

FREE ZONES AND REGIONAL DEVELOPMENT

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TABLE OF CONTENTS

	Page
INTRODUCTION	1
FREE ZONES.....	3
A. Free Zones in History.....	3
B. Free Zones in the 20 th Century	4
C. Enterprise Zones.....	5
D. Enterprise Zones in North America: the U.S. Example.....	6
ECONOMIC IMPACT	7
ENTERPRISE ZONES IN CANADA.....	9
CONCLUSION.....	10
SELECTED REFERENCES	11



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INTRODUCTION

Some regions of Canada are relatively poor, and their economies remain underdeveloped despite the investment of billions of dollars in regional development programs over the last 30 years. Such regions are generally far from large urban centres, and many of them have been hard hit by the decline of the mining, forestry and fishing industries in particular. Most of them are in the Atlantic provinces, but there are also some in Quebec and other parts of the country, especially in rural areas. Statistics show that unemployment is higher and incomes are lower on average in provinces where a large percentage of the population lives in rural areas (see Table 1).⁽¹⁾

In New Brunswick, for example, where half the population lives in rural areas, the unemployment rate was 11.2% and per capita gross domestic product (GDP) was \$27,090 in 2001. In Ontario, where most people live in urban areas, the unemployment rate was 6.3% and per capita GDP was \$37,380, 78% lower and 38% higher respectively than in New Brunswick – a substantial difference.

(1) According to Statistics Canada's definition, "an urban area has a minimum population concentration of 1,000 persons and a population density of at least 400 persons per square kilometre, based on the current census population count. All territory outside urban areas is classified as rural. Taken together, urban and rural areas cover all of Canada." In 1961, 30% of Canadians lived in rural areas, compared with only 20% in 2001. See Statistics Canada, *Canada at a Glance 2003*, Catalogue #12-581-XPE, October 2003.

Table 1
Population by Province, in Descending Order by Urban Percentage,
and Related Statistics, 2001

	Population	% in urban areas	% in rural areas	Per capita GDP (dollars)	Unemployment rate (%)
<i>CANADA</i>	30,007,094	79.7	20.3	35,141	7.2
Ontario	11,410,046	84.7	15.3	37,380	6.3
British Columbia	3,907,738	84.7	15.3	31,948	7.7
Alberta	2,974,807	80.9	19.1	49,386	4.6
Quebec	7,237,479	80.4	19.6	30,983	8.7
Manitoba	1,119,583	71.9	28.1	30,180	5.0
Saskatchewan	978,933	64.3	35.7	32,781	5.8
Newfoundland and Labrador	512,930	57.7	42.3	25,770	16.1
Nova Scotia	908,007	55.8	44.2	26,726	9.7
New Brunswick	729,498	50.4	49.6	27,090	11.2
Prince Edward Island	135,294	44.8	55.2	25,036	11.9

Sources: Statistics Canada, *Provincial Economic Accounts*, 2002 preliminary estimates, April 2003.
Statistics Canada, 2001 Census (<http://www.statcan.ca/english/census2001>).

The federal government has long paid special attention to disadvantaged regions and, in addition to making equalization payments to the have-not provinces, continues to administer a number of programs designed to promote economic recovery. The Atlantic Canada Opportunities Agency, the Enterprise Cape Breton Corporation, the Economic Development Agency of Canada for Quebec Regions and various other federal government organizations and initiatives are generally intended to promote economic development and diversification in regions where economic growth is slow and job opportunities are few. In the 2002-2003 fiscal year, the federal government alone put over \$1 billion into various regional development initiatives and programs.⁽²⁾ Despite these efforts, economic stagnation persists in a number of regions, which leads some people to question the effectiveness of current economic development programs.

In the United States, the federal government and a number of states have established *free zones* in some disadvantaged areas to attract investment and promote economic recovery and job creation. Such zones are often used as a local and regional economic

(2) Government of Canada, *Public Accounts of Canada*, 2003.

development tool, particularly in industrialized countries, where they are known as “enterprise zones” or “business incentive zones.” Hence it is worth asking: Could the establishment of free zones in disadvantaged areas of Canada boost economic activity there?

