, P., and Magntorn Garrett, J., "Tariff inversion in UK Freeports offers little opportunity for duty savings", UK Trade Policy Observatory, 28 July 2020. Available online at: https://blogs.sussex.ac.uk/uktpo/2020/07/28/tariff-inversion-in-uk-freeports-offer-little-opportunity-for-duty-savings/

7 Ibid.

8 "Apply to delay or pay less duty on goods you import to process or repair", HM Revenue & Customs, 4 July 2022. Available online at: https://www.gov.uk/guidance/apply-to-delay-or-pay-less-duty-on-goods-you-import-to-process-or-repair#how-to-apply

9 "Apply to operate a customs warehouse", HM Revenue & Customs, 4 July 2022. Available online at: https://www.gov.uk/guidance/apply-to-operate-a-customs-warehouse

Again, this does involve the friction of establishing a warehouse, and there are limitations on the processing that can be carried out, but it is another limit on the utility of freeports in pure customs terms.[10]

The existence of these policy tools is partly why freeports in the traditional sense are more common in countries where state capacity is not sufficient to enable the smooth operation of such schemes; developed countries tend instead to focus on freeports "focused on facilitating trade logistics".[11] The USA is a notable exception, operating the fourth largest number of freeports of any country worldwide.[12] In this it is a major outlier; the other members of the top ten are largely developing nations.[13] The use of freeports in the United States reflects less a lack of capacity to run alternative programmes—many freeports listed are 'subzones' designated for a specific company—and more the relatively aggressive tariff schedule on imported intermediate goods.[14]

Britain does not resemble the United States in this respect. Tariffs on intermediate inputs are low, and while the USA has recently engaged in a costly bout of protectionism—including a trade war with China—which has damaged companies, British policy has focused on lowering barriers to trade.[15]

In combination, these things mean that the pure benefits in customs terms to locating businesses in new UK freeports are likely to be slim. This is why there is a risk that some jobs and economic activity in freeports will be diverted from other parts of the country, rather than resulting from pure growth. This is not in and of itself necessarily a bad outcome; there is some implication that allocation is being distorted away from the optimal location of firms, but as this is being achieved through the partial removal of other distortions, this will still be a net positive so long as the direct and indirect taxpayer-funded subsidies offered are not too large.

Some redistribution of economic activity through strategically situated freeports would fit with the government's Levelling Up agenda.[16] But if freeports did no more than that, it would be a missed opportunity. The objective of full-fat freeports should be to ensure that the investments made, jobs created, and output produced

10 "Check if you can carry out simple repairs or process your goods in a customs warehouse", HM Revenue & Customs, 15 June 2020. Available online at: https://www.gov.uk/guidance/check-if-you-can-carry-out-simple-repairs-or-process-your-goods-in-a-customs-warehouse

11 "World Investment Report 2019: Special Economic Zones", United Nations Conference on Trade and Development, 2019. Available online at: https://unctad.org/system/files/official-document/wir2019_en.pdf

12 Ibid.

13 China, the Philippines, India, Russia, Turkey, Thailand, the Dominican Republic, Kenya, Nicaragua.

14 Data from the World Bank World Integrated Trade Solution on average weighted tariffs on intermediate inputs in 2019. https://wits.worldbank.org/CountryProfile/en/Country/USA/Year/2019/TradeFlow/Import/Partner/all/Product/UNCTAD-SoP2

15 Flaaen, A., Pierce, J., "Disentangling the Effects of the 2018-2019 Tariffs on a Globally Connected U.S. Manufacturing Sector", Finance and Economics Discussion Series 2019-086, 23 December 2019. Available online at: https://www.federalreserve.gov/econres/feds/files/2019086pap.pdf

16 "Levelling Up the United Kingdom", Department for Levelling Up, Housing and Communities, 2 February 2022. Available online at: https://www.gov.uk/government/publications/levelling-up-the-united-kingdom are an *addition* to the economy, rather than a diversion. Redirecting economic activity from one region to another is clearly inferior to producing positive-sum growth across the country.

The success of freeports in developing nations and the United States is driven by addressing the inefficiencies that exist within local governance and economic structures, whether a business environment unsuited to investment or a tariff regime that raises production costs. The fact that these inefficiencies can be created by local as well as national governments indicates that delegating their operation to regional government bodies or quangos is a bad idea. If freeports in the United Kingdom are to produce the best possible outcomes, they should in turn target the UK's own domestic policy inefficiencies regardless of source.

USING FREEPORTS TO BOOST GROWTH

Freeports could still play a role in generating genuine growth in Britain by targeting key economic distortions introduced by existing taxes and regulations. It is worth noting that free zones do not need to be literal freeports or even free airports. It is perfectly feasible to place freeports within the country in areas with sufficiently good transport links and account for goods moving in and out in the manner we already do with bonded warehouses and Inward Processing Relief, or to even run freeports without the customs elements. 'Virtual freeports' could link ports with university enterprise campuses a significant distance away.

