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The Impact of International Tax Reforms on Special Economic Zones

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This Report builds on the content of UNCTAD *World Investment Report 2022*. It was prepared by UNCTAD team at the Division on Investment and Enterprise (DIAE) led by Bruno Casella, under the overall supervision of James Zhan. The report benefited from the collaboration with the team at the WU Global Tax Policy Centre of Vienna University of Economics and Business led by Jeffrey Owens, including Ruth Wamuyu Maina and Joy Waruguru Ndubai. Comments and feedback from David Bradbury, Samir Hamrouni and Martin Gustavo Ibarra are gratefully acknowledged. Production of the report was supported by Elisabeth Mareschal.

Executive summary

- Special Economic Zones (SEZs) have become an important economic development tool for countries to attract foreign investment. Corporate income tax (CIT) incentives – together with preferential customs and foreign trade regimes – are a core component of the investment promotion toolkit for many SEZs.

- As the decade-long international initiatives to tackle harmful tax regimes and profit shifting are now heading to some major outcome – most notably with the signature of an agreement to apply a global minimum CIT rate by 138 jurisdictions (Pillar II) and the early commitment to implementation by some major investor countries – it is the appropriate time for SEZs to get prepared.

- Given the pending implementation of the international tax reforms, a proactive attitude by SEZ managers is now necessary. A proactive response to the challenges posed by the tax reforms would ultimately lead to a shift in the traditional focus of SEZs' investment promotion strategies from fiscal incentives to other types.

- Yet, international tax reforms are not the only challenge that SEZs face. They add to challenges posed by ongoing structural trends, including in particular (a) the heightened focus on sustainable development, (b) the unfolding of the Fourth Industrial Revolution and (c) the changes in patterns of international production.

- From a broader strategic perspective, international tax reforms may represent an opportunity for SEZs to reshape their value proposition wholesale, acting as an accelerator of the process of transformation from the traditional model of SEZ to a modern one, better equipped to address the challenges and leverage the opportunities of ongoing changes. In recent years, even before the major developments in the global tax reform leading to the Pillar II agreement, UNCTAD has repeatedly urged SEZs to engage in such a transition.

- The changes envisaged in the international tax system are profound – fundamentally strategic and highly technical at the same time. A successful response by SEZ managers and authorities to the challenges posed by the tax reforms would include the following four steps: a. Build knowledge and awareness (*engage*); b. Assess the likely impact (*analyse*); c. Redesign tax incentives *(adjust);* d. Explore alternative (non-tax) measures and value propositions (*reshape*).

Introduction

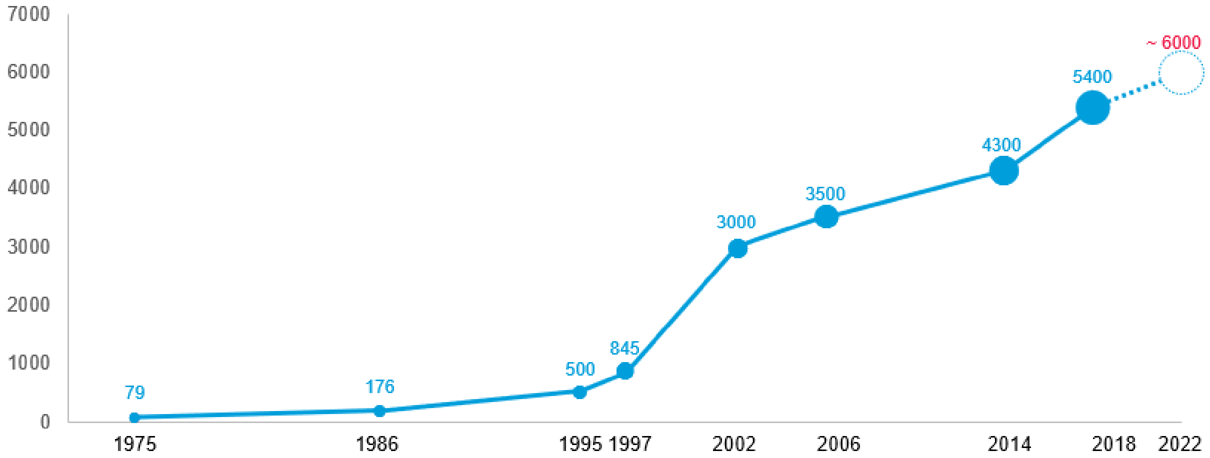
International tax standards are currently undergoing the most significant reform undertaken in the last 100 years, and investment policymakers, including special economic zone (SEZ) authorities and managers, now need to pay close attention to the impact this will have on investment promotion. Among the key reform proposals, the members of the OECD/G-20 Inclusive Framework on Base Erosion and Profit Shifting have agreed on the implementation of a global minimum tax applicable to certain multinational enterprises (MNEs) earning more than €750 million annually (UNCTAD, 2022). The Global Anti-Base Erosion (GloBE) rules will limit the use of corporate income tax (CIT) incentives by requiring that foreign affiliates of affected MNEs pay a minimum effective tax of 15 per cent on their profits in all the jurisdictions in which they operate. This reform is expected to dissuade MNEs from shifting profits and tax revenues to low-tax jurisdictions and thus slow the current race to the bottom in CIT between countries, particularly developing ones (UNCTAD, 2022).

