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Free Zones: Conditions for Success and Evolution

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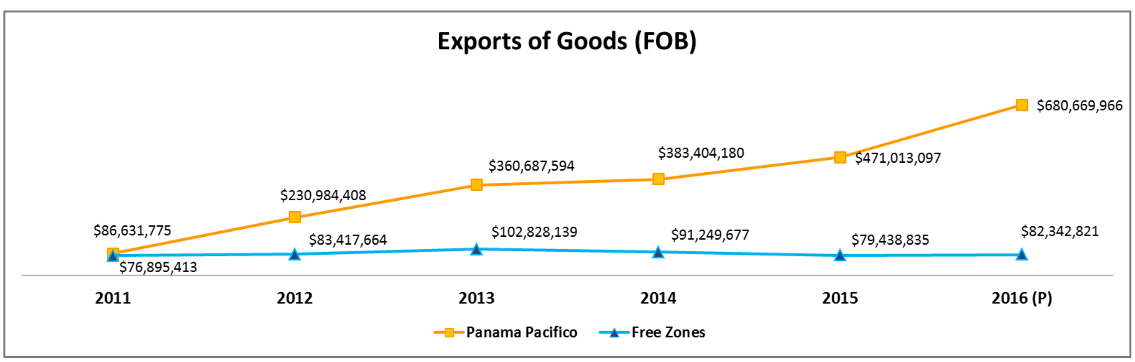
The concept of free zone or special economic zone goes back to the middle ages, when Asian and Baltic peoples employed the term of free port. These ports provided customs advantages and trade facilities to ensure better access and storage. In the middle of the last century, free zones were recognized as instruments to generate employment and develop manufacturing exports, and special regimes and various tax benefits started to be created to encourage their development. In some cases, these territories were established in poles of development, but mostly, they were set up near ports, airports and border areas to enhance their connectivity.[1]

In Panama, there are three main types of free zones, the Colon Free Zone (CFZ), the Special Economic Area of Panama Pacifico, and Free Zones covered by Law 32, totaling 12 active zones.[2]

The performance of these three types of zones has not been uniform. The Colon Free Zone has been experiencing a sustained decline in its traditional business, while Panama Pacifico has become an international benchmark of success. On the other hand, zones governed by Law 32, present as a whole a weak performance as shown in the graph that follows in terms of exports of goods.



Graph 1: Exports of goods from Panama Pacifico and Free Trade Zones. Source: National Institute of Statistics and Census (INEC). (P) Preliminary data.

[1] Ministry of Economic Policy and Planning of Costa Rica, 2008, *Contribution of Free Zones in the Areas of Less Development.*

[2] There is a fourth special regime corresponding to Law 19 of May 4, 2001, which establishes the Barú Free Zone under the special tax and customs regime of Free Tourist and Multimodal Logistics Support Zone.

The issue of free zones in Panama has an immediate importance because of the opportunity to take advantage of the Canal expansion and profit from implementing value added activities to the flowing cargo, whether logistics or postponement activities, and providing services to vessels and their crews, thereby generating economic benefits at the local level. These value added activities would be made performed in the free zones.

In preparation to take advantage of emerging business opportunities, the Deputy Minister of Foreign Trade of the Ministry of Commerce and Industries requested Georgia Tech Panama a study of free zones under Law 32, including an investigation of best practices, benchmarks and trends in this sector. The purpose of this paper is to share some of the findings of this study in terms of the key conditions for the success of free zones, including agglomeration economies and the modernization of the functionalities offered by free zones and the regulatory framework that governs them. These issues oriented our field research and provide guidance to recommend actions to improve the performance of this segment of free zones.

Agglomeration Economies

An approach to promote the success of free zones is to ensure that they enjoy agglomeration or cluster economies.[3] These economies consist of advantages in terms of costs, utilization of assets and conditions for innovation which are made possible by the proximity of similar or complementary firms, and support institutions, located in a particular geographical area. Specifically, these advantages arise from the **collaboration** between companies which allows the scaling of their influence to negotiate the acquisition of resources and common services, the more effective coordination of their activities (for example, the consolidation of goods to achieve economies of volume in transportation), and the use of redundant assets in the conglomerate (storage space, equipment and people). The higher asset utilization and cost advantages are manifested in an **increased productivity** of the companies in the conglomerate, thus contributing to their competitiveness.

