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Export Processing Zones and Other Special Regimes in the Context of Multilateral and Regional Trade Negotiations

Jaime Granados

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C O N T E N T S

EXPORT PROCESSING ZONES AND OTHER SPECIAL REGIMES IN THE CONTEXT OF MULTILATERAL AND REGIONAL TRADE NEGOTIATIONS

Jaime Granados *

Export processing zones and other special regimes will be subject to substantial regulatory reforms as a result of the gradual integration of countries into the international economy. On the one hand, commitments in the World Trade Organization (WTO) entail the elimination of export subsidies. On the other, regional integration schemes normally exert pressure to eliminate tax and tariff exemption/reduction mechanisms on imports of inputs or equipment that are incorporated into or used in exports going to the trading partner in such schemes. The combined effect of these two forces has caused or will cause a substantial change in the way these special regimes operate. This study seeks to explain such factors and to posit some very general scenarios on the mechanisms of export processing zones and other special regimes.

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I. INTRODUCTION

Export processing zones (EPZs) and other special regimes have been used very widely, not only in Latin America but throughout almost the entire developed and developing world. Their main goals, among others, have been to promote exports, attract export-oriented investment, diversify the national export supply, foster relatively less developed regions, and create employment. The literature has often assessed their results relative to the original policy objectives, and on several occasions the results have been deemed to be mixed.[1]

EPZs and special regimes arose at different times in each country. In many cases the EPZs originated in exception regimes that allowed countries to undertake partial and limited opening on a par with other restrictive, national-level trade policies. Generally, however, EPZs and other regimes were of particular importance when countries abandoned import-substitution policies and began implementing economic development strategies based on export-promotion. On the supply side, the underlying idea was to design a mechanism that could help overcome the strong anti-export bias evident in most countries, especially developing countries. On the demand side, particularly in developed countries, the aim was to foster greater exploitation of the competitive advantages of different parts of the world by making it easier to undertake certain production

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[1] For a detailed assessment of export processing zones see Madani [1999], available on the World bank website at *http://www.worldbank.org.*

processes in places where geography and the corresponding endowment of local factors made it more efficient. This would facilitate the restructuring of global production processes.

In some countries the relative success of such mechanisms is apparent from the fact that their use has diversified exports and, indeed, a very substantial share of total exports originate in EPZs regimes. In the Dominican Republic, Honduras and Costa Rica, for example, the share varies between 50% and 70%, which is far from negligible. Because employment levels are high in EPZs, moreover, they are important in keeping national unemployment rates low and in providing jobs for those who otherwise would probably be out of work. Much of the foreign direct investment reaching the countries, especially in Central America and the Caribbean, is targeted at EPZs as export platforms that are geared to the markets of more developed countries.

EPZs thus seem to play an important role. They have given impetus to an economic dynamic that, despite its problems, is unparalleled as a policy to attract investment and to promote and diversify exports (especially in these countries), although perhaps they have been less successful in developing backward linkages to the rest of the domestic economy.[2]

However, Latin America and the Caribbean are going through a time of change; a time when earlier paradigms are being renewed and when what previously seemed certain and stable is now less clear. The working hypothesis of this paper is that EPZs will be affected by the winds of change and that, in the medium and long term, they will probably evolve into something a little different from what they are today, at least as regards the production of goods.[3] Some elements of these regimes will be left behind -either because they represent a real or potential distortion to international trade or investment flows, or because they are incompatible with trade agreements that establish free trade areas or customs unions, or because they are simply unnecessary in the new context since the need for them is met through other mechanisms. This document will try to explain these considerations in detail.

The document will seek to assess the different forces currently apparent in the international political economy on the issue of EPZs and special regimes. We can then see what kind of pressures might arise when, and for what reason. The aim is not to offer an exhaustive, case-by-case or country-by-country analysis, although a precise understanding of the situation calls for such a study. This presentation will indicate only the general trends now taking shape, especially against the background of the negotiations on trade opening in which the Western Hemisphere and the whole world are engaged.

A central argument of this study is that while countries want to proceed further with a development strategy based on economic opening and greater integration in international markets, they will

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[2] The issue of the lack of productive linkages is central to the criticism of EPZs. Without entering into the causes of this problem here, it is worth exploring different premises. For example, is it a matter of a lack of competitiveness on the part of the local producer who normally prefers to be shielded by the protection of the local market? Is it a matter of a policy of the acquisition of companies in EPZs, many of them multinationals with pre-established supply channels for raw materials and inputs? These are interesting avenues for research.

[3] The observations that follow do not yet cover services. However, at the multilateral level some of the measures that distort trade in services might be being negotiated, and thus some similar kind of disciplines could eventually be applied to services trade.

feel pressure to change how the EPZs operate. For the most part, the source of this change will be the multilateral, hemispheric and subregional trade negotiations in which the countries of the Hemisphere are involved, negotiations that seek as far as possible to eliminate distortions to international trade and investment.

II. GENERAL OBSERVATIONS ON THE TREATMENT OF EPZs IN SUBREGIONAL TRADE INTEGRATION AGREEMENTS

Before exploring how integration agreements in the Hemisphere treat goods produced under these regimes, it is helpful to review briefly the economic thinking on EPZs and other special regimes in integration agreements. First, recall that a free trade agreement, like a customs union, seeks to eliminate tariff and non-tariff barriers to trade between the member countries. In a customs union the members also establish a harmonized trade regime towards third countries. In both cases, only goods originating in member countries can benefit from the preferential concessions negotiated in the agreement. In other words, an agreement must not be designed in such a way as to confer its benefits on third-party goods. In principle, this is achieved using two strategies.

The first is the rules of origin regime, which establishes criteria for determining the origin of goods and ensures that only those produced with domestic or mostly domestic inputs may benefit from the tariff preferences negotiated. This is necessary to avert trade "deflection" or "triangulation", which in very general terms means that third-party goods illicitly benefit from free trade by entering a country (paying tariffs or not) and then move to a partner country in the agreement without paying the tariff.