This reform is the culmination of decades of multilateral effort to regulate harmful tax competition and profit shifting, under the auspices of the OECD and the G20. It is not the first set of standards to have an impact on investment incentives adopted in SEZs. Indeed, some SEZs have already fallen within the scope of the evaluation of preferential tax regimes undertaken by the Forum on Harmful Tax Practices (FHTP) to determine whether and to what extent they are harmful. Given the substantial impact that international tax standards can and have had, it is crucial that SEZ authorities and regulators and the policymakers develop an understanding of the way in which international tax standards affect their investment promotion efforts.

This note aims to provide an overview of the features of the international tax arena that affect SEZs and provide some recommendations for policymakers who are managing and designing zones under growing regulatory constraints.

Between 5,000 and 6,000 SEZs operate globally, and the number is rapidly growing

Figure 1. Global historical trend in SEZs (Number of SEZs)



Source: UNCTAD, based on *World Investment Report 2019* (UNCTAD, 2019).

Note: The trend is indicative only. Historical estimates are based on ILO (2014) for 1975, 1986, 1995, 1997, 2002 and 2006; FIAS (2008) for 2008; *The Economist* (2015) for 2014; and UNCTAD (2019) for 2018. The latest year assessed was 2018. The value for 2022 is a (rounded) approximated figure based on estimates of the number of operational SEZs in 2018 (5,400) and of the number of SEZs in the pipeline in the same year (over 500) (UNCTAD, 2019).

The proliferation of SEZs around the globe has led to the establishment of about 6,000 zones in some 150 economies. Growth in the number of zones has accelerated over the last four decades, with more than a thousand established just between 2014 and 2018 (figure 1).

SEZs have become an important economic development tool. Governments worldwide, challenged by the rising global competitive pressure to attract mobile industrial activity and the growing importance of global value chains (GVCs), have turned to SEZs as a tool to encourage innovation, productivity and economic growth.

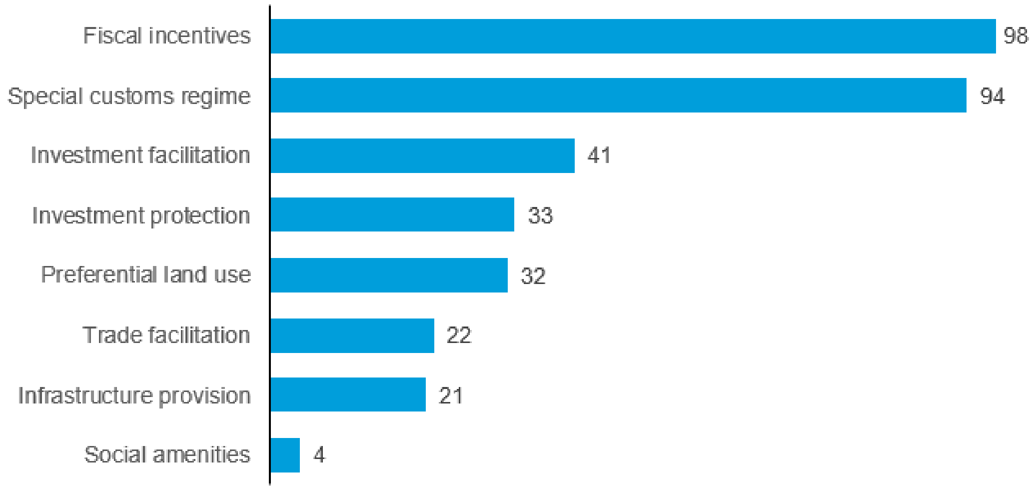
These zones have in common “geographically delimited areas within which governments facilitate industrial activity through fiscal and regulatory incentives and infrastructure support” (UNCTAD, 2019; p.128). Zones are typically part of countries’ competitive investment promotion packages and offer regulatory regimes that are distinct from the broader national or subnational economy in which they are established. As part of the distinct regime, the package of benefits available to investors includes “import and export duty exemptions, streamlined customs and administrative controls, liberal foreign exchange policies, and income tax incentives – all meant to boost an investment’s competitiveness and reduce business entry and operating costs” (FIAS, 2008; p.12).

