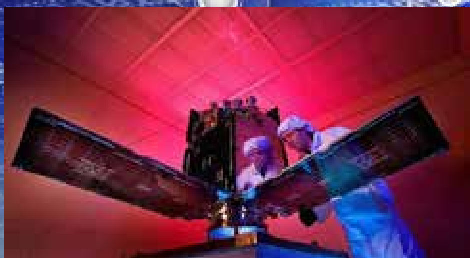

FREE ZONES AND INCENTIVES
TOWARDS A NEXT GENERATION

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For decades, Free Zones across the globe have successfully relied on a number of sources of competitiveness to attract investors and create static economic gains such as employment creation, unemployment alleviation, diversified exports and increased tax revenues. One of these sources of competitiveness has been the provision of a wide range of incentives, especially fiscal and customs incentives. The exact type and value of incentives awarded to companies locating in Free Zones varies from zone to zone.

However, the international context, under which successful Free Zones have been established, has changed drastically over the last two decades. Apart from the global economic recession of the 21st century and the further intensification of regional trade blocks, which collectively affected the volume of investment directed towards Free Zones, several developments specifically challenge the classical fiscal and customs incentives awarded to investors within Free Zones.

The World Trade Organization's (WTO) Agreement on Subsidies and Countervailing Measures (SCM) was designed to phase out incentives on export performance and use of local contents and Free Zones need to comply with these measures. The implication is that the options to differentiate by providing fiscal incentives within a Free Zone have become limited. Uniform incentive packages are offered within Free Zones across the globe. More and more, Free Zones award a standardized package of incentives that consists of a corporate income tax holiday in combination with preferential import and export duty treatment and other tax exemptions.

In search for diversifying their business environment and creating unique competitive advantages, Free Zones need to move away from overgenerous fiscal incentives that exclusively focus on increasing the profit margins. These low cost and low tax business environment strategies are easy to copy, replicate, and do not equip Free Zones with a distinct source of competitiveness.

This is not to say Free Zones should not provide any incentives to their investors. Free Zones still have the potential to mitigate some administrative risks (e.g. procedures for setting up a business) through their streamlined and simplified administrative procedures whilst financial and fiscal incentives could compensate for the more operational risks.

The different global context implies that Free Zone policy-makers must design their incentive packages in response to the evolving global market and the actual needs of investors to cater to their specific requirements and mitigate any remaining institutional and operational risks.

Aligning incentives with the needs of investors applies to both the investment motive as well as to the life cycle of the company investing. Resource-seeking investment are less prone to incentives as their investment location is mostly determined by the availability of a particular natural resource. On the other hand, incentives are highly appreciated by companies undertaking market-seeking and efficiency-seeking investment as their choice of potential investment locations is wider. Incentives may therefore tip the final location decision in favor of one location.

In terms of the life cycle of the company, new or "Greenfield" investments usually have a high need for capital that should finance the construction of a new facility, purchasing equipment and tools and paying salaries of employees in the initial phase of the investment. As the operational costs of the new investment in this phase are high, investors are more appreciative towards incentives that directly offset these vast capital expenditures. Examples include cash grants, investment allowances and deductibles. Fiscal incentives may be valuable for the expansion of existing investments which are up and running and make profit (in fact most new investments start making profits after on average 3-5 years). Other incentives may focus on supporting skill development through the deduction of training expenditures or R&D via the deduction of research expenditures are examples of the use of such incentives.

Competing on quality of incentives rather than the (excessive) amount of fiscal and customs incentives presents another prospect for Free Zones. Through their One-Stop Shop services and special regulatory status, Free Zones have the ability to develop innovative regulatory and administrative incentives combined with performance-based incentives linked with business development (e.g. skills development, technical services, local linkages, R&D and SME development). Developing and implementing cutting-edge incentives actually provides Free Zones with the opportunity to look for innovative, diverse and unique incentives, resulting in a distinct business environment that is more competitive to attract a diverse portfolio of investments and stimulate expansion investments of existing companies.

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