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Local Impact of Foreign Trade Zones

David Weiss

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Many economic development professionals view the luring of export driven industries into their regions as a way to stimulate the local economy. Foreign trade zones offer firms involved in international trade the prospect of reduced costs, not at the expense of the local government, but through reduced federal tax liabilities. Thus, many economic development groups view the zones as a potential economic development tool. However, this is a difficult tool to successfully implement. This working paper examines foreign trade zones, what are they, what benefits they provide, and the characteristics of successful zones.

Drawing on a survey of over 30 economic development officials involved with foreign trade zones, this working paper attempts to draw conclusions as to what goals are attainable with foreign trade zones, and what regional characteristics and complementary policies affect their effectiveness.

As the level of international trade grows, foreign trade zones are achieving tremendous attention as an economic development tool. Foreign trade zones (FTZ) offer firms the prospect of reduced operating costs. In doing so they become one more incentive for economic development practitioners to lure prospective companies and capture expansions by local firm.

The Basics

Foreign trade zones are areas located within U.S. boundaries but outside of its customs territory. Foreign goods can be imported duty-free into an FTZ and then either re-exported without duties or formally imported into the U.S. market accompanied by payment of U.S. import duty. Because most savings to the firm arise from reduced tariffs, the federal government and not the local area pays for the benefits provided to the firm using the zone. In theory, this sounds like an ideal economic development tool, providing a true financial benefit. However, in practice, people who run FTZs have been disappointed with their results. They often find that FTZs are difficult to administer and do not generate a significant amount of new employment.

Foreign trade zones consist of two types of zones: general purpose and subzones. In practice, general purpose zones and subzones are used for different activities.

The general purpose zone is created before any of its subzones and is normally located at a port of entry such as a shipping port, border crossing, or airport. A general purpose zone usually consists of a distribution facility or industrial park. Space is leased in a manner similar to any other industrial park or shared warehousing facility.

Activities in general purpose zones typically consist of inspecting, storing, repackaging, and distributing merchandise, and destroying defective merchandise, prior to re-export. For example, the Miami FTZ acts as a distribution center for European and Asian companies exporting into South America and the Caribbean. Manufacturing activities take place in only a few general purpose zones.

Subzones are areas that are physically separate from the general purpose zone but are legally and administratively attached. Subzones allow new or existing facilities that are located outside of the general purpose zone to take advantage of FTZ benefits. For example, subzones allow space-intensive facilities, such as assembly plants, to become part of an FTZ without using expensive port space. A subzone is used by a single company and is typically created around a manufacturing plant.

Benefits to the Firm

FTZs potentially provide firms with a wide array of financial benefits. Firms can repackage or assemble imported merchandise along with domestic components for re-export without having to pay a customs duty on the imported components. This benefit makes it competitive for exporters to operate within U.S. boundaries, and was the original goal of the FTZs. However, many firms have found it to be more convenient and cost effective to avoid duties on re-exported goods by alternative means such as bonded warehouses or duty drawback programs, which return tariffs on re-exported goods.

A second benefit of FTZs is that custom duties and taxes on goods for domestic consumption are not paid until the merchandise leaves a foreign trade zone and enters U.S. customs territory. In fact, while in a zone, merchandise is not subject to taxes of any kind. Furthermore, defective imports can be discarded before tariffs are paid, so that tariffs are not paid on unusable products. In practice, the deferral of both tariffs and domestic taxes until the imported merchandise leaves the trade zone is the major benefit enjoyed by current users of general purpose zones. Most of these establishments are repackaging and distribution centers.

A third benefit of FTZs is that firms may keep merchandise in a zone indefinitely. This allows firms to weather periods of poor sales without paying import duties, and to defer import quotas. If import quotas have been met for the year, the merchandise can be stored in the FTZ until the next year so that it will not be included in the current year's quota.

In addition to the financial benefits provided by FTZs, there are two often cited logistical advantages. First, for the foreign suppliers of manufacturers that practice just-in-time manufacturing, FTZs provide a local storage site for components, allowing for better timing of deliveries. Second, FTZs provide a form of guarantee for foreign producers' ability to deliver goods in a timely fashion. The foreign company can store its goods tax free in an FTZ until the goods are sold. Meanwhile, the purchaser has greater assurance that the supplier can deliver the merchandise on schedule.