The essence of SEZs and free trade zones is an exceptional customs and foreign trade regime (regulated by the Kyoto International Convention). But in addition to these incentives, many zones, particularly in developing countries, provide exemptions or reductions of CIT. Taxes on corporate income typically include taxes on profits; withholding taxes, including on dividends paid to shareholders and management fees; and taxes on gains earned from sales of assets.

CIT incentives will be primarily affected by the ongoing reform of the international tax regulation. For SEZs, one of the principal concerns is whether investors would have located in a zone without the provision of incentives (FIAS, 2008).

Almost 80 per cent of SEZ laws provide for fiscal incentives

Figure 2. Investment attraction tools in SEZ laws (Number of laws as of 2018, n=127)



Source: *World Investment Report 2019* (UNCTAD, 2019).

The provision of tax incentives, including those targeting CIT, has traditionally been a key feature of the benefit package that SEZs offer to international investors. In 2008, the World Bank found that "the typical package of fiscal incentives offered by [export processing zones] almost universally includes corporate tax holidays or reduced tax rates, import duty exemptions, indirect tax abatements" (FIAS, 2008; p.38). The UNCTAD *World Investment Report 2019* estimated that 80 per cent of SEZ laws provided fiscal incentives such as tax holidays for a defined period (often 5 to 10 years) or the application of a reduced tax rate (figure 2). Tax exemptions typically applied to the payment of profit taxes, corporate taxes, wages and salaries taxes, and value added taxes (UNCTAD, 2019). In Africa, fiscal incentives have been among the most prevalent incentives used in SEZ programs to attract FDI: "Almost 90 per cent of African SEZ policies provide for fiscal incentives" (UNCTAD, 2021; p.48). Along the same line, up to 70 per cent of developing countries have at least one CIT incentive targeting SEZs specifically – a presence in SEZs being the third most important eligibility condition for granting CIT incentives to a particular investment (OECD, 2022).

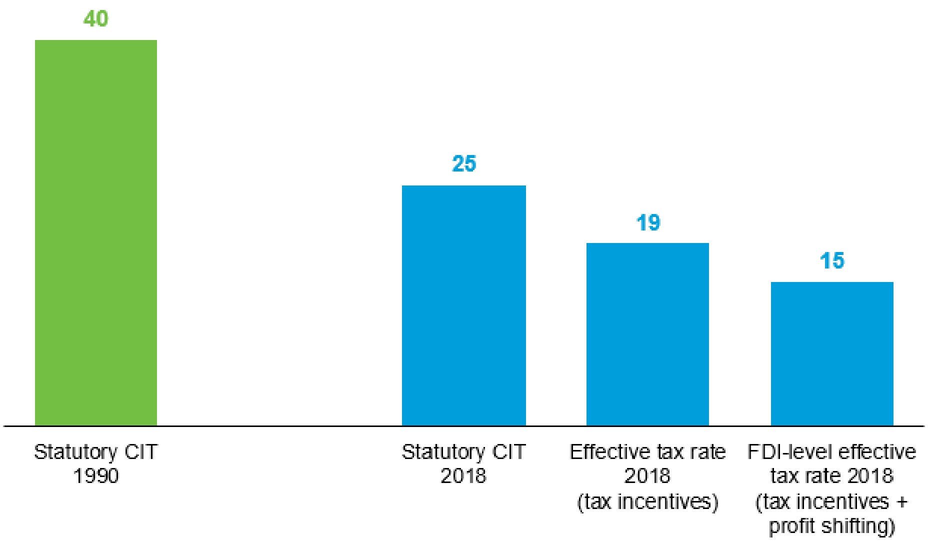
Common CIT incentives offered in zones include the following (UNCTAD, 2019):

- Reduced CIT rates.
- CIT exemptions on specific activities such as software development, research and development, and design activities.
- Relief from capital gains when investing in economically distressed areas.
- Partial or complete exemptions from CIT.

Overall, the use of CIT incentives in SEZ policy design is common, particularly in old-generation SEZs and in some developing regions such as Africa or Central America. As a result, SEZ authorities need to be aware of current trends in international taxation that may affect the implementation of such incentives, the modification of existing regimes or the adoption of new measures.