This section of the paper seeks to address the ways in which freeports can be used to drive growth and investment in the UK, identifying four policy areas where we believe they can make a noticable difference. As always, the success of any such policy will be based on the credibility of commitment towards its continuation; investors need security and confidence when making decisions. Our suggestion is that all freeports should see at least a 30 year guarantee of continuing operation.

A light touch planning regime

Planning rules present a major barrier to growth and investment in Britain, both by directly blocking high value uses of land and discouraging investment through the uncertainty they inject into firms' decision-making processes. Freeports offer an opportunity to circumvent these blocks to growth by taking local authority planning processes out of the picture.

It is worth noting here that the loss of growth resulting from inefficient planning regimes is caused both by a lack of investment in business property—factories, R&D labs, and so on—and from the spatial misallocation of labour resulting from insufficient housing in high-demand areas. While this second factor may sound relatively small, one study in the United States estimates that overly restrictive housing supply lowered aggregate growth by more than *50%* from 1964 to 2009.[17] If freeports

17 Chang-Tai Hsieh and Enrico Moretti, "Housing Constraints and Spatial Misallocation", May 2017. Available online at: https://www.nber.org/system/files/working_papers/w21154/w21154.pdf can target the restrictions on British growth created by inefficient planning permission processes, they are likely to result in massive productivity increases. To take just one example, Britain has world-leading universities in London and firms that are desperate to make use of these talent pools. What it doesn't have is suitable space for these companies to work in, with London offering just 90,000 square feet of suitable space compared to Boston, Massachusetts' 14.6 *million* square feet.[18]

The benefits generated by the reform of planning rules would naturally be increased by the placement of freeports within already successful areas—London, Cambridge, Oxford, Manchester, and the like—rather than in new areas, simply because these are the places where spatial constraints bite hardest. However, there would also be clear gains to liberalising planning in 'left-behind' areas. The most important point here is that while it is difficult for government policy to create clusters, it is startlingly easy to destroy them by simply refusing to allow them to exist. Freeports offer a chance to punch through the red tape throttling UK growth. The successes achieved by earlier freeport schemes were attributable in large part to new developments, which are capable of driving virtuous cycles of growth in local areas. The location of businesses attracts demand for housing and services, which in turn create further incentives to make use of the area.

This opportunity has been recognised before. The Urban Development Corporation (UDC) established by the Thatcher government to develop Canary Wharf was handed the power to purchase land, build infrastructure, and take over planning approval from local authorities.[19] In combination with the Isle of Dogs Enterprise Zone—which gave a full tax allowance for building costs and relaxed planning controls—this enabled the designated area to develop at speed.[20]

Establishing similar corporations in 2022 to develop freeports would provide a significant boost to the British economy. Giving the UDCs a mandate to maximise economic growth within their area would ensure that internal planning decisions are focused on efficiency and growth. To ensure that internal incentives are aligned, UDCs could be treated as private companies with a duty to generate returns for their shareholders—in this case, initially the British government—and remuneration linked to performance.

This structure would work particularly well alongside the tax reliefs envisioned for freeports. If some share of this relief is allocated to the UDC for the running of the area, in combination with being able to construct and rent out buildings, or sell land for development, the net effect would be to provide powerful internal incentives in favour of growth and efficiency. Notably, when the UDC is ultimate landowner, or at least generating significant revenue from the land it governs, it will internalise many of the externalities generated by its planning decisions, making sure that they

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18 "Life Sciences: Trends and Outlook", Savills, March 2020. Available online at: https://pdf.euro.savills.co.uk/commercial---other/spotlight---life-sciences---trends-and-outlook-march-2020.pdf

19 Church, A. "Urban regeneration in London Docklands: a five-year policy review", Government and Policy, 1988, volume 6. Available online at: https://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.457.1474&rep=rep1&type=pdf

20 Ibid.

are relatively efficient. The working presumption should be that so long as a building is safe and external costs minimal, it will be granted planning permission.

The utility of these freeports is limited by worker availability. In particular, high skilled workers on good pay tend to expect high quality accommodation, which will not always be available in the immediate vicinity of freeports placed with the intention of levelling up an area. An obvious extension to the free zone model is the establishment of partner residential zones; areas where the UDC would be able to grant permission for residential and retail use, building communities in a purposeful way, and addressing shortages of housing.

Again, there would be significant benefits to creating freeports in cities with significant shortages of desirable housing for workers. Designating a square mile outside of Warwick as a mixed free zone incorporating housing, research facilities, and appropriate manufacturing activities would be precisely the sort of growth-boosting policy freeports should seek to implement.