While these benefits can be substantial, they stimulated only tepid growth in FTZs from their inception in 1934 through the 1970s. However, FTZ use increased dramatically in the 1980s as new regulations made it more feasible for firms to use FTZs to circumvent inverted tariffs.

Inverted tariffs

Tariffs in the United States are usually implemented to protect U.S. producers from foreign competitors. Tariff schedules are normally structured so that foreign components and raw materials are taxed at a lower rate than foreign finished goods in order to encourage U.S. manufacture of high value added goods.

Sometimes, due to the broad and multilateral nature of trade negotiations, unintended consequences may occur from the tariff schedules. For example, the duty rate on a final good may be lower than the rate of its components. This is called an inverted tariff. Its effect is that U.S. firms that import components must pay a higher tax on those components than foreign firms who export finished products into the U.S., thereby reducing the tariff protection on the finished goods industry.

In the case of inverted tariffs, FTZs allow firms to avoid the tariff on intermediate goods and instead utilize the lower tariff on domestic finished goods. Firms can import foreign components into FTZs for use in domestic finished goods without paying tariffs. The tax rate and the value of the merchandise may change as a result of processing or manufacture in the zone. The firm can then choose to pay the duty and taxes at either the tax rate of the foreign component or at the finished good rate.

In the case of inverted tariffs, foreign components can be imported and then manufactured into the final product, and the tariff can be subsequently paid on the imported components at the lower final product rate. This restores the tariff protection for domestic producers of final goods. For example, suppose that tariffs on imported automobile components range from 4 to 10 percent, while the tariff on completed automobiles is 2.5 percent. An auto manufacturer who imports the components can assemble a car in an FTZ and pay a 2.5 percent tariff on the imported components included in the car, rather than the 4 to 10 percent tariff.

Allowing manufacturers to avoid inverted tariffs has become the dominant financial benefit of FTZs. In 1987, the International Trade Commission conducted a survey of establishments operating in subzones. Of the 55 firms responding, just over two-thirds established FTZ status to avoid inverted tariffs. Additional firms, particularly in the sugar processing and petroleum refining industries, would have liked to have avoided inverted tariffs through the use of FTZs but were allowed to operate in the zones only under strict constraints placed on them by the FTZ Board. The FTZ Board, which approves all FTZ applications, imposed these constraints in response to objections by competitors and suppliers.

Only 16 firms took advantage of intended FTZ benefits such as deferring or avoiding duties on goods destined for re-export. Six firms used privileged foreign status which allows imports to be valued for customs purposes before being combined with domestic components.

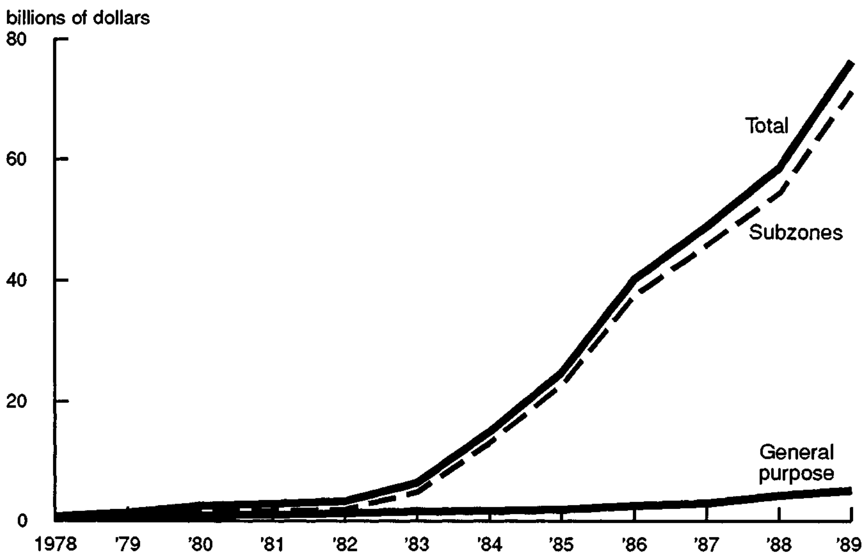
The increased use of FTZs to avoid inverted tariffs during the early 1980s was due to two regulatory changes which increased the inverted tariff savings available to manufacturers in the zones. In 1980, the Treasury Department excluded domestic value added from the dutiable value of finished goods entering the United States from FTZs. In 1982, the Customs Service further excluded overhead costs (such as transportation and insurance) from the dutiable value of goods leaving the FTZs.

