# Written evidence submitted by Professor David Tyfield and Dr Andy Yuille (Lancaster University) and Professor Matthew Cotton and Dr Nicholas Gray (Teesside University), all in personal capacity, to the Environmental Audit Committee: Inquiry on carbon border adjustment mechanism

## Executive summary

* In March this year the Government designated 8 new Freeports in England, one of its flagship policies to drive regional economic growth, international trade, and innovation.
* Businesses operating within Freeport sites benefit from reduced tariffs, business rates, and national insurance contributions; alongside simplified customs, planning and data processing requirements.
* A carbon border adjustment mechanism (CBAM), or equivalent measure, appears necessary to drive the decarbonisation of international supply chains.
* There is likely to be both local and national resistance to applying a CBAM in Freeports, as project success is based on their exemption from normal import tariffs and customs procedures
* If a CBAM is introduced to the UK, but Freeports are exempt, this generates a high risk of additional carbon leakage, with Freeports actively undermining progress towards net zero policy commitments.
* Simplified regulatory requirements within Freeport zones may make the application of a CBAM more difficult even if they are not directly exempt.
* We recommend that a CBAM is introduced to the UK, that it applies equally in designated Freeports, and that measures are put in place to ensure effective enforcement on Freeport sites
* This may require a rebranding and redirection of the Freeport initiative to become “CarbonFreePorts”, where distinct advantages for trade and industry remain in place but with the emphasis shifted from *low* tax and regulation to *different* tax and regulation, incorporating specific incentives on low-carbon industry, innovation and mobility.

## Introduction

1. We are Professor David Tyfield and Dr Andy Yuille (Lancaster University) and Professor Matthew Cotton and Dr Nicholas Gray (Teesside University). We are in the early stages of a short research project entitled “CarbonFreePorts: Freeports as opportunities, not threats, for place-based decarbonisation of transport”, funded by the EPSRC, via the DecarboN8 network grant coordinated by Leeds University. We are investigating the scope for aligning the Freeports policy initiative within the broader net zero agenda, and the risks of non-alignment. We wish to draw the Committee’s attention to the risks of additional carbon leakage and increased transport emissions as a result of the Freeports policy, and potential solutions for mitigating those risks. We note the absence of explicit reference to Freeports in the inquiry’s call for evidence and, given the prominence of the policy within the Government’s programme, recommend that the Committee gives special consideration to how this policy might interact with a carbon border adjustment mechanism (CBAM).

## Freeports – background and context

1. In March 2021 the Government announced that it would designate eight new Freeports in order to:
* Establish national hubs for global trade and investment
* Regenerate / ‘level-up’ coastal regions
* Create hotbeds of innovation
1. Freeports are a central plank of the Government’s foreign and domestic agendas, intended to both drive and ‘level up’ regional growth as part of the post-Covid recovery, and to strengthen post-EU exit ‘Global Britain’s’ position at the heart of a network of international trade (1). Freeports are martime and/or airport-based special economic zones, designated as operating areas for businesses to import, process and re-export goods, and where normal national tax and customs rules do not apply. At a Freeport, imports can enter with simplified customs documentation and without paying tariffs. Businesses operating inside designated areas in and around the port can store and manufacture goods using these imports, before exporting again without paying the normal tariffs on imported goods and completing simplified customs checks and paperwork. However, tariffs are payable on the finished product when it reaches its destination, including if that destination is in the UK but outside the Freeport. The 8 UK Freeports also benefit from other reduced taxation and regulatory burdens (business rate relief, buildings allowance, capital allowance, stamp duty relief, lower national insurance contributions, relaxed and simplified development planning regime) and access to a limited pot of seed capital funding. The essence of the Freeport policy is that these are low tax, low paperwork, lightly-regulated zones.
2. The Government, and political leaders in the areas where the Freeports are located, have significant ambitions for the Freeports’ capacity to drive economic renewal. For example, the Mayor of the Tees Valley Combined Authority described a ‘tsunami of jobs and investment’ to ‘turbocharge’ the regional economy with an estimated £3.4 billion economic boost and 18,000 jobs (2). The Liverpool City Region Local Enterprise Partnership foresees an initial increase of £850m and 14,000 new regional jobs through new investment (3). Job and capital growth drives local and national political support for Freeports. Such economic benefits are assumed to derive from the Freeports’ status as low tax, lightly regulated zones that are exempt from normal import tariffs and customs checks. There is therefore a risk focus upon job growth will overshadow other concerns associated with Freeports, including the need for decarbonisation, especially where it involves new forms of taxation or regulation.