The second strategy is the restriction or elimination of any mechanism whereby a member of the free trade area grants preferential tariff or tax treatment to imports of extra-regional inputs. This includes EPZs and other special regimes. This is a logical consequence of the first strategy and similarly seeks to obviate trade deflection. In this case the aim is to ensure that third-party inputs, imported for use in other products that are then exported to another member in a free trade area, do not "breach" the wall of tariff protection in one member and enter the destination country incorporated into other products without having paid import tariffs. This would be a threat to the integrity of the other country's tariff policy, since goods would be "slipping" through the back door without paying tariffs.[4]

The two strategies are perfectly complementary. The origin regime determines the precise amount of extra-regional inputs that a product may have for it to qualify as being from a member country, and thus benefit from free trade. Restrictions on mechanisms to exempt extra-regional inputs, for their part, control the tariff levels that those extra-regional inputs pay to avoid trade deflection.

Following this theoretical introduction, it is time to examine the treatment that the main Western Hemisphere agreements grant to goods produced in EPZs and under other special regimes.

There is no uniform treatment of goods produced under EPZ regimes in most of the Hemisphere's free trade or customs union agreements. Some agreements refer to "export processsing zones" *per se* while others, eschewing the term, refer more broadly to "special regimes", "free zones", "duty drawback or deferral programs", or certain special regimes. In general, reference is made to other,

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[4] In a perfect customs unions, however, this logic does not apply. In theory, there should be no rules of origin in a customs union, in principle because all imports of extra-regional inputs are subject to the same tariff level (and this removes the possibility of trade deflection), because there is a common mechanism for tariff collection and free movement of any good once it enters and pays the common external tariff (CET).

more specific instruments, such as duty drawback, tariff exemptions, inward processing, *maquila*, temporary importation and so forth. EPZs use some of these more specific instruments. In some countries each of these is a separate regime, and they can classified in broad terms -and only for the purposes of this analysis- as "special regimes".

To cope with this terminological difficulty we can say that, in essence, what interests us here are all those regimes that allow certain goods, be they inputs or equipment, to enter a country either exempt from tariffs and other import duties, or else under a regime that suspends the latter; in general the goods must be re-exported in a fixed period, must be used in processed goods that are then exported, or must be used in production for export. In some of these regimes, especially the more inclusive systems like those in EPZ, goods receive other non-tariff benefits such as exemption from direct taxes, particularly income tax. Together, all of the foregoing seek to promote exports and, in many cases, to attract foreign investment.

In general, the Hemisphere's integration agreements vary in their treatment of exports from EPZs: in some accords the treatment is very restrictive; in others it is relatively liberal. What follows is necessarily general and simply identifies the broad outlines. Each agreement has its own peculiarities and complexities, which are beyond the scope of this analysis.

Table 1 shows in general terms how some trade agreements in the Americas treat these special regimes. The variety is evident not only in the way in which the different regimes are referred to, but also in the treatment. It must be stressed that each agreement has its own provisions for dealing with specific situations. This study will examine only a few of those situations.

In many cases, such as MERCOSUR, CARICOM, and the CACM, there was simply an agreement not to grant the preferential treatment stipulated in the accord to goods produced under such regimes. In other words, it is presumed that goods produced under special regimes should pay the normal import tariff if they are to enter the internal market, the free trade area or the customs union. In the Andean Community, in the agreement between CARICOM and the Dominican Republic, and in the accord between the latter and Panama, there are no specific rules in this regard, but it is plain from the texts that these countries have some concerns about importing products produced in other countries under these regimes (Table 1).

TABLE 1
SPECIAL IMPORT REGIMES IN
SOME TRADE AGREEMENTS IN THE AMERICAS

Agreement	Source	Treatment
NAFTA, 1994	Article 303 and its annexes	Refers to programs of duty drawback and deferral. A transitional period of 7 years to January 1, 2001 was agreed. After that period, paid duties cannot be refunded, and customs duties on goods for export, or that are to be included in other goods for export, or substituted for other goods for export to the territory of another member of the agreement, cannot be reduced or exempted, in an amount that exceeds the lesser between the total amount of customs tariffs paid or levied on imports of the good to its territory, and the total amount of customs tariffs paid to the other member with respect to the good that is later exported to the territory of that other member.
MERCOSUR, 1994	Resolution CMC/DEC N° 8/94	Refers to free trade zones, industrial zones, export processing zones and special customs areas. Goods under these regimes are subject to the payment of the common external tariff or the national customs tariff, as the case may be. Because of their geographic location, the special customs areas of Manaos and Tierra del Fuego are not included in these provisions until 2013.

TABLE 1 (cont.)