These changes enhanced the FTZ value of avoiding inverted tariff structures. Not only is the high tariff on intermediate components avoided, but the alternative tariff on final products is now paid on only its "foreign" content, and not on a larger base that would negate the savings from a lower tax rate.

Growth in the amount of merchandise moving through the zones has been astonishing (see Figure 1). In 1980, total merchandise received in FTZs was $2.6 billion. By 1985, this figure had grown to $24.8 billion, an increase of 57 percent per year. Over the next four years volume increased at an annual rate of 32 percent, reaching $76.3 billion in 1989.

Figure 1

FTZ merchandise received



Source: Foriegn Trade Zone Board and U.S. International Trade Commission.

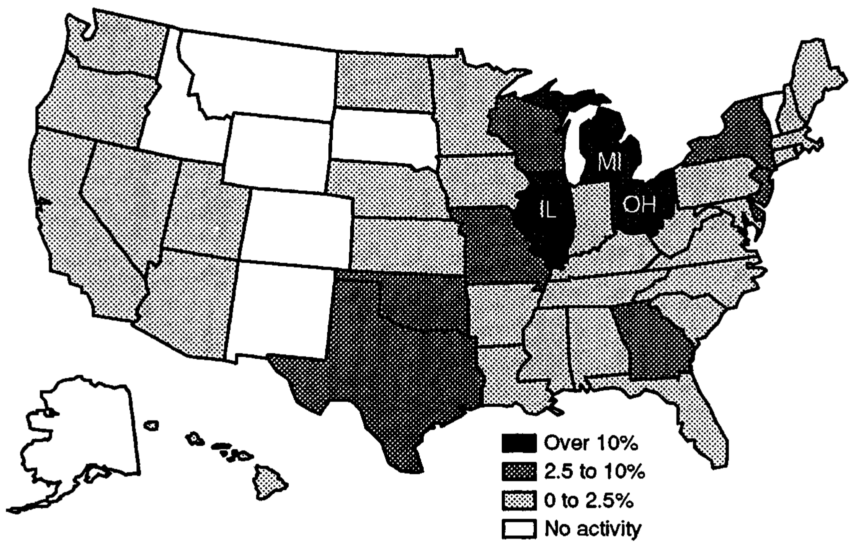
The rapid growth does not appear to be slackening. For example, Detroit's zone increased its shipments from $9.7 billion in fiscal 1987 to more than $18 billion in 1989. Furthermore, activity in subzones, where manufacturing to avoid tariffs takes place, has come to dominate general purpose zones. In 1970, subzones accounted for 9 percent of all merchandise received in FTZs.

In 1986 the share of merchandise entering FTZs received by subzones peaked at 94 percent, and is currently at 93 percent.

Most of this growth is in automobile manufacturing in subzones, which accounts for the strong midwestern concentration of FTZ activity (see Figure 2). In 1981, there was one automobile assembly plant located in a subzone, accounting for 28 percent of all goods received in FTZs. By 1986, there were 24 automobile assembly plants located in subzones, accounting for 85 percent of all goods received in FTZs. Furthermore, through February 1990, another 16 subzones for automobile assembly and 15 subzones for automobile components have been approved.

Figure 2

Share of shipments received by FTZs, 1989



The dominance of FTZs by the automobile industry can also be seen by examining the distribution of goods of foreign origin entering the zones (see Table 1). In 1989, of the $18.8 billion of foreign goods entering FTZs, automobiles and automobile parts accounted for $10 billion. This amount does even include many components that fall into other categories such as the electronics or radio/cassette decks sectors.

Table 1

Major products of foreign origin received in FTZs, 1989

Sector	General Purposes	Subzones	Total
Auto parts	253.3	8,317.0	8,570.3
Crude oil		2,188.8	2,188.8
Photo/Optical equipment	19.4	1,484.0	1,503.4
Autos	1,227.1	178.3	1,405.3
Radio/Cassette decks	44.6	789.8	834.5
Machinery	778.0		778.0
Electronic products	502.9	207.1	709.9
Refined petroleum	27.1	262.6	289.7
O.J. concentrate	288.7		288.7
Other motor vehicles		156.5	156.5
Televisions and parts	110.1	19.7	129.8
Toiletries	123.9		123.9
Steel	80.2	24.6	104.8
Office equipment	14.2	85.3	99.5

SOURCE: Foreign-Trade Zones Board.