Packages of local investment

One of the primary barriers to the effective operation of freeports in this model will be overcoming local objections to the new planning system. Just as people object to individual development proposals, they can be expected to object even more strongly to the suggestion of a meta-proposal approving significant development nearby. The most obvious policy suggestion here is to simply buy objectors out. Direct cash payments to nearby households over a short period, funded by the revenue generated by the freeport, would be a simple way of turning them into stakeholders in its initial success. However, depending on the revenue generation model adopted there may be insufficient cash flow to achieve this aim, and the costs could prove to be exorbitant. A better alternative would be to address the stated concerns of local residents. The arrival of a large number of new jobs and neighbours should be a boon to a community, but existing residents often worry that local infrastructure—from roads and public transport to schools and GP surgeries—will not keep pace, resulting in deterioration of service. These concerns could be alleviated by providing each freeport with a package of investment for the surrounding area.

This would not only assist with reducing objections and making the area more attractive for high skilled workers, but would also offer opportunities for levelling up. Directing some of these funds through local authorities with a mandate to spend them on broadly defined categories of investment—rather than dispersing the money into other budget areas—would assist with meeting local needs. In other cases, central allocation (for free schools, for instance) may be more appropriate. The aim is to ensure that the benefits are felt in the immediate aftermath of a UDC being established, tying the two together.

Helpfully, many of these elements are best practice for the creation of successful freeports. The success or failure of these programmes is often dominated by the availability of infrastructure and services, the quality of workers attracted, the strength of links to the wider local economy, and the quality of transport links to the world and wider economy. Connecting freeports to major infrastructure projects—such as High Speed 2—and providing good local amenities are precisely the sort of steps that give them the best chance of success.

Tax for investment

Almost all taxes create deadweight loss through the destruction of economic activity. Freeports should seek to minimise these distortions through alterations to the tax regime aimed at favouring investment and growth.

Broadly speaking, the creation of different tax regimes is common to special economic zones across the world, with some 80% making use of fiscal incentives such as preferential rates, exemptions, tax holidays, and reductions on VAT for services improving facilities within the zone.[21] Examples of policies adopted in other countries include Turkey's technology development zones exempting profits from R&D activities from corporation tax, or China's high-tech development zones offering a two year tax exemption from corporation tax, tariff-free imports of equipment, and preferential treatment for employees.

The problem with these policies is that while they are very likely to drive firms to locate in freeports, they are also expensive (which may partly explain why India considered phasing out certain tax benefits for its own special economic zones).[22] This means that any tax breaks offered need to be laser-focused on genuine growth-creation in order to justify the cost to the exchequer.

UK 'enterprise zones' currently offer significant reductions in business rates, worth up to £55,000 per year for five years.[23] These are an expensive way to reward landowners, rather than cut costs for businesses; business rates tend to be absorbed into rents,[24] with the result that the actual costs faced by businesses don't vary. With that said, there are still clear gains to be made in terms of how business rates are charged. Current practice means that investments in buildings and building quality can result in a significantly higher business rates bill. This is particularly damaging because business properties are an *input* into the production process, rather than an output themselves; a factory is used to produce goods, a restaurant is used to provide services. Business rates therefore attack investment in more productive forms of delivery.

One way to address this issue would be to make use of the potential of freeports as a trial for broader economic policies and introduce a *land value tax* in place of the standard business rates regime. This would offer an opportunity to test out one of

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21 "World Investment Report 2019: Special Economic Zones", United Nations Conference on Trade and Development, 2019. Available online at: https://unctad.org/system/files/official-document/wir2019_en.pdf

22 "New law for SEZs", The Hindu, 14 August 2022. Available online at: https://www.thehindu.com/business/Industry/new-law-for-sezs-commerce-ministry-proposes-host-of-incentives-to-revamp-special-economic-zones/article65767987.ece

23 "Business rates relief", available online at: https://www.gov.uk/apply-for-business-rate-relief/enterprise-zones

24 Adam Smith Institute, 'Business Rates Are a Tax on Landlords, Not on Businesses', March 2016: https://www.adamsmith.org/blog/economics/business-rates-are-a-tax-on-landlords-not-on-businesses the key recommendations of the Mirrlees review,[25] and to do so in a way that would encourage investment in physical equipment.

A second policy which would encourage investment would be the introduction of permanent full expensing for freeports, in line with the recommendations made by Sam Dumitriu and Dr Pedro Serodio for the UK as a whole.[26] Full-expensing allows the full value of investments in capital to be offset against profits in the year they are made, rather than over an extended period (where the value of the offset is eroded by inflation and the time value of money), and would result in a significantly improved incentives for capital investment in freeports.