This paper describes the concept of a free zone, particularly its history and background in other countries. It also provides an overview of the literature and examines the economic impact of enterprise zones, as a basis for determining whether such zones should be established in disadvantaged regions of Canada.

FREE ZONES

In general, a free zone can be defined as a small geographic area in which industrial and/or commercial activity is subject to special taxation rules.⁽³⁾ It can take various forms and consequently various names. For example, it can be a “free trade zone,” an “industrial free zone,” an “enterprise zone” or a “free banking zone.”

A. Free Zones in History

Throughout their long and varied history, free zones have been intended to stimulate free trade, investment and job creation by easing the tax burden and eliminating needless government regulation. In most cases, they were geographically remote and by their very nature exempt from the national customs and excise system.

Free zones were invented at the time of the Greeks and the Romans, two peoples who promoted free trade in various ways. Obviously, the nature and scope of free zones have changed appreciably since then.

The first known free zone was the island of Delos in the Aegean Sea, over 2,000 years ago. Trade there was exempt from, or “free” of, duties and taxes. Delos was an important port of call between East and West, and it became one of the key trade centres in the Mediterranean.

(3) P. Lorot and T. Schwob, “Les zones franches dans le monde,” *Notes et études documentaires* (La Documentation Française), No. 4829, 1987.

During the Middle Ages, a number of Western European cities and ports were designated as free zones, notably the port of Hamburg between 1189 and the end of the 19th century.

During the colonial period, European powers with booming economies, such as the Netherlands and Great Britain, established free trade zones at strategic points in their territories, often in or near a port (e.g., Hong Kong and Singapore). Those free zones focused mainly on trade in and storage of commodities from overseas. After the industrial revolution, they gradually shifted toward industrial processing. Today, industrial free zones are widespread, while free zones based exclusively on trade have almost completely disappeared.⁽⁴⁾

B. Free Zones in the 20th Century

Free zones spread around the world in the last century. In developing countries, industrial free zones emerged in the 1960s. The first of these was in India, based on the model of the Shannon Airport area in the Republic of Ireland that became a moderately successful free zone in 1959. Today, there are free zones in China, Mexico, Brazil and a number of other countries.

In most cases, these free zones are export processing zones, also known as “export processing free zones.” The United Nations Industrial Development Organization (UNIDO) defines an export processing zone as follows:

An administratively, and sometimes geographically, distinct area enjoying special status allowing for free import of equipment and other materials to be used in the manufacture of goods earmarked for export. This special status generally involves favourable legal provisions, especially pertaining to taxation, which constitute foreign investment incentives.⁽⁵⁾

In addition to customs privileges, a number of free zones in developing countries offer generous investment subsidies, extended tax holidays, freedom to repatriate all profits, streamlined regulatory requirements, labour assistance, and strike prevention laws.

The establishment of free zones in which commercial corporations and enterprises benefit from such privileges is designed in particular to create jobs in the host country, generate foreign currency revenue, transfer technology and modern management skills, and promote manufacturing industry growth and regional development.

(4) *Ibid.*

(5) *Ibid.*

The most prosperous free zones are, naturally, located close to major world trade routes or centres, where inputs can be received easily and duty-free and the finished products can be exported conveniently.

Industrialized countries also have free zones where companies can import goods duty-free. During the last century in particular, the United States established a number of “foreign trade zones” to encourage American firms to expand into the international market, notably by attracting economic activity and investment that would otherwise go to other countries.

C. Enterprise Zones

When the economy in various parts of the United Kingdom collapsed in the early 1980s, British authorities decided to establish free zones to meet economic development needs in inland regions hard hit by recession and unemployment.

The idea of setting up free zones in economically depressed areas was first proposed in 1977 by Peter Hall, a professor of urban planning at the University of Reading. He advocated what was essentially complete laissez-faire, asserting that tax exemptions, deregulation and debureaucratization would fuel the entrepreneurial spirit and could facilitate economic recovery and job creation.