The FTZ Controversy--a Look Into the Future

The use of FTZs to circumvent inverted tariffs was certainly not the original or primary intention of the FTZ legislation. The continued use of FTZs as a tool to circumvent import tariffs on intermediate goods remains an area of public debate.

In those circumstances where inverted tariffs work against the public interest, this use of FTZs serves to correct ill-conceived trade policies and the undesired results of tariff negotiations. For example, the tin plate in the containers in which imported pineapple enters the United States carries no tariff. Prior to acquiring FTZ status, Hawaiian-based Dole Pineapple Co. paid a 3.9 percent ad valorem rate of duty on tin plate imports that are used to make cans to package pineapple. This tax put the firm at a competitive disadvantage with respect to canned pineapple importers. In order to give

Dole equal treatment on the tin plate it uses to can its domestic pineapple, the FTZ Board approved Dole's use of the trade zone to eliminate this disparity.

However, some national tariff policies are intended to protect domestic producers of intermediate goods regardless of the interests of final goods producers. In such situations, the use of FTZs to avoid inverted tariffs circumvents the intended tariff protection of industries and regions.

Although FTZs have provided significant benefits to industries such as automobiles, steel pipe, and typewriters, there are often complaints about FTZ use from other domestic industries. The use of FTZs to reduce tariffs on goods brought into the United States and to avoid other trade restraints (such as quotas) has quickly become apparent to competitors and suppliers of firms operating in the zones.

Steel companies accuse ship builders and automobile manufacturers of circumventing trade agreements. Auto parts suppliers complain that auto manufacturers take advantage of FTZs to import their components. Similar complaints have been made about bicycles and television components.

For these reasons, the FTZ Board's policy has been to act more judiciously in expanding the use of FTZs as a means of circumventing inverted tariffs. For example, concern about sugar processors avoiding the high tariffs on sugar has resulted in severe limitations being placed upon the activities of sugar processors within zones. In practice it is FTZ Board policy that if inverted tariffs occur because of a Congressional policy, as with bicycle or television manufacturers, then FTZs cannot be used to avoid inverted tariffs. However, if the inverted tariffs were not part of a conscious policy but a by-product of trade negotiations, as in the auto industry, then FTZs can be used to avoid inverted tariffs.

When opposition to an FTZ application is extensive, the FTZ Board makes a decision by balancing the competing interests involved, in some cases placing severe restrictions on the use of the zone or discouraging the subzone application.

New regulations regarding the authorization and regulation of foreign trade zones were recently approved and became effective on November 7, 1991. From the FTZ grantee's point of view there are two major changes.

First, the limits for general purpose zones have been extended to 60 miles from the outer limits of the port of entry boundaries. This will make more communities eligible to apply for foreign trade zone status for the economic development programs.

Second, if the zone is not activated within five years of approval, the grant of authority will be inactivated. This second change will make it more important for economic development groups to have a clear plan as to who will be using the FTZ.

Changes effecting zone users have both made approval criteria more specific and more stringent. Currently subzones are approved unless the proposed activity is shown in some way to be "detrimental to the public interest." Under the new rules, acknowledging that subzone status is a privilege, not a right, subzone applicants now have a clear burden of demonstrating a significant public benefit. Although this aspect of the regulations was technically true under earlier rules, the criteria are now more specific and this rule will probably be more strictly enforced. In practice what will probably happen when an activity already takes place in a FTZ, the FTZ status will not effect the tariff rate, or if output is for export only, the status will be quickly approved. However, if the activity in any way contradictory to trade policy, involves foreign goods subject to quotas, or is an attempt to avoid inverted tariffs, then the activity will undergo an extensive economic impact review. This review will include the effect of the activity on overall employment, net exports, retention or creation of business activity, impact on related domestic industries, and other concerns relevant to the public. In all likelihood these changes will significantly slow down the growth in manufacturing in subzones.

Economic Development Benefits

Amid this controversy, the number of foreign trade zones continues to grow. Some FTZs generate large amounts of shipments, while many are never activated. Through interviews with over 30 people who are either the grantees or operators of foreign trade zones it is possible to determine what goals are obtainable through FTZs and characteristics that make FTZs successful (See Appendix I for a discussion of survey method).