At the origin of the tax reforms: a race to the bottom to attract FDI

Figure 3. Corporate tax rates on FDI income (Per cent)



Source: UNCTAD, based on *World Investment Report 2022* (UNCTAD, 2022).

The tax race to the bottom primarily concerns competition between countries to lower effective tax rates (ETRs) in order to attract foreign direct investment (FDI). The average ETR on foreign profits of MNEs has been declining to as low as about 15 per cent, as captured by UNCTAD *FDI-level ETR* – a novel notion of effective tax rate that combines the effects of generous tax incentives and of international tax arbitrage perpetrated through profit shifting (UNCTAD, 2022). Such ETR at 15 per cent is 10 percentage points below the current statutory CIT and about 25 percentage points below the average statutory CIT three decades ago (figure 3). This downward trend has raised serious concerns about potential damage to government revenue collection, especially in developing countries where tax collection is particularly low as a share of gross domestic product. Combating harmful tax competition and profit shifting has been the driving force behind the efforts to reform the international tax system, particularly in the last decade.

The *World Investment Report 2019* (UNCTAD, 2019) highlighted that the proliferation of SEZs around the world, driven in large part by competitive pressures in a tightening market for internationally mobile investment in industrial capacity, has also contributed to the race to the bottom. Low taxation and relaxation of regulations and standards applicable to (predominantly international) investors have traditionally been key elements of SEZs' value proposition (UNCTAD, 2019; Chaisse and Xueliang, 2020). In evaluating the African SEZ landscape, UNCTAD highlighted the magnitude of the problem for regional free trade area members seeking to attract FDI:

> "…a zero-sum competition at the regional level could see SEZs at the centre of an incentives "arms race" or a bidding war, with countries using their SEZ-related policy incentives as a means to win over FDI to their countries. African nations could thus end up engaged in a race to the bottom and facing a prisoner's dilemma: although they would benefit by cooperating at the regional level, they act in their own self-interest, trying to offer the best incentives while tilting the playing field towards lower [environmental, social and governance, or ESG] standards in the hope of outdoing regional competitors." (UNCTAD, 2021; p.67)

Regulating this zero-sum competition or race to the bottom is now one of the principal objectives of the international tax community. In particular, the focus is on the recovery of forgone revenues, in order to boost domestic resource mobilization for economic recovery as well as financing for sustainable development and climate change adaptation. The key objective is to encourage countries to redesign incentives to be more effective while meeting the requirements of new international tax standards.

Although fiscal incentives may play a role in attracting investment to SEZs in the short term, it is controversial whether they have a positive impact on the long-term success of a zone. In 2008, at the extreme of the race to the bottom, the World Bank recognized that “the use of generous incentives packages to offset other disadvantages (such as poor location or insufficient facilities) is ineffective in terms of overall zone performance, due in large part to the increasing commonality of zone investment incentives in recent years” (FIAS, 2008; p.5). Fiscal incentives, particularly tax holidays and full exemptions, represent revenue forgone by host countries, so in the interest of protecting national tax bases, their effectiveness in attracting investment must be regularly and carefully reviewed.

The international agenda to address harmful tax regimes matters for SEZs

Figure 4. Features of harmful tax regimes and relevance for SEZs

Main features of harmful tax regimes	Relevance for SEZs
Imposition of a **low or zero effective tax rate** on the relevant income	Where SEZ regimes include reduced corporate tax rates or full exemptions ➤ Fiscal incentives are generally key tools in SEZ attraction strategies, with tax holidays, tax exemptions and reduced tax rates being prominent.
A **ring-fenced** regime	Where SEZ regimes are partially or fully isolated from the domestic economy ➤ Most fiscal incentives specifically target SEZs: they introduce special regimes in SEZs that do not apply to the rest of the economy.
A **lack of transparency** of the operation of the regime	Where regulations, decision-making or operations are opaque ➤ SEZ laws or regulations are at times unavailable, inaccessible or out of date, or investment arrangements arise through private agreements not published by the government.
Limited or absent **exchange of information**	Where SEZs are in jurisdictions where the government has opted not to engage in exchange of tax information ➤ Less likely to arise today as the majority of SEZ host jurisdictions are members of the Global Forum on Transparency and Exchange of Information for Tax Purposes.

Source: UNCTAD.