Sir Geoffrey Howe, of the Conservative Party, took up the idea in 1978 and proposed the formation of “enterprise zones,” also known as “business incentive zones,” to encourage industrial development. Legislation permitting the establishment of such zones was passed after the Conservatives came to power in 1979. Between 1981 and 1986, 28 enterprise zones were created in industrial areas for a period of 10 years. The key features of those zones were to apply equally to firms that were already there and firms that moved there. Those features were as follows:

- exemption from local taxes
- exemption from the undeveloped land tax
- simplification of customs procedures
- total deductibility of capital investment from taxable profit from the first year on
- streamlined priority processing of building permit applications
- priority handling of administrative formalities

Unlike export processing zones, these enterprise zones focused not only on the export market but also on the domestic market. The goal was clear: promote economic recovery and job creation in urban areas and disadvantaged regions by introducing a regime that would encourage employment-generating private investment. The enterprise zone program was scrapped by Tony Blair's Labour government, which described the experiment as a failure. Nevertheless, the enterprise zone concept was adopted in the United States, and there are still thousands of such zones scattered across virtually the entire country.

D. Enterprise Zones in North America: the U.S. Example

There have been enterprise zones in the United States since the early 1980s. They are based on the British model. Used primarily by individual states as an economic development tool, they have lost none of their popularity with governments over the years. They are intended to combat poverty and unemployment in urban centres and are widespread in the United States, particularly in urban and rural areas with above-average unemployment. Just about every state has established zones in which businesses are offered various subsidies to stimulate economic activity, promote employment and reduce poverty. Louisiana alone had 1,669 enterprise zones in 1996.⁽⁶⁾ Companies that move into such zones generally receive attractive capital and employment subsidies, a range of tax breaks and a number of other generous incentives.

The U.S. federal government jumped on the bandwagon in 1993. The *Empowerment Zone and Enterprise Community Act* led to the establishment of the community empowerment program, which provides subsidies to poverty-ridden cities and rural communities. Cities and communities that can demonstrate that they have an action plan to promote economic activity and reduce poverty can be designated as "enterprise communities" or "empowerment zones" and qualify for subsidies of up to \$100 million over 10 years. In addition, businesses located in these enterprise communities and empowerment zones enjoy various tax breaks. There are currently 172 enterprise communities and empowerment zones.⁽⁷⁾

(6) J. Fox and D. Shribman, "The Little Policy Idea That Could," *Fortune*, Vol. 134, No. 9, 11 November 1996.

(7) See the Rural Community Empowerment Program Web site (<http://www.ezec.gov/>).

ECONOMIC IMPACT

According to a majority of independent studies on the economic impact of enterprise zones, it is difficult to establish a correlation between the formation of enterprise zones and economic renewal, especially job creation.⁽⁸⁾ It seems that the incentives offered to businesses have not led to the economic growth expected by the proponents of enterprise zones.⁽⁹⁾ When there has been growth within the zones, it can be attributed to other factors in many cases. Although very few studies have looked at enterprise zones in rural areas,⁽¹⁰⁾ there is no evidence to suggest that the results would be any different there.

In the United Kingdom, most of the studies show that the establishment of enterprise zones did not produce more industrial activity in the zones.⁽¹¹⁾ In their 1987 assessment of British enterprise zones, Gunther and Leathers found no indication that the formation of such zones incontrovertibly resulted in economic renewal and job creation within the zones.⁽¹²⁾ In their judgment, the incentives offered to businesses had only a marginal effect on their decision whether to move to and invest in an enterprise zone. Moreover, the incentives ended up costing governments a great deal since they were offered not just to new companies but also to firms already in the zones. Researchers estimate that the cost to the British government was over US\$250,000 for each job “created” in the enterprise zones.⁽¹³⁾ The project was gradually phased out.