There appears to be two major reasons that economic development groups have obtained FTZs. First, many groups obtain FTZs as part of their overall economic development program, to aid in job development and retention. At the very least the FTZ acts as a signal that the area is serious about attracting companies. Second, zones are sought to help a particular local plant or a new plant requires subzone status before it will move to the area. For example, Peoria's application for a zone was sponsored by Caterpillar, Inc.

Although zones have been sought for both job retention and attraction, in practice they have performed better at retaining jobs. The financial benefits provided by FTZs are usually not great enough to cause firms to move but they do give firms a competitive advantage and thus make a difference in local job retention.

Like most other economic development tools, FTZs cannot stand on their own. They must be used with other incentives. FTZs fit best with transportation networks such as airports, railroads, and shipping ports. If the volume of shipments through the zone increases transportation needs, the area can support a wider range of transportation services and thus should yield better service to the area as a whole. This increased volume will also increase the tax base.

The financial benefit of increased traffic can be very large. One zone operator noted that when a ship whose cargo was steel, docked, unloaded, and warehoused the steel, $40,000 in revenues were generated. The steel was stored in the FTZ until import quota problems were solved. Without the FTZ, the ship would not have docked and used the other port services. So this increase in revenue can be directly attributed to the FTZ.

Economic development groups view FTZs as a tool that will make them competitive with other cities. Many economic development professionals believe that because a trade zone is now a requirement for locating major new plants involved with foreign trade, FTZs are now a necessary part of an economic package. The Diamond Star plant in Illinois, representing 3,000 jobs, made subzone status in an FTZ a prerequisite for locating in the area. However, this requirement may disappear as it becomes more difficult for manufacturers to acquire subzone status.

Successful Trade Zones

Overall, most FTZ grantees, the group authorized by the Foreign Trade Zone Board to establish, operate, and maintain a zone, have discovered that a FTZ is a poor tool for increasing jobs. But some grantees have been very successful in using it as a tool to help local companies. The formula some areas use of building an industrial park with a zone and hoping for business, just does not work. The local area should have a basic international trade base, a reason for trade, such as ports and airports. The zone should be treated as an economic development tool, and not as a major incentive for attracting companies. Therefore, the zone must not only be marketed but combined with other economic development initiatives.

As with any real estate development project, FTZs must be properly located, preferably by an airport, seaport, or railroad. Delaware's FTZ is a case in point. Although the zone, and economic development groups associated with it, do no marketing, it is located near two auto plants and a major port. There is a clear demand for its FTZs services. In fact, the FTZ application was made at the request of the two auto plants. Baltimore's FTZ is another example. Originally its zone was incorporated into a new industrial park built on an old army base. The FTZ could not attract users. Later, a new operator took over the FTZ and the zone was moved closer to the marine terminal and rents were lowered. There are now 200 people working for new companies in the zone and three piers have been added to the zone.

FTZs are much more likely to succeed if they have major initial tenants. Many FTZs of substantial size started with a large manufacturing plant in a subzone, providing cash flow. The zone in McAllen, Texas, did not start with a major tenant, and even with its close proximity to the manufacturing plants on the Mexican border, it took 15 years to become profitable.

To fill general purpose zones with tenants, buildings are needed, but usually zone operators need signed tenants to raise the money to build buildings. Also, lack of operator expertise scares potential tenants.

They will not sign on unless the operators are proven. This is kind of a Catch-22. The best solutions are to have the operators of a currently active zone run the zone, or have experienced customs brokers become the operators. Either of these operators will probably instill enough confidence with prospective tenants to sign a lease. Both the critical mass of signed tenants or experienced operators are helpful in activating an FTZ.

In most cases, operators are extremely important for making a general purpose zone viable. The Bridgeport, Connecticut, zone was not active until private operators petitioned to take it over. These operators were experienced in trade and freight forwarding. They also have a clear incentive in making the zone successful. An increase import-export traffic will potentially increase the demand for their services. An operator of this type relieves a strained economic development staff of much work.

The trade zone grantee should not forget that the general purpose zone needs tenants to cover its costs. Some grantees do not allow the operator to take in tenants that do not use the trade zone privileges. However, many tenants currently are not involved with trade. Instead, these tenants lease trade zone space so that they have the option to use its privileges in the future. Thus, the restriction that the FTZ warehouses can only be used by FTZ users and not domestic users can lead to failure because the warehousing space will not be fully utilized.