Agreement	Source	Treatment
Andean Community, 1991	Dec. 282 CAC and the Declaration of Santa Cruz de la Sierra of January 2002	Refers to tariff exemptions, understood to be regimes that allow free consumption with the corresponding exemption, reduction or drawback of tariffs. It was agreed not to grant new tariff exemptions as of March 31, 1991 because they would contravene subregional tariff commitments. There are some exceptions but they require a favorable judgment of the *Junta* on their compatibility with the purposes of the Decision. With respect to special customs regimes, and in line with the definitions of the 1973 Kyoto Convention, it was agreed to embark on harmonization. In the Declaration of Santa Cruz de la Sierra on January 30, 2002, the five presidents reaffirmed their commitment to harmonize the temporary import and other special regimes for intra-subregional trade. It is acknowledged that there should be a rules of origin regime to "avoid distortions in intra-Community trade".
CARICOM, 1973	Art. 16. CARICOM's founding treaty	Refers to the partial or total drawback or remission of import taxes. Each member country can refuse to treat goods that benefit from such drawback or remission as common market goods.
Mexico-Bolivia FTA, 1995	Article 304	Refers to tariff deferral or suspension regimes defined as free zones, temporary imports under bond, temporary imports for export, bonded warehouses, *maquiladoras* and other export processing industries. A transitional period of 8 years to January 1, 2003 was agreed. Thereafter, paid duties cannot be refunded and customs duties cannot be reduced or exempted for goods to be exported or incorporated into other goods to be exported, or substituted for other goods to be exported to the territory of another member country of the agreement, in an amount that exceeds the total customs tariffs paid or levied on the quantity of that imported good that is materially incorporated into the good exported to the territory of the other member, or substituted for identical or similar goods materially incorporated in the good exported to the other's territory, making due allowance for waste. Countervailing disciplines were agreed in the event that the import of goods produced under these regimes cause damage to the national industry.
Mexico-Costa Rica FTA, 1995	Article 305	Refers to programs of duty drawback and deferral. A transitional period of 7 years to January 1, 2002 was agreed on. Thereafter, paid duties cannot be refunded and customs duties cannot be reduced or exempted for goods to be exported or incorporated into other goods to be exported, or substituted for other goods to be exported to the territory of another member country of the agreement, in an amount that exceeds the total customs tariffs paid or levied on the quantity of that imported good that is materially incorporated into the good exported to the territory of the other member, or substituted for identical or similar goods materially incorporated in the good exported to the other's territory, making due allowance for waste. Countervailing disciplines were agreed in the event that the import of goods produced under these regimes cause damage to the national industry.
Mexico-Nicaragua FTA, 1998	Article 305	Refers to programs of duty drawback and deferral. A transitional period of 7 years to January 1, 2002 was agreed on. Thereafter, paid duties cannot be refunded and customs duties cannot be reduced or exempted for goods to be exported or incorporated into other goods to be exported, or substituted for other goods to be exported to the territory of another member country of the agreement, in an amount that exceeds the total customs tariffs paid or levied on the quantity of that imported good that is materially incorporated in the good exported to the territory of the other member, or substituted for identical or similar goods materially incorporated into the good exported to the other's territory, making the allowance for waste. Countervailing disciplines were agreed in the event that the import of goods produced under these regimes cause damage to the national industry.
Mexico-Guatemala, Honduras and El Salvador FTA, 2000	Article 305	Refers to programs of duty drawback and deferral. The signatories reserved their rights and obligations in accordance with their legislation and the WTO agreement. There can be consultations if a member is affected by the application of these programs.
Chile-CACM FTA, 2001	Annex 3.04(2)	Goods exported from Chile to Costa Rica cannot benefit from the Drawback Program for Chilean Exporters. Exporters to Costa Rica must forego the benefit.
Canada-Chile FTA, 1997	Article C 03 and Canada's tariff reduction lists	Refers, first, to exemption from customs duties conditional on performance requirements. In principle, neither country can grant such exemptions. Second, some of Canada's tariff reduction lists are conditional on the Chilean government's notifying the Canadian government that the good to be exported does not benefit from the duty drawback program.
Canada-Costa Rica FTA, 2001	Canada's tariff reduction lists	Refers to tax exemptions and other export subsidies granted under the protection of the free zone regime. Implementation of the agreement's different categories of tariff reduction will enter into force 120 days after the government of Costa Rica satisfactorily notifies the government of Canada that it has eliminated all such exemptions and subsidies.

TABLE 1 (cont.)

Agreement	Source	Treatment
Dominican Republic-CARICOM FTA, 1998	Action Plan, iii)	Refers to free zones. Although no legal disciplines have been agreed, there is an action plan to negotiate such disciplines and an agreement on a series of principles. The latter include: (1) products from free zones must not enjoy additional advantages to those they now enjoy in the different customs territories, and (2) no less favorable treatment than the one they now enjoy in reciprocal trade.
Trade agreement between the Dominican Republic and Panama, 1985	Article V	Refers to free trade zones or free zones. Establishes that goods produced in such zones in the contracting parties may, exceptionally, benefit from the present treaty when the Permanent Joint Committee so agrees.
CACM-Dominican Republic FTA, 1998	Article 3.05 and Protocol to the treaty	Refers, on the one hand, to duty drawback and deferral programs. In this regard the signatories reserve their rights and obligations in accordance with the WTO agreement. Additionally, however, the agreement makes express reference to free zones and special fiscal and customs regimes. In that regard, Article 4.1 of the protocol to the agreement states that goods produced under such regimes may be admitted to the territory of the other signatory under conditions that are no less favorable than those applying to the goods of one signatory produced in its own free zones or under other special regimes.
Central American Common Market		There are no specific legal provisions in this regard. However, the practice adopted in the five CACM countries is that free intra-regional trade is not granted to goods produced in free zones. (see, for example, government of Costa Rica article in that country's *La Nación* newspaper, February 28, 2002, p. 25A).

In NAFTA, very broadly speaking it was also agreed to refuse entry to goods produced under those regimes enjoying the benefits of free trade. However, in this case a period of seven years was set for implementing the restriction, in principle to facilitate the adjustment of industries that would be affected by the measure.[5] Article 303 of NAFTA, which regulates this matter, does something very interesting: it implicitly relates the progressivity of the tariff elimination program to progressivity in the elimination of duty drawback and deferral programs. This approach was not taken in Canada's later agreements, nor in those between Mexico and other Latin American countries.[6]

Canada adopts a formally different approach in its agreements. In 1989, in its free trade accord with the United States, Canada agreed on a restrictive approach similar to that of the later NAFTA. In its agreements with Chile and Costa Rica, however, Canada made the categories of tariff elimination conditional on its being satisfactorily notified that the benefits of the EPZ (in Chile's case) and the simplified duty drawback regime (in Costa Rica's) were not granted to goods exported to Canada. There is something similar in the agreement between Chile and Costa

[5] A transition regime aims to allow companies to adjust to the new system, among other things by seeking new suppliers within the free trade area that will replace the previous extra-regional suppliers. The period can be a function of the agreement's tariff elimination program. Local producers can continue to acquire inputs, equipment and raw materials from regional suppliers inasmuch as the tariff elimination program allows relatively easy and tariff-free imports. Tariff elimination acceleration disciplines -typical of NAFTA-type agreements- can serve to correct deficiencies identified in this period of adjustment and integration of the productive apparatus.

[6] Article 303 establishes that there can be no reduction, drawback or exemption for an amount above the lesser between (1) the tariff that extra-regional inputs would pay when imported into the national territory and (2) the tariff that would have to be paid on the goods to be exported to the other member country. In principle, this means that when the transition period is over and the goods move freely, the amount of the duty reduction, drawback or exemption can never exceed 0%; in other words, they are eliminated.