The results in the United States are similar. According to the National Association of State Development Agencies, states that introduced enterprise zone programs

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- (8) T. Lambert and P. Coomes, “The Effectiveness of Louisville’s Enterprise Zone,” *Economic Development Quarterly*, Vol. 15, No. 2, 2001. See also R. Greenbaum and J. Engberg, “An Evaluation of State Enterprise Zone Policies: Measuring the Impact on Urban Housing Market Outcomes,” in F. Redburn and T. Buss (eds.), *Public Policies for Distressed Communities Revisited*, Lexington Books, Landham, Maryland, 2002.
- (9) Government of Australia, Bureau of Transport and Regional Economics, “Government Interventions in Pursuit of Regional Development: Learning from Experience,” Working Paper No. 55, June 2003.
- (10) T. Buss, “State Enterprise Zones: How Well Have They Worked?” in Redburn and Buss (2002).
- (11) L. E. Papke, “What Do We Know About Enterprise Zones?” [U.S.] National Bureau of Economic Research, Working Paper No. 4251, 1993.
- (12) W. Gunther and C. Leathers, “British Enterprise Zones: A critical assessment,” *Review of Regional Studies*, Vol. 17, No. 1, 1987.
- (13) P. Marshall, “Do Enterprise Zones Work?” *Congressional Quarterly’s Editorial Research Reports*, Vol. 1, No. 16, 28 April 1989.

have not yet undertaken systematic cost-benefit analyses of the zones.⁽¹⁴⁾ Nevertheless, studies by independent experts show that the incentives offered in enterprise zones had virtually no impact on investment and job creation.

David Dowall reaches this conclusion in a study of enterprise zones in California.⁽¹⁵⁾ In response to a survey, almost all of the firms in enterprise zones reported that the subsidies and other benefits provided by California's program did not play a major part in their decision-making. Dowall concludes that the enterprise zone incentives did not help the firms to overcome the competitive disadvantages they faced, and did not make a significant contribution to increasing investment and creating jobs. Similarly, statistical analyses by Lambert and Coomes in 2001 indicate that the establishment of an enterprise zone in part of Louisville, Kentucky, failed to stop the job drain, while the number of people employed in a comparable area grew, despite the lack of incentives such as those given to firms in the Louisville enterprise zone.⁽¹⁶⁾ Studies of enterprise zones in Indiana⁽¹⁷⁾ and New Jersey⁽¹⁸⁾ report similar findings.⁽¹⁹⁾

Finally, a recent assessment of the federal community empowerment program by the U.S. Department of Housing and Urban Development noted that it was difficult to determine with certainty what effect the initiative had had on distressed communities.⁽²⁰⁾

This overview of the literature indicates that the establishment of enterprise zones in the United Kingdom and the United States, at great cost to the governments, failed to produce the expected results. A number of analysts believe that the incentives and subsidies provided to firms in the enterprise zones play only a marginal part in the firms' decision-making process. These advantages essentially benefit firms already established in an area designated as

(14) Buss (2002).

(15) D. Dowall, "An Evaluation of California's Enterprise Zone Programs," *Economic Development Quarterly*, Vol. 10, No. 4, 1996.

(16) Lambert and Coomes (2001).

(17) Papke (1993).

(18) M. Boarnet and W. T. Bogart, "Enterprise Zones and Employment: Evidence from New Jersey," *Journal of Urban Economics*, Vol. 40, No. 2, 1996.

(19) See also Fox and Shribman (1996).

(20) Office of Policy Development and Research, U.S. Department of Housing and Urban Development, *Interim Assessment of the Empowerment Zones and Enterprise Communities (EZ/EC) Program: A Progress Report and Appendices*, November 2001 (http://www.huduser.org/publications/econdev/ezec_rpt.html).

an enterprise zone, and do not necessarily attract other businesses; hence, they do little to serve their purpose.⁽²¹⁾ While some studies show that the incentives offered in an enterprise zone may have some effect on the decision whether to invest, that effect is minor, since for the most part the decision depends on other, more important factors.⁽²²⁾ Incentives are seldom able to offset various deficiencies in underdeveloped rural areas, including a lack of well-trained, skilled labour, inadequate infrastructure (transportation and communication systems, etc.), rigid regulatory and institutional constraints, and geographic isolation (proximity to markets and associated businesses is usually very important).⁽²³⁾

ENTERPRISE ZONES IN CANADA

What, then, of the Canadian government's programs to foster economic development and job creation in the regions? Federal responsibilities for regional development have mostly been handed over to regional development organizations under the Minister of Industry. Enterprise zones are not part of the federal government's regional development strategy, and the government does not seem disposed to embark on such initiatives at the moment.