## Freeports and decarbonisation

1. The Freeports Bidding Prospectus (4), published in November 2020 as a guide for potential bidders to put forward proposals for sites to be designated as Freeports, noted that the Government would ‘welcome’ and was ‘interested in’ Freeports bids that contributed to the net zero agenda. It states that “Freeports have great potential to contribute towards the government’s decarbonisation agenda and Net Zero ambition” (para 4.1.1), and provides examples of ways in which this could be taken forwards. Bidders were asked to “outline how their Freeport ambitions support decarbonisation and how they aim to reach Net Zero carbon emissions by 2050 or earlier” in the way that their proposals would be delivered (para 4.1.1). However, the different types of tax relief and other measures offered did not take the opportunity to embed incentives towards the net-zero transition, for example via enhanced reliefs for investments in zero-carbon assets, innovation or enhanced environmental standards for new developments in Freeports. While we therefore recognise the potential for Freeports to contribute to decarbonisation, we must also acknowledge that decarbonisation is not strongly embedded as a component of the national Freeports programme – it is framed as a stated ambition rather than a clear objective. We highlight that Freeport designation signals the prioritisation of regional economic growth over environmental considerations, although we acknowledge that environmental considerations are not excluded.
2. Furthermore, there is evidence of *policy* divergence between the Freeport agenda and the net zero agenda. Most analysts agree net zero ambitions require differently-focused regulatory and tax regimes. We raise concern that a lighter regulatory and tariff regime is incompatible with net zero policy goals. The *raison d’etre* of Freeports – to increase international trade – will necessarily increase demand for maritime, air and surface transport, with likely consequent increases in emissions (and associated air quality issues), both localised and aggregated national/global totals. They are being encouraged to host and develop industrial sectors that have to date been responsible for high levels of carbon and other emissions (e.g. the Liverpool City Region Freeport intends to develop industrial clusters in automotive supply chains, chemical manufacturing, food manufacturing and logistics (5)) This presents a window of opportunity to accelerate decarbonisation of precisely these high-carbon sectors, but this will only happen to the extent that incentives and regulations are explicitly oriented to this end.
3. As an example, the Liverpool City Region Freeport is promoted as providing “the ability to create zero carbon manufacturing and industrial hubs, connected by non-fossil freight to the rapidly decarbonising maritime industry” which “intend[s] to meet and exceed the ambitions for climate action demonstrated by international trading partners” (5). The Teesside Freeport is emphasising its role as a hub for (‘green’, electrolytic) hydrogen and carbon capture, use and storage (CCUS) technologies (6, 7). If, however, a CBAM is introduced in the UK but Freeports are exempt from it, or their special status makes its application more difficult, this would damage these low-carbon potentials and ambitions and contribute to carbon leakage, as we explain below.

## Freeports and CBAMs

1. The question for the Committee, and for the Government, then, is how will designated Freeports be engaged by any potential CBAM regime? If they are exempt from a CBAM (or a CBAM is applied differently within Freeport sites) due to their exemption from normal tax and customs rules, there is an evident risk that they could contribute to significant additional carbon leakage. Even if industrial clusters within some or all Freeport sites advance low-carbon operations as per the Government’s ambitions and those (now emerging) of the individual Freeport projects – e.g. through the use of on-site renewable energy or innovative techniques, processes, or materials – market forces could still drive businesses within Freeport sites to utilise readily available, existing high-carbon foreign supply chains to secure competitive advantage. This risk may increase in the case of goods that are re-exported from Freeports without ever entering UK customs jurisdiction. In such a scenario Freeports designed specifically for exports from the UK, could undermine the application of a CBAM regime as a measure to combat carbon leakage by offering a get-out for British-based industry simply by relocating to Freeport locations. This could also result in increased transport emissions if, for example, components are shipped in to Freeports rather than using UK-produced goods.
2. We agree with the Climate Change Committee (8) and Grantham Research Institute (9) that decarbonising UK industry can only be achieved through measures, such as a CBAM, which incentivise or regulate the decarbonisation of its international supply chains. For such mechanisms to function effectively they must be applied universally, i.e. there cannot be zones with the UK, such as Freeports, where the mechanisms do not apply. This would generate perverse incentives and pull in the opposite direction to the Government’s ambition for Freeports to contribute to decarbonisation.
3. The simplified customs regime within Freeport sites also adds an extra dimension of complexity to the application of CBAMs within Freeports, as it is likely to increase the difficulty of accurately and comprehensively tracing the provenance and history of imported goods and components. This is particularly the case if goods are re-exported from Freeports without ever effectively entering UK customs jurisdiction. There is international evidence of the relaxed customs procedures at Freeports being associated with trade in counterfeit goods, drug trafficking, smuggling of untaxed goods, trade-based money laundering, and tax evasion (10). These concerns underpinned the EU’s recent ‘clampdown’ on Freeports operating within its boundaries (11). The same logic would apply to a difficulty in identifying and tracking high-carbon goods that could circumvent a CBAM, even if one were applied within the Freeport sites. There are additional difficulties in assessing and measuring compliance with either national or company policies in such deregulated locations (12).
4. These issues are complicated further by the fact that many Freeports do not simply consist of one site at which all Freeport measures will apply. The Liverpool City Region Freeport, for example, consists of a primary customs site, three tax and customs sites, 12 customs sites (which will benefit from the customs measures but not the tax measures associated with the Freeport) and plans for an as-yet unknown number of further ‘Freeport opportunity zones’, spread across eight local authority areas (5). Similarly, plans for the Teesside Freeport suggest it will be dispersed across at least 8 major sites, plus the airport, spread across all five local authorities of the Combined Authority region.
5. Despite these potential conflicts with the decarbonisation imperative, which we recognise as an urgent issue not just for the UK but for the world, it is likely that the application of additional tariffs or tightening of customs controls in special economic zones whose success is predicated on a low tax, light regulation regime that is “effectively outside a country’s customs borders” (1) (p 4) would face substantial resistance both locally and nationally.