Rica. What is original about this approach is that there are no provisions in the text of the agreement itself. Such provisions are "camouflaged", so to speak, in the annexes outlining the elimination categories. The final outcome, however, is the same. The reason for this approach might lie in the fact that if it were done in the elimination categories and if specific reference were made to certain concrete programs in each country (which are not all in effect in every country), the sphere and scope of the obligation would be less and would cover only those programs; any other schemes or regimes would be unaffected. In Costa Rica, for example, other processing regimes are apparently unaffected by the scope of the obligations in the FTA with Canada. Similarly, a duty refund regime that entails no export subsidy would face no problem. Canada is displaying a slightly more flexible approach here.

Other agreements to which Mexico is party seem similar to NAFTA. A close reading, however, reveals very significant differences. In the case of the FTAs with Costa Rica and Nicaragua, there are restrictions on the duty drawback or exemption programs that come into effect seven years after the agreement's entry into force. This is somewhat similar to NAFTA. The timeframe is eight years in the case of the FTA with Bolivia. In these three FTAs, however, the disciplines do not remove the possibility that the duty drawback or exemption programs might be maintained. The accords simply regulate the programs so that they are not excessive and do not themselves amount to an export subsidy. If Canada adopted a slightly less restrictive approach than NAFTA, the Mexican approach is even more flexible in this regard. It is even more so in the FTA with the Northern Triangle (Guatemala, Honduras and El Salvador). In that agreement the four countries took a different approach: they reserved their rights in the WTO in this respect, as we will see below. Finally, some of Mexico's FTAs establish temporary safeguard disciplines to obviate any damage that might be caused by the import of goods produced under special regimes during the transition period.

Central America and the Dominican Republic take an original approach by granting a form of national treatment to the entry of goods from EPZs. That is, goods produced in EPZs can be imported to the territory of one of the parties but only on the same terms as the national legislation of that party allows for the entry of goods from its own EPZs. The entry of goods from EPZs, however, is generally prohibited entirely or subject to quantitative and qualitative restrictions, and is conditional on the payment of import duties.

What is behind this situation? Why are countries still apprehensive at the prospect of free trade in goods produced under special regimes? In principle there are five answers. It should be kept in mind that each agreement has its own dynamic, and that not all of these responses apply to all agreements to the same extent. In fact, the brief description above of regional approaches indicates the differing levels of flexibility with which certain countries tackle this issue.

(1) As mentioned earlier, the problem of trade deflection is the first motive. From the viewpoint of tariff collection, if deflection were allowed then goods that did not originate in special regimes would enter duty-free by virtue of the agreement. This could amount to a contravention of tariff collection policy.

(2) The same argument can be made from the viewpoint of the competitiveness of local producers. In the context of free trade areas, in which each country preserves its external trade policy

and its own most favored nation (MFN) tariff levels,[7] the goal of barring imports of goods produced in EPZs springs from the fact that if it were allowed it would place local importers at a disadvantage relative to their counterparts in the exporting country, who produce under the protection of the free zone regime. That is, a producer established in an EPZ could import inputs from outside the region without paying duties, incorporate them into a specific product, and then export them to the other country. For their part, producers in the latter country who produce for the local market do not necessarily have access to duty-free imports of the inputs they need in order to produce; rather, they have to pay the MFN tariff to import such inputs. Consequently, they are in a situation that could jeopardize their competitiveness, which normally would be unacceptable. As indicated, points (1) and (2) are two sides of the same coin, and they seek to forestall the possibility that the conclusion of a free trade agreement will lead to the establishment of "export platforms" -that is, insular mechanisms through which preferential conditions are exploited to place in the other market goods that pay no tariffs or taxes in the first market.

(3) Because it is through such disciplines that the integration scheme induces its producers to acquire inputs and equipment within the free trade area, thereby securing the inter-industrial integration that the agreement is pursuing.

(4) Because EPZ regimes normally grant a series of advantages -in addition to the tariff benefits- to producers established within them. Often, for example, they enjoy total or partial, temporary or permanent exemptions from direct or indirect taxes. These producers often benefit from certain others measures, sometimes related to incentives to export or to attract foreign investment, such as training, special exchange rate regimes, bonuses and another financial transfers. As with tariff exemptions, these conditions are not granted to national producers who are producing for the national market. Consequently, they again might find themselves at a disadvantage.

(5) Because restrictive disciplines such as these can serve to attract foreign investment. Extra-regional suppliers who were selling inputs to a company established in an EPZ would be compelled to move to the country where their buyer is located, since otherwise they could lose the buyer entirely. This is because if they do not move they will now have to pay import tariffs and taxes in order to sell to the traditional buyer. The extra-regional suppliers have substantial reason to locate in the other country, and thus benefit from tariff preferences.

It is evident that the reasons are significant, and that in each country those reasons have a different relative importance that is dictated by many variables. As shown below, adoption of these disciplines has spurred interesting changes in countries that have passed through this stage, such as Mexico. Later, this study will show the effects that these disciplines can have on the management of policies on tariffs and the attraction of foreign investment in a given country, how there can be pressure to harmonize the internal tax legislation applicable to companies that are inside and outside EPZs and, finally, how some of the changes that they induce can help make the country more commercially open to the rest of the world.

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[7] This argument is also applied to customs unions with an imperfect CET and only with respect to such imperfection -that is, those products without harmonized tariff levels-. The argument does not apply to a perfect customs union.

III. THE TREATMENT OF EPZs IN THE WTO

The terms "free zone" and "export processing zone" do not feature in the terminology of the WTO. Nonetheless, it is clear that some WTO disciplines regulate some essential aspects of EPZs, especially when they are analyzed as mechanisms to stimulate goods exports, an issue duly regulated by the Agreement on Subsidies and Countervailing Measures.