Following the publication of the 1998 Report on Harmful Tax Competition, the OECD’s work on harmful tax practices recognized that tax havens and harmful preferential tax regimes (or harmful tax practices) that reduce ETRs significantly below rates in other economies have the potential to cause harm to national tax bases. The report identified features that could suggest a potential to facilitate harmful tax competition, chief among them no or low ETRs, ring-fencing, lack of transparency, and ineffective exchange of information. These features are generally relevant to old-generation SEZs. The publication of the 1998 report initiated the effort to address harmful preferential tax regimes and tax havens. One of the outcomes was the establishment of the Forum on Harmful Tax Practices (FHTP), intended to evaluate the preferential tax regimes adopted by countries to determine whether and to what extent they are harmful.

Box 1. The Forum on Harmful Tax Practices

The FHTP was tasked with facilitating a coordinated approach, based on international cooperation, to reviewing tax-related legislative provisions or administrative practices that constitute harmful tax practices. It is important to note that FHTP reviews are thus not concerned with individual SEZs but with the "corporate tax rules of SEZ regulations that can potentially relate to one, several, or all SEZs in each country" (Heitmuller and Mosquera, 2021; p.482).

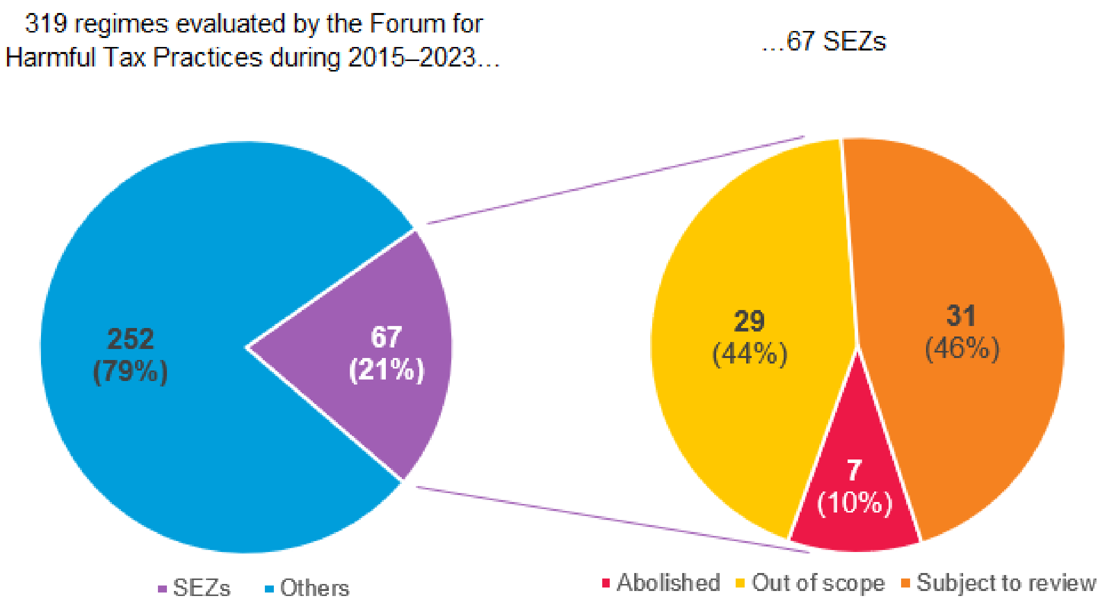
To fall within the scope of the FHTP's review, in addition to the key features raised in the text, an SEZ's tax incentive regime must apply to income from geographically mobile activities – such as financial and other service activities or the provision of intangibles (OECD, 2015). This means that regimes focused on attracting plants, buildings and equipment fall outside of the scope. The regime also must relate to the taxation of business income; therefore, consumption taxes are not covered. In-scope zones could include those offering incentives to high value-added services sectors such as finance and trade, as well as to intellectual property and technology development.

Where an SEZ or certain features are found to be harmful, the country under review has the opportunity to abolish the zone or to remove the harmful features within a set timeline. If the country does not eliminate the harmful features or abolish the zone, other countries have the option to "take defensive measures to counter the effects of the harmful regime, while at the same time continuing to encourage the country applying the regime to modify or remove it" (OECD, 1998; p.36).

Source: UNCTAD.