To make sustainable the advantages of productivity, they must be improved and evolve, which occurs through **innovation**. The concentration of companies from similar industries facilitates innovation. The key issue is in what areas the companies decide to collaborate and in what areas they decide to compete. In the areas they decide to collaborate, the effect of scaling is equally important to achieve minimum economic size (critical mass) for investments in innovations. An example of this would be the implementation of a digital platform to coordinate the logistics operations of the conglomerate. The distribution of the investment among several companies will decrease their individual investment, but as a group, they would probably get a more sophisticated system than one that could be acquired by an individual company.

Finally, a successful conglomerate promotes **growth** by attracting new companies that want to enjoy the benefits of the area, generating a virtuous circle of synergies. The higher the number of companies, the greater the opportunities to achieve productivity advantages and promote innovation.

The Evolution of Free Economic Zones

[3] Michael Porter, 1998, *Clusters and the New Economics of Competition*, Harvard Business Review, and *The Competitive Advantage of Nations*, 1990, The Free Press.

Dr. Gokhan Akinci of the World Bank has coined the phrase of Economic Zones 3.0, referring to the evolution of free zones and the characteristics of this new generation.[4]

According to him, the evolution of the economic zones has three stages. The first consists of the creation of **export processing zones** (zones 1.0). The objectives of these zones include the attraction of foreign direct investment, the promotion of exports of goods and the generation of employment. Generous tax exemptions are available at this stage and the focus is on the manufacture of goods, mostly ignoring services and local suppliers. Due to international trends, including the strengthening of regional trading blocs, the rules of the World Trade Organization, the homologation of incentives, the globalization of value chains, and concerns over climate change, social issues and security, give rise to the **special economic zones** (zones 2.0). Emphasis of zones 2.0 includes the formation of clusters, public-private partnerships for the development and management of the zones, a shift towards the adoption of incentives to stimulate specific issues, regulatory frameworks that promote contexts friendly to businesses, the adoption of international standards on environmental and labor issues, the increase of local content in products and services, the linkage with the local communities, and the simplification of government requirements through single windows and alignment of regulatory bodies.

In order to increase the benefits to countries, **economic zones 3.0** maintain zones 2.0 approaches, but deepen their emphasis on global value chains, increased local participation in such chains and technology transfer. This is achieved through the attraction of international suppliers to close gaps in local capabilities, certification of local companies that are able to add value within global value chains, investment in new technologies, improvements in human capital, and aligned incentives to promote such conditions. Fundamentally, according to Dr. Akinci, the desired results at this level of development are: (1) increased employment; (2) increased local value in exports; (3) increased local investment; and (4) improved productivity of local firms.

Dr. Mohan Guruswamy of the World Free Zones Organization summarizes the **drivers of competitiveness** in the new free zones as:[5] *Smart* (using new technologies), innovation, security and sustainability, supporting each of these drivers through respective certifications.

Regulatory Framework

Three key components of the **value proposition** of free zones are: necessary conditions that must be satisfied by free zones to be successful, tax incentives offered to companies that are located there, and agile government processes and controls. As a whole, these aspects should be addressed by the regulatory framework for these zones. This framework, coupled with other aspects, such as geographical location, connectivity, economic, social and political stability, business environment, availability of skilled labor, and logistic infrastructure, constitute the country value proposition for free zones.

Previous sections described the success **conditions** for free zones. Basically, their design should approximate that of zones 3.0 and promote the economies of agglomeration. Additionally, apart from conventional tax exemptions, **incentives** should be directed to promote the generation of value-added activities, increasing the role of local firms within global value chains, the certification

[4] G. Akinci, 2017, *Economic Zones 3.0 - The Next Generation*, Third World Congress, World Free Zones Organization, Cartagena, Colombia.

[5] M. Guruswamy, 2017, *Designing of Next Generation Free Zones*, Third World Congress, World Free Zones Organization, Cartagena, Colombia.

of international standards, investment in technological innovation, and the implementation of environmental and sustainability management systems.[6] Finally, **governmental processes** must be simplified. Agile processes have been identified as "soft incentive" that can be effective differentiators because they remove unnecessary burden and reduce overhead costs in business.[7]

Ensuring the described regulatory framework requires **institutional capacity** in the Government to rigorously review applications to develop free zones and to monitor their operations confirming that they reflect best practices and help build a business environment that promotes competitiveness.

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[6] Leading countries in free zones in the region are making significant progress in their incentives and legal frameworks. See: Luisa Castro, 2017, Technical Note GTP-TN-17-02, Free Trade Zones Regulations in Costa Rica, Colombia and Dominican Republic.

[7] Douglas van der Berghe, 2017, *Doing Business in Free Zones*, third World Congress, World Free Zones Organization, Cartagena, Colombia.