The Agreement on Subsidies establishes that in very general terms there are three types of subsidies: prohibited subsidies, permitted subsidies and actionable subsidies. In principle, and without reference to the detailed legal questions involved in examining these issues, prohibited subsidies are basically those conditional on the export of the product (export promotion) or the use of national inputs rather than imports (import substitution). There is an illustrative list of prohibited export subsidies in Annex 1 of the Agreement on Subsidies. This will be discussed below. Permitted subsidies are basically certain policies on environmental protection, on aid to a country’s disadvantaged regions, and on the promotion of research and development. These subsidies could be granted in very limited terms and for only five years after 1994. Actionable subsidies are any other kind of official policy that entails a specific financial contribution or price support mechanisms that offer a benefit to the producer. They are actionable insofar as they cause damage to a national industry, end or erode the advantages that the trade partner expects of the WTO agreements, or cause serious harm to another member’s interests. Their actionability resides in the fact that the affected countries have legal recourse to detain or compensate for the import of subsidized products. Such a recourse might be to embark on a specific and swift procedure to resolve the conflict with the other trade partner, or the imposition of a countervailing duty.

As mentioned, Annex 1 of the Agreement on Subsidies includes an illustrative list of the export subsidies that, being such, are prohibited.[8] These subsidies include:

- The granting of direct subsidies to a company or branch of production, such subsidies being dependent on export performance;

- Total or partial exemption, remission or deferral of export-related direct taxes or social security contributions that the companies should pay. Direct taxes includes taxes on income, wages, interest, rents, royalties and any other form of income and property taxes.

- Any special deduction granted to exporters for the purpose of calculating the basis on which direct taxes are assessed, and that is more advantageous than that granted for production for the domestic market.

- The exemption or remission of indirect taxes on the production and distribution of exported goods, in an amount that exceeds the taxes levied on the production and distribution of similar goods when they are sold in the domestic market. Indirect taxes includes sales tax, consumption tax, valued added tax, business volume tax, franchise tax, stamp tax, transfer, inventory and equipment taxes, fiscal adjustments at the border, any other tax different from direct tax and import duties (customs tariff and any other duty or tax on imports).

[8] As indicated, this list is purely illustrative. Any other subsidy that accords with the definition in Articles 1 and 3 of the Agreement on Subsidies is prohibited.

- The remission or refund of import duties in an amount that exceeds that levied on imports used in the production of the exported product.
- Internal transportation and freight tariffs for exports provided or imposed by the authorities that are more favorable than those applied to internal consignments.
- Government supply of goods and services for use in the production of goods for export on more favorable terms than the supply for domestic production.
- Guarantees or export credit insurance systems at subsidized rates, and subsidized export credits.

It can be seen that many of these instruments are precisely those used in the free zone regimes, EPZs and *maquila* schemes in general. The most popular and most clearly affected by these regulations -although not the only one- is the exemption of income and another direct taxes. Exemption from income tax is one of most important reasons why many companies set up in a free zone or EPZ. The refund of or exemption from import tariffs is only prohibited multilaterally when such a concession exceeds the amount that would be levied on the production and distribution of similar goods for the domestic market.[9] The 1994 GATT clearly treats direct tax exemptions differently from indirect tax exemptions.[10]

In the Uruguay Round it was agreed in general terms that developing countries would comply with the obligation to refrain from granting export subsidies as of January 1, 2003 (Article 27 of the Agreement on Subsidies); in other words, they were given a transition period of eight years after 1995. As part of the negotiations for the launch of the Doha Round in November 2001, however, the countries renegotiated this commitment and extended it for five more years, plus an additional extension of two years (seven years in all).

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[9] For these reasons it is likely that an exemption from indirect taxes, including import tariffs on inputs (typical of a free zone) would only be WTO-incompatible to the extent that the exemption was for an amount more than the one that would be applied if the product were to be sold for consumption in the internal market. Only in that case is there an export subsidy. The problem is that EPZ companies are often exempted from the tariff and other import taxes for all their foreign purchases, not only those inputs used in the production of the good. In principle this "excess" seems to be incompatible with the WTO.

[10] The underlying economic logic is as follows: traditional economic theory states that in a context of perfect competition, a general percentage tax on earnings would not affect production or prices. To do that, the burden of the tax would have to fall on the producer. This presupposes that producers transfer the cost of the indirect tax to the price of the good and thus to the consumer, which in theory would not happen with direct taxes because they are paid at source, probably on earnings. Hence, according to the theory, direct taxes do not affect the good's final price. On the other hand, an exemption from direct taxes would affect the final price insofar as a "non-excessive" exemption from indirect taxes does not have a distortionary effect on the market (quite the contrary). According to some, this distinction is artificial. See, for example, Ostergaard [2001].

IV. THE RESULTS OF THE MULTILATERAL NEGOTIATIONS IN DOHA

Article 27 of the Agreement on Subsidies establishes a mechanism whereby developing countries can seek an extension of the original eight-year period for the elimination of export subsidies. If for economic, financial, or development reasons a developing country believes that it needs such subsidies, it could request the extension of the deadline to abolish them if it did so before January 1, 2002. The WTO Committee on Subsidies and Countervailing Duties would consider the request and could accept or reject it. If granted, the beneficiary country must allow annual examinations to discuss extension or removal of the concession, untied to a fixed schedule. In principle, if after these annual examinations the Committee decides that the export subsidies are wholly justified by the country's economic, financial or development needs, such subsidies can be preserved on terms specified by the Committee. If the Committee fails to reach agreement on the matter, or if the decision is negative, the country must remove the subsidies within two years.

In Doha, however, the ministers agreed on a set of procedures for considering requests to extend the deadline (WTO [2001]). There it was agreed that the only countries that could make such a request are those whose share of total world exports was not above 0.10% in the period 1998-2000, and whose gross national income was not above US$ 20 billion in 2000. The WTO prepared a list with the relevant data on all countries, of which more than 30 developing countries were eligible for the extension.

The programs eligible for the extension are as follows: (1) export subsidy programs; which are (2) total or partial exemptions from import duties and internal taxes[11] conceded before September 1, 2001.