One in five tax regimes under scrutiny are SEZs

Figure 5. Tax regimes under scrutiny (Number and per cent)



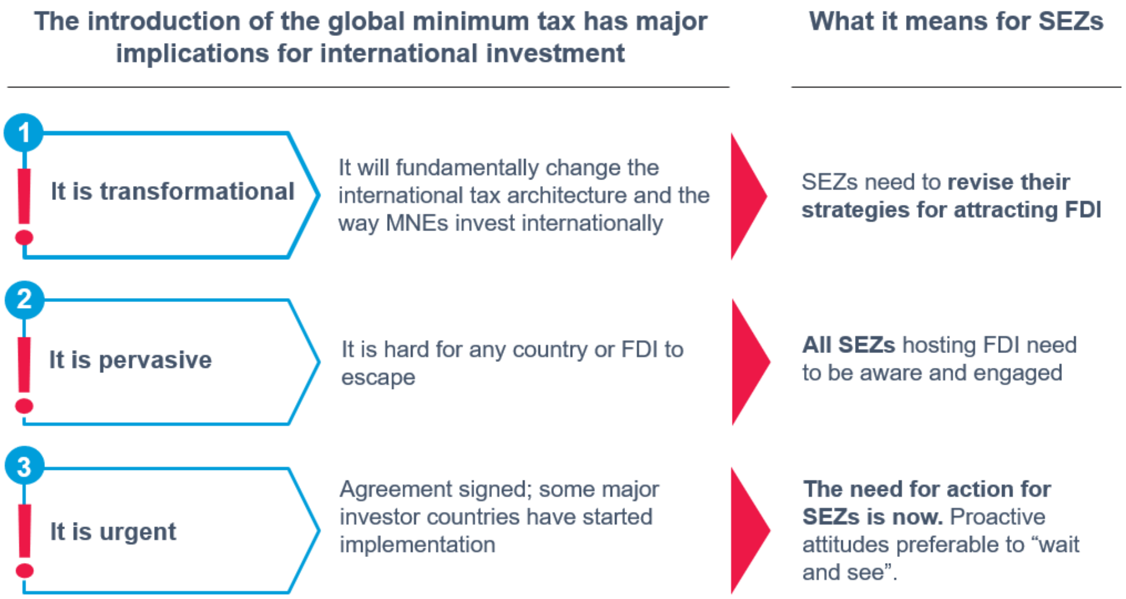
Source: UNCTAD elaboration on FHTP data.

Notably, as of 2023, of the 319 regimes evaluated by the FHTP since the start of the Base Erosion and Profit Shifting project, 67 regimes – 21 per cent – were SEZs (see also annex table). This indicates that SEZs remain relevant to the discourse on harmful tax competition. Out of the 67 SEZ regimes reviewed, 7 were abolished and 31 were found to be harmful or potentially harmful, thus requiring amendment (figure 5).

Not all countries' SEZ regimes have been subject to FHTP review. Yet, no country has ignored a review, and this "can be considered as first evidence that countries do not maintain SEZ policies that contradict with the international tax regime" (Heitmuller and Mosquera, 2021; p.485). In light of this outcome, the design of SEZ policies can no longer be undertaken in isolation from international tax standards. Authorities and policymakers should use the experiences of the regimes already reviewed as guidance for future compliance with the FHTP standards. One notable case is the Cabo Verde Maio regime, which has been designed to comply with the FHTP standards. Taking this initiative creates certainty for investors and eliminates the need to cater to investors who may have already benefitted from incentives by way of grandfathering.

The global minimum tax (Pillar II): a historic change in the FDI landscape, with SEZs at the forefront

Figure 6. Implications of the global minimum tax on international investment and relevance for SEZs



Source: UNCTAD.

Over and above the ongoing reviews of the FHTP, in 2020 member jurisdictions of the Inclusive Framework on Base Erosion and Profit Shifting agreed to introduce a global minimum tax (Pillar II). The objective of the global minimum tax is to ensure that MNEs pay at least a minimum level of taxation on their profits in all the jurisdictions where they operate (UNCTAD, 2022). The rules introduce a minimum ETR of 15 per cent, which functions as a top-up tax applied in each jurisdiction where a multinational operates and has an effective rate below the minimum. This top-up will be collected by the jurisdiction where the headquarter of the MNE (the ultimate parent entity) is located (*Income Inclusion Rule; IIR*) or, where it is not applicable, by an intermediate jurisdiction (*Undertaxed Payment Rule; UTPR*). Host countries are still given the option to apply the top-up tax first – before home countries can do so – to protect tax revenues (*Qualified Domestic Minimum Top-Up Tax*).

The implications of the introduction of a global minimum tax on multinationals are significant. For foreign investment and investment policy, the new tax reform is (1) transformational, (2) pervasive and (3) urgent (figure 6).

1. Transformational: *A minimum tax of 15 per cent on the foreign profits of the largest MNEs will significantly change the way in which MNEs invest internationally.* The first and most important effect is on tax competition to attract FDI. As the minimum tax reduces tax rate differentials between host countries, taxation becomes much less important as a driver of MNEs' location decisions. This is a major change for investment policymakers and for the activity of organizations that deal with FDI attraction, such as SEZs and investment promotion agencies (IPAs).