When bringing in outside operators it is important that they have an incentive to see the zone succeed. Unless the zone is extremely well situated with respect to trade, marketing is essential to its success. Many zones fail because not enough money and effort are allocated to marketing. This lack of funds often occurs because it is unclear whether the operator or grantee was responsible for marketing. If the operator has a deep rooted interest in the general purpose zone's success, he or she will be willing to market the zone.

Another error of responsibility occurs when economic development groups from different areas jointly control an FTZ. If the general purpose zone is not in a particular group's territory, that group does not retain all of the benefits of new tenants. Or one group believes another group will market the zone and it will gain some of the benefits. Either way, there is little incentive to market the zone.

Once responsibility or an incentive to market the zone is established, it must be done full force. Zone operators and grantees cannot wait for users to approach the zone; they must get the word out. Battle Creek, Michigan, has been extremely successful in attracting firms. It has 64 firms using its zone, 19 are foreign. The marketing strategy includes not only a video tape but one person spends one day per week on marketing the zone.

Well organized strategies market to both local and non-local firms. Often information on the FTZ is included in response to any requests for business information on the local area. Many well marketed zones also have the state include information on the FTZ with their responses for information about business location.

In this marketing strategy, small firms should not be overlooked. Several of those interviewed believed small companies could not effectively use FTZs because of the bureaucratic overhead and the threat of fines. However, operators of established FTZs believe that this is entirely untrue. Economic development groups can perform feasibility studies to determine whether or not a firm can benefit from being in a zone and customs house brokers can assist small firms by providing advice and doing the paper work.

It is also suggested that the grantee be set up to move quickly to help firms establish subzones. Also, many companies are unwilling to change their accounting system to match the zone system so they are unable to use the zone. Therefore, the better prospects are firms just entering foreign trade, and thus do not have an accounting system in place, or firms with new and/or innovative management that are willing to change their accounting systems.

Conclusion

Foreign trade zones were originally intended to encourage exporting industries and thus could be viewed as an economic development tool. Instead they are generally used to circumvent tariffs on imported goods, thus, their effect on national employment is unclear and their effect on local employment is minimal. Now that FTZs are widespread, they have become an economic development tool that merely brings an area on par with other areas.

Success of a foreign trade zone is not guaranteed. However, some zone attributes and management practices can significantly effect its success. First, location is essential. There must already be a reason for trade to be in the area, and a transportation system is important. Second, even with a large capital investment, foreign trade zones will not work without marketing. To guarantee the marketing takes place, one of the involved organizations should be given clear responsibility for it. In addition the zone operator should be experienced in trade activities and have the proper incentives, and freedom, to market the zone. So, although in most cases foreign trade zones will not have a significant impact on local employment, they can help local companies compete.

Appendix I

The survey (See following page) was designed to answer the following questions concerning economic development: What were the community's expectations for the foreign trade zone? In light of these expectations, how successful are foreign trade zones as an economic development tool? Success was also being measured in terms of jobs retained or new jobs brought into the local area. However, after the first group of interviews, it was quickly realized that very few economic development specialists were willing to attribute new jobs or retained jobs to the foreign trade zone.

Therefore, the questions asked during most of the interviews sought to identify the characteristics of active zones that differentiate them from inactive zones. The assumption is that an inactive zone is unsuccessful, and the higher the level of activity in a zone, the more successful it is at stimulating economic activity.

FEDERAL RESERVE BANK OF CHICAGO

QUESTIONNAIRE

FOREIGN TRADE ZONES

MARCH 1991

I. Economic Development Effects

What were the expected benefits to the community of developing a foreign trade zone (FTZ)?

Was the FTZ originally developed as part of an overall economic development strategy or, rather, to meet the immediate needs of a specific economic development project?

How is the FTZ integrated into your package of economic and non-economic inducements?

II. Job Impact of Foreign Trade Zones

Have you been able to document any primary or secondary increases in employment due to the FTZ in your area?

Have any establishments located in your area, either wholly or partly, because of the FTZ?

Has your FTZ prevented the loss of jobs or the closing of a plant?

What percent of the firms operating in your FTZ are foreign owned?

III. Costs and Benefits of Foreign Trade Zones

What have been the benefits and costs of having a FTZ in the area?

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