Table 2 reflects the situation of some countries in the region:

TABLE 2
LATIN AMERICA AND WTO EXTENSION PROCEDURES

Country	% of world exports 1998-2000	Gross National Income (US$ billions, 1999, World Bank)	No. of country on WTO list	Beneficiary of agreed extension procedures
Panama	0.01	8.7	67	Yes
Honduras	0.02	4.8	81	Yes
Guatemala	0.04	18.6	100	Yes
El Salvador	0.05	11.8	101	Yes
Dominican Republic	0.09	16.1	116	Yes
Costa Rica	0.10	12.0	120	Yes
Peru	0.11	53.7	121	No
Colombia	0.20	90.0	134	No
Chile	0.28	69.6	141	No
Venezuela	0.39	87.3	143	No
Argentina	0.44	276.1	146	No
Brazil	0.88	730.4	158	No
Mexico	2.39	428.9	172	No

Source: Data from WTO document G/SCM/38 of 10/26/2001 and the World Bank.

[11] Note that the measure has to be an export subsidy. Import duty drawback or exemption that does not -according to item (g) of the illustrative list- exceed the amount of tax levied on the production and distribution of similar goods when they are sold in the domestic market is not prohibited because it is not an export subsidy.

In line with the mechanism, countries should have submitted their extension requests to the Committee by December 31, 2001. By December 15, 2002 the Committee should reach a decision on a deadline extension for each country for calendar year 2003. The decision is based on the programs' compliance with transparency criteria (scope, coverage and degree of intensity or favorability) and eligibility criteria. Then come the annual examinations to decide on the extension of the deadline or the timeframe for the subsidies to be granted in the following calendar year.[12] It is important to emphasize here that the decision to extend the deadline for another year should be based **solely** on the program's eligibility criteria, on transparency, and on standstill -that is, the benefits of the program cannot be expanded in any way. Thus yearly extensions will be possible up to 2007.

When the period has expired, the ordinary disciplines of Article 27 are re-applied. In other words, any developing country can request an extension of the deadline on the basis of its economic, financial or development needs. The Committee can decline or approve the request. If it declines or fails to reach agreement, the beneficiary country will have two more years to abolish the programs. We have found no provisions stipulating that the elimination should be gradual during that period.

It is interesting to note here that, to date, 18 Latin American and Caribbean countries have sought an extension from the WTO Committee.[13] Another country (Colombia), which is not eligible for the extension procedures agreed by the ministers in Doha, has made its request according to the ordinary process of Article 27, paragraph 4. Whether Colombia's request is accepted or not, the mere fact that it made it "buys" the country at least two more years, from 2003 onwards, to remove the programs.

The concessions won by developing countries in the Doha negotiations consist basically of the fact that if they decide to request an extension of the period for the elimination of export subsidies, which expires on December 31, 2002, and then for an annual renewal of the extension for a total of seven years, they can do so and they will be given the extension quasi-automatically. In other words, they must only meet the requirements of transparency, eligibility and standstill for the Committee to give them the annual extension for the five yearly periods, plus the final extension of two more years. Thus these countries have a clear expectation that the period will be extended. This expectation did not prevail before Doha because, according to Article 27.4, they had to go to the Committee and make a case for economic, financial or development need, and the Committee had to approve the extension by consensus, which is hard to justify and secure. In short, the decision was unknown, and unpredictability is incompatible with a well-structured export or investment-attraction scheme.

This decision, again, has a very significant impact on the way in which EPZs currently operate, as well as on other regimes geared to promoting exports, creating jobs, or attracting foreign investment

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[12] However, if at some point a product exported from a beneficiary country becomes "competitive at the global level" (that is, it accounts for more than 3.25% of total world trade in that product for two consecutive years), then the export subsidies must be removed within two years.

[13] Antigua and Barbuda, Barbados, Belize, Bolivia, Costa Rica, Dominica, El Salvador, Guatemala, Grenada, Honduras, Jamaica, Panama, the Dominican Republic, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Suriname and Uruguay. See WTO document G/SCM/40/Rev.2.

and which, to those ends, grant export subsidies. Hence the terms "free zone" or "export processing zone" do not appear anywhere, but the regime's main components -exemptions from internal taxes and import duties that amount to an export subsidy- are directly affected by the discussions and the decisions taken in Doha.

This final outcome of Doha can only be understood in the much wider context of the trade-offs that were necessary there and during the preparatory phase so as to reach agreement on the launch of a new round of multilateral trade negotiations. It illustrates, moreover, how the developing countries were able to put what they view as their interests on the negotiating table in a way that is effective and unprecedented in the history of the multilateral trading system. Not for nothing is the ninth round of WTO negotiations officially termed the "Doha Development Round".

A first partial conclusion is that EPZ schemes in Latin America and in the Caribbean are soon to undergo some significant changes. On the one hand, since the countries are involved in negotiations for free trade areas and customs unions, there is a dawning awareness of a certain systemic incompatibility between EPZs and free trade areas. It is not audacious to speculate that in the context of the Free Trade Area of Americas (FTAA), which could come into being as of 2005, countries could again impose restrictions on goods from EPZs. On the other hand, the WTO is also seeking to eliminate export subsidies, since such subsidies distort international trade. Thus all countries have agreed that those exemptions from internal taxes and import duties that amount to an export subsidy must be removed in the near future.

In other words, EPZs as we know them today will be subject to two strong pressures that will probably change them: on the one hand, the FTAA and other regional integration agreements, (insofar as they would not allow tariff exemptions for extra-regional inputs); and on the other, the WTO (which will prohibit direct tax exemptions -mainly income tax- and other export subsidies).

V. ADJUSTMENT EXPERIENCES IN OTHER COUNTRIES

Even if one takes into account the heavy dependence on special regimes in some countries, thus far few countries have been obliged to make substantial changes in the way that those regimes operate. Perhaps one of the more interesting cases is Mexico in the context of NAFTA. Exports of goods produced under the *maquila* system have increased substantially and constantly, both in absolute terms and relative to non-*maquila* exports. In 1980, for example, *maquila* exports accounted for 14% of the total; in 1998 they accounted for 41% and were growing at an annual rate of 18.5% (Karp and Sánchez [1999]). Employment in *maquila* industries doubled to 1.3 million in the period 1993-1998.[14]

In fact, the ways in which *maquilas* operate have changed. As mentioned earlier, Article 303 of NAFTA establishes restrictive disciplines with respect to imports of extra-regional goods produced under duty drawback and deferral schemes. Remember that when NAFTA entered into force in January 1994 it was agreed to offer a seven-year period to Mexican goods that were benefiting from drawback or duty deferral, a period that expired on January 1, 2001. As part of the preparations for the implementation of that commitment, Mexico established a mechanism that was more or less similar to the one that Canada had implemented earlier when it concluded the FTA with United States. The mechanism is known as the "Sectoral Promotion Program" (PROSEC) and basically consists of the granting of an MFN tariff preference, not above 5% in most cases, for a list of over 5,000 inputs used in 22 branches of production.[15] To benefit from this reduction, however, the companies that use the inputs must register with the program.[16] Both exporting companies and those producing for the domestic market can profit from this program.