2. Pervasive: *(Almost) no country or FDI can afford to ignore Pillar II.* The mechanism that has been devised for implementation is such that it is sufficient for a relatively limited number of investor home countries (for example G20 or OECD members) to apply the top-up tax for the effects to become almost universal. What lends Pillar II its force is not the acceptance of minimum taxation by recipient countries, but the willingness of higher-tax parent countries to enforce it. In that sense, the global minimum tax envisaged in Pillar II does not require global agreement and, moreover, is hard for host countries to escape. Adding to the pervasiveness of the tax reform, where countries fall within the scope of application of Pillar II, affected FDI includes investment from large MNEs ("in scope", with annual consolidated revenues above €750 million), which corresponds to the majority of FDI – between 60 and 70 per cent, depending on the region (UNCTAD, 2022; figure III.18, p. 153).

3. Urgent: *The investment community, including SEZs, is urged to get ready now, to be able to meet the challenges posed by the imminent implementation of the reform.* Pillar II will have major implications for national investment policymakers and investment promotion institutions, and for their standard fiscal toolkits to attract FDI. The magnitude of the changes at stake requires the investment community, including SEZs, to prepare for them now. SEZs should be aware that over 50 jurisdictions are already taking steps towards implementation (OECD, 2023b). In December 2022, for instance, the European Union (EU) unanimously adopted the Minimum Tax Directive, which ensures a minimum level of taxation for MNE groups and large-scale domestic groups within the Union. Member States now have until 31 December 2023 to implement the Directive into national law. The Directive is based on the Model Rules on Pillar II agreed to by the Inclusive Framework. The implementation of the reform by the European Union alone would affect not only in-scope inward investment in the Union, but also outward investment from – and conduit investment through – EU jurisdictions. Furthermore, there is an expectation that the first moves of major investors will trigger a domino effect on other countries.

These features have clear and immediate impacts on the activity of SEZs. SEZs thus should be fully aware of the scope and expected effect of the changes.

Pillar II will render some of the most common tax incentives granted by SEZs to foreign companies ineffective

Figure 7. Common corporate income tax incentives to attract FDI and impact of Pillar II

Incentive type	Pillar II impact	Incentive type	Pillar II impact
a. Reduced rates		**b. Deductions**	
Zero-rated	High impact	Accelerated depreciation and immediate expensing	Little/no impact
Below 15 per cent	High impact	Loss carry-forward	Little/no impact
Above 15 per cent	Little/no impact	Deductible qualified expenses	Varialbe/unclear impact
c. Exemptions		**d. Other incentives on income-related taxes**	
Tax holidays	High impact	Incentives on withholding taxes	Little/no impact
Specific exemptions: location, sector, entity	Varialbe/unclear impact	IP box	Varialbe/unclear impact
		Tax credits	Varialbe/unclear impact
Participation exemptions	Little/no impact	Incentive on capital gains taxes	Varialbe/unclear impact

● Little/no impact ● High impact ● Varialbe/unclear impact

Source: *World Investment Report 2022* (UNCTAD, 2022).

Note: This high-level summary table is indicative, aimed at providing an overview of the level of exposure of each category of incentives to the impact of Pillar II. More punctual assessment requires a technical evaluation of each category of incentives, see for example Liotti et al., 2022.

The key rationale for granting an income-based tax incentive is to stimulate certain responses from a corporate entity by reducing its ETR (relative to the standard treatment). In this respect, all tax incentives operating through corporate income taxation produce some kind of reduction in the ETR faced by the beneficiary and are thus potentially affected by Pillar II to the extent that such reduction may result in an ETR falling below the minimum of 15 per cent.

In reality, because of the way in which the ETR of an MNE entity is calculated within the Pillar II framework, the nexus is not so straightforward. An assessment of Pillar II impact on specific categories of incentives demands a number of rather technical considerations. Ultimately, the application of Pillar II will affect specific tax incentives more than others (figure 7). UNCTAD *World Investment Report 2022* provides a detailed assessment of the implications of Pillar II rules for selected incentives to attract FDI (UNCTAD, 2022).