Other countries frequently offer tax incentives for individuals to work within freeports, allowing firms to attract talent to relocate. This is likely to be a less popular approach within Britain, as it would lead to significant income differentials between workers in the same city based simply on where they happen to work. A more practical suggestion might focus on the role of freeports as trade facilitators, allowing the operator of freeports to handle the paperwork associated with Inward Processing Relief and VAT rather than requiring individual traders to do so. The key thing for successful freeports is the provision of services and opportunities not available elsewhere in the economy; this would be an extremely useful one.

In the event that the UDC model is followed, it would be possible for the UDC to collect some part of the surplus through rents or sale prices, providing an income stream to continue the development of the area. It is worth noting that full capitalisation of these benefits would significantly reduce the overall value of freeports, and should be avoided.

A regulatory sandbox

The popularity of freeports in developing countries is partly due to their greater flexibility. Governments looking to implement major economic reforms face political, fiscal, and practical constraints. Any significant shake-up of regulation creates losers as well as winners, and the continued existence of damaging rules is generally quite a good sign that the would-be losers have proven sufficiently well-organised and invested to have been able to keep the rules in place. The cost of implementing new rules and regulations can be high, requiring the creation or retooling of bureaucracies and guidelines, enforcement on the ground, and adjustment across the economy to new standards. And it is not always certain in advance what the precise effect of any reform will be.

Freeports offer a partial solution to these problems by allowing the alteration of regulation within geographically defined areas. In political terms, the vast majority of the country is left unaffected, with only the pecuniary effect of the area's output feeding into general economic activity. The limited size of freeports means that in

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25 IFS, 'Tax By Design: The Mirrlees Review', September 2011: https://ifs.org.uk/mirrlees-review

26 Sam Dumitriu and Pedro Serodio, "Abolishing the Factory Tax: How to Boost Investment and Level Up Britain", Adam Smith Institute. Available online at: https://static1.squarespace.com/static/56eddde762cd9413e151ac92/t/5e4c2406d37804306a23664c/1582048264192/Abolishing+the+Factory+Tax+-+Sam+Dumitriu+%26+Dr+Pedro+Serodio+-+Final.pdf turn this is less likely to cause massive disruption to the business models of companies currently enjoying economic rents. It is less costly to administer a new policy over a square mile of land than it is over an entire nation. And testing policies 'on the ground' prior to any national roll-out significantly reduces the risk associated with their eventual implementation.

The Chinese government in particular has made liberal use of special economic zones in piloting more market-oriented models for economic activity with great success; these special economic zones in 2007 accounted for 22% of GDP, 46% of foreign direct investment, and 60% of exports, while also registering 50,000 patents and hosting 1.2 million research workers.[27]

Britain is not (yet) navigating the transition from a communist state to a relatively free market economy, but there are clearly areas where simplification of processes, deregulation, or different regulation could produce efficiency gains. Using freeports to trial these policies would be a low-cost way of proving to critics their efficacy, or avoiding potentially costly mistakes.

Again, it is worth emphasising that the key benefit to this policy is not the creation of a loophole in regulation for small clusters of firms scattered across the country, but the generation of evidence on the success or failure of these policies that is then used to inform decision-making for the country as a whole.

This approach could even extend to innovative programmes for increasing exports to partner countries. Simply adopting the regulatory standards of another nation across the UK is unlikely to ever win favour with the British public, and indeed represents one of the primary reasons that the UK voted to leave the European Union and its Single Market. This does not mean there is no scope for pragmatic alignment within geographically defined areas; miniature versions of the Northern Ireland protocol, limited to individual sectors. We could imagine, for instance, a free zone focused on pharmaceutical activity with regulation overseen by the United States FDA, the Australian Therapeutic Goods Administration, or the European Medicines Agency. Any such programme would require the approval from the country the free zone was intended to work with; it may well be the case that this would be refused in many cases. This does not mean that there is no benefit to looking into the possibility, or no nation which would take the offer up.

While this policy suggestion is necessarily vague - the entire point is that a whole range of regulatory ideas will be tried, abandoned, tinkered with, and in some cases eventually approved - it is also one with significant potential for boosting economic growth. If adopted, freeports would effectively function as the testing ground for British economic policy, boosting growth and employment while enabling policy ideas to quickly reach proof-of-concept stage, rather than languishing in economic journals and policy papers.

27 Douglas Zihua Zeng, "China's Special Economic Zones and Industrial Clusters: Success and Challenges", World Bank Blogs, 27 April 2011. Available online at: https://blogs.worldbank.org/developmenttalk/china-s-special-economic-zones-and-industrial-clusters-success-and-challenges

CONCLUSION

This brief has set out to identify the steps for developing a successful freeports programme in Britain that will generate jobs, investment, and growth. The UK is already blessed with a globally-oriented economy benefiting from sensible tariff and trade facilitation schemes, which limit the direct applicability of the freeport model. However, the spirit of the model—localised alleviations of wider economic distortions—can be applied in the form of freeports targeting the UK's own economic issues: primarily planning, taxation, investment, and regulation.