The Uruguayan case should also be mentioned here. With MERCOSUR's entry into force, the operation of Uruguayan EPZs was restricted by the approval in December 1994 of Decision N° 8 in the Protocol of Ouro Preto. Through tax exemptions at the national level, the state had fostered such zones as a way of attracting foreign investment and creating jobs, and a large number of them were set up throughout the country. With the approval of that Common Market Group decision,[17] however, the EPZs were obliged to adapt their activities so as to safeguard the investments made. As of 1994, all goods produced in or entering the EPZs could not secure the certificate of MERCOSUR origin and, from a tax viewpoint, they had to pay the CET if they entered the territory of any of the other member countries. Hence the manufacturing establishments installed in the zones had to become free service and logistics zones and zones for the distribution of, especially, extra-regional

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[14] Mexico, Presidency of the Republic, Sixth Report of the Government, Statistical Indicators Section.

[15] The following industries: electrical, electronic, furniture, toys and sporting goods, footwear, mining and metallurgy, capital goods, photographic, agricultural machinery, various industries, chemicals, rubber and plastics, iron and steel, medicines and medical equipment, transport, automotive and vehicle parts, paper and cardboard, leather and hides, textiles and clothing, chocolates and confectionary, and coffee. See NAFTA WORKS, January 2001 at *http://www.naftaworks.org*

[16] PROSEC is designed so that only producer companies, not the importer or marketer, benefits from a preference. This explains why Mexico did not simply choose to reduce the MFN tariff for the more than 5,000 products. According to some sources, to have done so on an MFN basis would have caused more serious harm to Mexican producers of those products, and PROSEC balanced out the interests of the latter and of the *maquiladores*.

[17] This decision affects all the free zones in MERCOSUR except for the special zones in Manaos (Brazil) and Tierra del Fuego (Argentina). These, by virtue of a political decision, are free from this limitation until 2013.

goods. The Uruguayan government issued a decree establishing that some of the companies in the EPZs, under certain conditions, could cease to be so and could be declared companies of national interest, enjoying other incentives as if they were established in any part of the non-free territory.

The authorities in Costa Rica, in preparation for assuming the commitment to eliminate export subsidies in 2003, identified a series of options on the best way to solve the problem arising from the need to remove some of the EPZs' incentives to exports and foreign investment.[18] In Costa Rica the main problem was how to comply with multilateral obligations and at the same time maintain an appropriate tax system that did not adversely affect the country's capacity to attract foreign investment and retain the investments already made. The main component of the proposed strategy was a tax reform that, in broad terms, harmonized the payment of income tax at a rate of between 10% and 15% for all local and foreign companies, irrespective of whether they exported or not, or of whether they operated under special regimes or not. This entailed a complete overhaul of the national tax system. Initially, according to the national press, the proposal triggered reactions from foreign investors (*El Financiero*, 07/30/01, *http://www.financiero.co.cr*). At the Doha ministerial meeting, however, since the ministers decided to defer the deadline for seven more years, the debate ended.

As is plain, the cases of Mexico, Uruguay and Costa Rica are very different and stem from very dissimilar circumstances. The former two arise from compliance with regional obligations (NAFTA and MERCOSUR), particularly those related to drawback or the suspension of import tariffs. The other case springs from compliance with WTO obligations and is more related to the prospect of income tax exemptions. It should be made clear that the provisions of Article 303 of NAFTA have no connection to direct tax exemptions, and that the WTO provisions on export subsidies do not prohibit tariff deferral or drawback mechanisms. Additionally, in Mexico and Uruguay there is a problem of tariff policy; in Costa Rica there is a problem of tax and investment-attraction policy. Nevertheless, both instruments (exemptions from tariffs and direct taxes) are used very often in free zones and EPZs. The reason for the combined analysis here is simply to demonstrate that pressures on special regimes, once again, come from both flanks.

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[18] Costa Rican Ministry of Foreign Trade, Proposal on Reform of the Free Zone Regime, 2003. Available at the ministry's website: *http://www.comex.go.cr*

VI. WHAT CAN BE SAID ABOUT THE FUTURE OF EPZs AND SPECIAL REGIMES IN GENERAL?

There is no precise answer to such a broad question. On the one hand, the instruments that fall under the heading "EPZs and special regimes" are very diverse. For each instrument there can be different obligations -multilateral as well as current or potential regional or subregional commitments. In that light, offering general prescriptions can amount to an unwise over-simplification of reality. A case-by-case analysis is essential, so as to determine the impact of each current or potential trade agreement on every special regime in every country. As mentioned earlier, there are no clear signals in the trade negotiations on, for example, services. Negotiations on subsidies in services and investment incentives are still at a very early stage. It is impossible at the moment to discern clear signals on the treatment that would be accorded to an EPZ exclusively for services, or how a firm supplying services would be treated in a manufacturing EPZ. It is not the purpose of this study to undertake a casuistic analysis, however, but rather to call attention to very general trends -to which the document confine itself for the moment.

It is important to begin this section by suggesting that this tendency towards change in EPZs or special regimes does not necessarily mean that there will be a drastic shift in the overall production patterns to which firms in EPZs or special regimes are subject. It is too early to assess the results of the implementation of NAFTA's Article 303, but to date it has not been known to have caused significant dislocations in output and trade in NAFTA.[19] Admittedly there was uncertainty during the transition, but in the end all the indications are that 2001 marked little more than a logistical change in Mexico, which did not necessarily indicate a shift in competitiveness and which certainly represented neither an exodus of companies or investors nor a massive slump. The adjustment measures (PROSEC) instituted by the Mexican government might have helped in that regard.