Quebec, however, has independently established a number of enterprise zones in recent years within its own jurisdiction, notably the Montréal area. Examples include the *Cité du multimédia*, the *Cité du commerce électronique*, the *Technopôle Angus*, the *Cité de l'optique* and, in particular, the Montréal Foreign Trade Zone at Mirabel. The Mirabel Zone was created in the 1999-2000 provincial budget to encourage firms in the aeronautics, international logistics, aeronautical training and light manufacturing industries to move to the industrial area adjacent to Mirabel Airport and thus help Montréal's international airport assume a major role in the economic development of Mirabel, Greater Montréal and the province of Quebec.⁽²⁴⁾ The Montréal Foreign Trade Zone at Mirabel is:

(21) P. Collits, "What's Wrong with Enterprise Zones?" *Sustaining Regions*, Vol. 2, No. 1, 2002.

(22) J. Potter and B. Moore, "UK Enterprise Zones and the Attraction of Inward Investment," *Urban Studies*, Vol. 37, No. 8, 2000.

(23) P. Fisher and A. Peters, "Tax and Spending Incentives and Enterprise Zones," *New England Economic Review*, March-April 1997.

(24) Government of Quebec, *Création de 1 700 emplois d'ici 2003*, News Release, 22 October 2001 (http://www.premier.gouv.qc.ca/general/communiqués/archives_commumiqués/2001/octobre/com20011022.htm).

a development corporation of the government of Québec which provides fiscal and financial assistance in such areas as corporate income tax, tax on capital and on employer Health Services Fund contributions as well as refundable tax credits on plant construction and the acquisition or leasing of eligible capital assets.⁽²⁵⁾

On 12 June 2003, however, Yves Séguin, Québec's Minister of Finance, announced that the tax incentives offered to businesses in the Zone were being eliminated,⁽²⁶⁾ since they were considered too generous.⁽²⁷⁾ Québec's new government realized that the tax measures for enterprises in the Zone were mainly benefiting large, prosperous companies that did not really need them, such as Bombardier Aeronautics, rather than smaller businesses in genuinely depressed areas.⁽²⁸⁾ In addition, Québec's Department of Finance found that the tax incentives did not create new jobs but, according to Mr. Séguin, simply helped move companies and existing jobs into the designated zones,⁽²⁹⁾ at great cost to the government.

CONCLUSION

It is now 25 years since British university professor Peter Hall put forward the idea of establishing free zones to stimulate local and regional economic development. The creation of enterprise zones in the United Kingdom and the United States over the last 20 years has been expensive for governments but for the most part has failed to produce the desired results. A number of studies have shown that the economic benefits of creating enterprise zones have been far less significant than expected, perhaps even negligible. This outcome is not surprising, since a company's decision whether to invest in a particular region has more to do with factors other than tax incentives.

(25) Montréal Foreign Trade Zone at Mirabel, *A new director general for the Montréal Foreign Trade Zone at Mirabel*, News Release, 28 February 2003 (<http://www.zonemirabel.com/english/quoi.htm#Directeur>).

(26) A number of tax breaks for businesses in various designated zones were eliminated as well.

(27) However, firms that were already located in the zone will continue to receive the initial incentives, provided they meet certain conditions (Montréal Foreign Trade Zone, *What's New, Budget 2003-2004* (www.zonemirabel.com/english/quoi.htm)).

(28) J. Richer, "Les 'cités' coûteront 4,5 milliards à l'État," *Le Devoir*, 24 October 2003, p. A3.

(29) *Ibid.*

In Quebec, the tax breaks offered through enterprise zones in recent years attracted some businesses to areas such as the Montréal Foreign Trade Zone at Mirabel. Most of those businesses, however, were already established in Quebec and simply moved to the designated zones to take advantage of the generous tax incentives. A Quebec government study shows that very few new jobs were created.

Overall, the establishment of enterprise zones in disadvantaged regions of Canada, especially in rural areas plagued by major structural problems, would be very costly to the public purse without any guarantee of a lasting improvement in economic activity.

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