## Lessons to be learned for decarbonisation ambitions

1. There is very little research directly connecting Freeports with CBAMs. However, some lessons may usefully be learned from considering the wider environmental performance and potential of special economic zones more generally and from considering the stated ambitions of the new UK Freeports in this area.
2. On the one hand, special economic zones from around the world have been associated with serious environmental degradation, including air, land and water pollution, and the production of significant quantities of industrial waste (13, 14). However, these were sometimes associated with zoning measures that included lowering or exemption from environmental standards, which has not been proposed for UK Freeports. Although Freeports will face a relaxed planning regime, the Government is encouraging – but not requiring – this to be implemented in ways that contribute to rather than undermine decarbonisation. But if such exemptions were to be applied, or if deregulation made the enforcing of standards more difficult – for example if UK Freeports were to be exempt from CBAMs, or if their relaxed customs regimes made applying CBAMs more difficult – it is reasonable to assume that a similar pattern would follow and that Freeports would provide a ‘back door’ for untaxed high-carbon goods to be imported, handled, stored, and/or further processed before export or onward transport within the UK, thus potentially contributing to significant carbon leakage.
3. As such, an ill-considered combination of a CBAM and the Freeport policy may have precisely the contrary effect to that intended, potentially even increasing the UK’s carbon leakage. Moreover, the only businesses paying for the CBAM, and hence shouldering an effective penalty, would be those exporting goods entirely produced in the UK and/or unable (for whatever reason) to get into a Freeport zone, which would likely be British SMEs not bigger and more powerful corporations. We do not expect that penalizing specifically British business in this way is the intention of government policy.
4. On the other hand, there is recent evidence from the UK and globally that special economic zones, despite being predicated on low tax, light regulation regimes, can be directed along more sustainable trajectories. Although we have highlighted risks in this submission, we are keen to also emphasise the opportunities to embed Freeports in the UK’s decarbonisation plans. Monaghan et al (2016) surveyed the 24 Enterprise Zones established in England between 2012-2015, and concluded that 83% were in some way connected to ‘cleaner production’ or the low-carbon economy, and set out recommendations for creating greener special economic zones in future (15). Investors in SEZs may be expected to conform to enhanced environmental standards, although this is more common in the Global South (16) (pp 187-189). The World Bank and others are advocating that special economic zones be specifically oriented to develop “eco-industrial parks” and other more sustainable place-based business models (17). In this context, UK Freeports could be developed as exemplars of low-carbon SEZs. This would, however, demand a shift in emphasis for the Freeports policy, in which specifically environmental regulation or tax is just as stringent, if not even tougher, but other incentives for business are in place. This could include tax exemptions and even positive government subsidies targeted specifically to encourage low-carbon innovation and industry.
5. While our new ‘CarbonFreePorts’ project is has only just begun, we note finally that we would be happy to offer further findings to the Committee from the project as it develops.

## Recommendations

1. In light of the above, we recommend that:
* The Committee highlights to government the potential risks of continued and increased carbon leakage if a) a CBAM or equivalent measures are not introduced, and b) a CBAM is introduced but is not applicable, or is difficult to apply, on Freeport sites.
* The Committee recommends to government that a CBAM is introduced to the UK, that it applies equally in designated Freeports, and that measures are put in place to ensure that it can be effectively enforced on Freeport sites.
* The Committee recommends to government that, in line with this, opportunities are taken to ensure that the future development of the Freeports policy initiative coheres with and is fully integrated into the net zero agenda, in particular with regard to reducing carbon leakage and helping to drive the decarbonisation of UK industry’s international supply chains.

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