Current global production dynamics conform to strategic adjustments made by companies that compete at the international level and that, in many cases, exploit more competitive productive factors in the countries of Latin America and the Caribbean. Most companies operating under these regimes have internationalized their production or are multinationals that perform certain stages of the production chain in these countries. This pattern, which has helped drive the economies (especially those bordering the Caribbean basin), could accelerate further as more integrated those economies are. Inasmuch as the essential core elements prevail (the availability of low-cost labor and proximity to the large markets of the north), the companies will continue to operate, albeit it in a transformed regulatory scheme. The FTAA, for example, could modify these special regimes but would do so to a large extent because they would be unnecessary in a free trade context, especially in a hemisphere with the abundant resource endowment that the Western Hemisphere has. In a free trade scheme there would be improved inter-industrial integration without the need for special regimes whose costs of administration could be quite high.

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[19] Recent studies have undertaken a preliminary analysis of this issue and have concluded that the logic of NAFTA has not prevailed over the logic and strength of Mexico's *maquiladoras* or export processing zones. See Sargent and Mathews [2001], p. 1,739. Note, however, that the changes in 2001 are very recent; in the medium term, the logic and regionalist pressure of NAFTA may prevail.

With all these data, what form might EPZs assume in the future, once they lose significant tax exemptions? Again, there are no precise answers. In part the answer depends on how the EPZs have developed to date, their geographic location, the profile of the companies based therein, the kind of incentives that they can offer, the type of investment promotion policy that a government follows, the kind of industrial policy that the countries might adopt in the future, the country cost, the country risk, the pressure of lobbying by companies that benefit from the regimes and so on. Similarly, there is a need to define the impact of other external factors, such as China's accession to the WTO, the incorporation of textiles to the GATT in 2005, the FTAA's tariff reduction and rules of origin schemes and so forth. Some EPZs might become logistical centers for external trade. Perhaps others will specialize in the international provision of services. Others could specialize in extra-regional exports or simply disappear because the cost-benefit ratio is unfavorable. It should not be forgotten, however, that many companies now benefiting from these special regimes might simply continue to benefit from the free market conditions that will prevail under a future FTAA. Everything, again, depends on many variables. One of the most crucial is the treatment of export processing zones (we saw that there are modalities of modalities) the origin of inputs, the FTAA's rules of origin, the provisions on accumulation that can be negotiated, provisions on the treatment of certain small economies and so on. The important thing is that the potential to maintain and boost production will remain, and will not necessarily disappear just because the regulatory and tax schemes change.

It is likely that as a result of these forces, much of the production in EPZs and special regimes will be incorporated into the national productive apparatus, and that there will be a harmonization of the tax regimes applicable to intra- and extra-zone companies. As shown above, the reform effort begun in Costa Rica clearly pointed in this direction. Similarly, to offset some deficiencies in the supply of certain raw materials and inputs not found in the region, some "competitive reductions" in the MFN tariff might be necessary. Canada's response to the FTA with the United States and Mexico's response to NAFTA took this approach. It is plain that much analysis remains to be done in the very near future.

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VII. CONCLUSIONS

In summary, note the following main ideas:

(1) It is reasonable to expect that the WTO and the regional and subregional integration agreements -particularly a future FTAA- because of their combined effect, will exert pressures for the transformation of EPZs and certain special regimes.

(2) The WTO commitments are clear. According to procedures agreed on by the ministers in Doha, in general terms most developing countries must eliminate export subsidies in the form of the total or partial exemption of import duties and internal taxes by 2009 at the latest. The commitment to eliminate export subsidies stems from the multilateral goal of averting distortions to international trade.

(3) The subregional integration agreements in the Hemisphere have very different approaches to the treatment of goods from free zones and other special regimes. They include the more restrictive procedures (MERCOSUR, CACM, CARICOM and to some extent NAFTA), others that are progressively more flexible (Canada's FTAs, followed by the accord between the Dominican Republic and the CACM, and then Mexico's agreements), and those that reveal concern in this regard but that have not developed corresponding disciplines (the Andean Community, Panama-Dominican Republic, Dominican Republic-CARICOM). The goals pursued are varied, but the most common one is to obviate the creation of "export platforms".

(4) Future FTAA commitments in this respect are not clear at the moment, largely because the matter is now under negotiation. If the present agreements are any indication of the future, however, and considering the more restrictive scenarios, it is possible that goods imported under these special regimes will eventually be subject to payment of import duties in the export market. This, however, can change according to what the countries negotiate in the FTAA.

(5) In a general analysis such as this it is very difficult to specify the kind of changes that will be made in each country, and more difficult still to do so for each EPZ or regime. Such an analysis should be undertaken in each country so as to secure a better understanding of the implications, to prepare better for trade negotiations, and to consider better options on a case-by-case basis.

(6) The advent of hemispheric trade integration could jeopardize the formal operation of EPZs as we know them today. However, this is far from being a threat to the companies' capacity to continue to export. Theoretically, the FTAA should offer firms more opportunities for imports, production and exports. Perhaps some EPZs are simply unnecessary in the context of a free trade area. Others could become free service zones, and perhaps others could become logistical and operations centers or could concentrate on trade with other extra-hemispheric regions using residual incentives.

(7) As a result of these forces, two phenomena might arise: (a) a tendency towards the harmonization of tax regimes applicable to companies inside and outside EPZs or -the same thing from a different perspective- the gradual incorporation of companies that benefit from

EPZ and other regimes into the national productive apparatus; the latter would probably be subject to a fiscal regime that differs from the current one; and (b) a reduction in the MFN tariffs for certain inputs whose regional supply is uncompetitive.

(8) Finally, it is worth stressing the synergy between the multilateralism of the WTO and the regionalism of the FTAA. The issue of EPZs and certain special regimes amounts to a "touchstone" to readdress the matter of the interactions between the FTAA and the WTO. It is clear how there could be complementarity between the goals of the two initiatives. There is mutual support in the attainment of common objectives, since multilateral and regional forces together seek to rationalize and liberalize international trade.

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