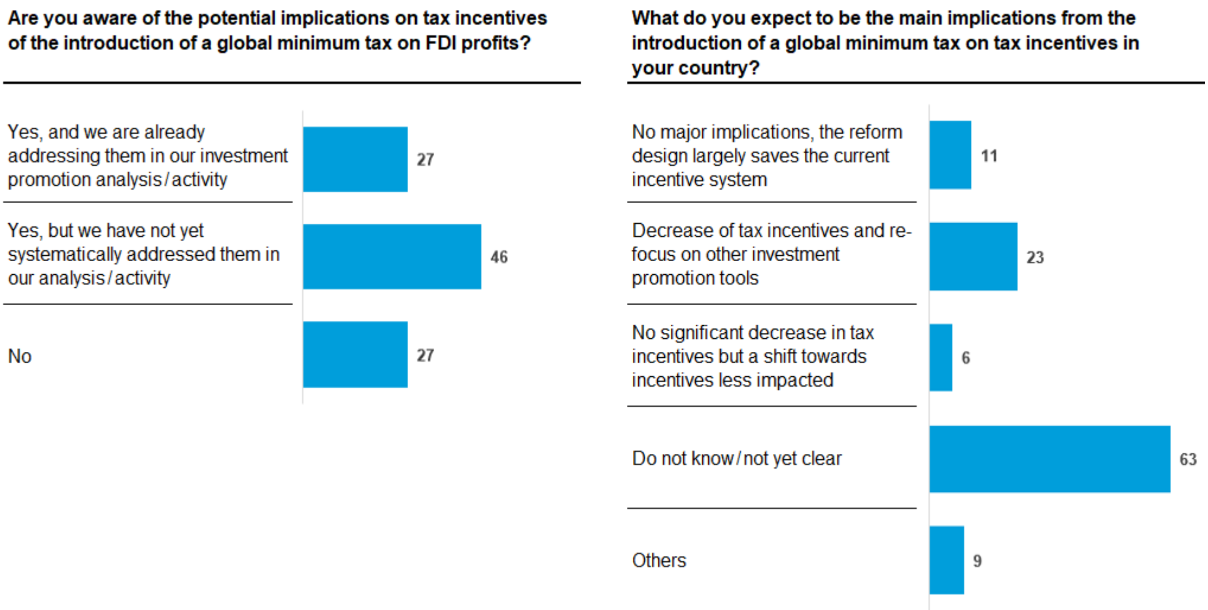
In summary, looking specifically at the incentives most frequently used,

- Accelerated depreciation and loss carry-forward provisions will remain largely effective.
- Tax holidays and full exemptions will lose all or most of their attractiveness.
- A range of other incentives will be affected to various degrees depending on their design (figure 7).

In-scope MNEs operating in SEZs and receiving corporate tax incentives such as tax holidays, exemptions, or zero or low rates will be primarily affected. In developing countries, reduced tax rates and tax holidays are more common incentives than investment allowances or tax credits. Accelerated depreciation is also common in such sectors as agriculture and mining. Comparatively, developed countries rely more on expenditure-based incentives such as accelerated depreciation, investment allowances or tax credits, less affected by the global minimum tax (OECD, 2022).

Awareness of the implications of the tax reforms still limited

Figure 8. UNCTAD IPA survey (Per cent)

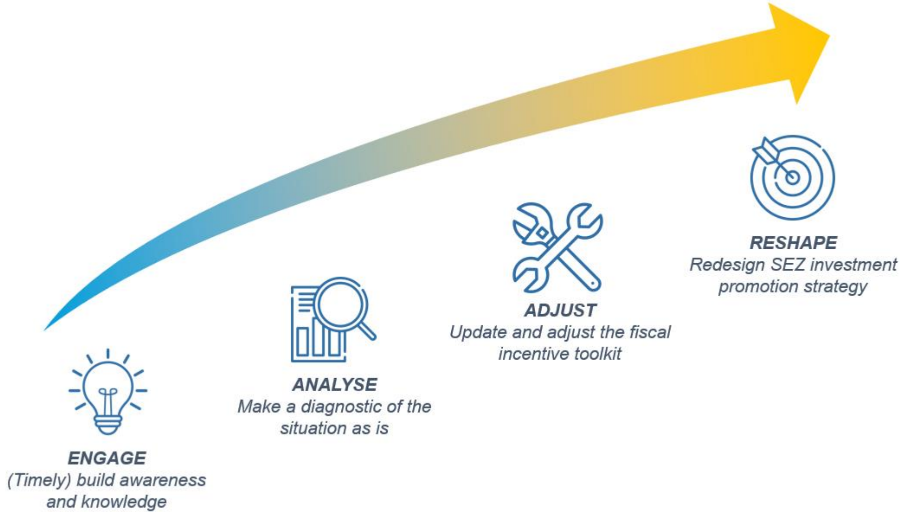


Source: UNCTAD IPA Survey, 2022.

As the most relevant reform of MNE taxation in a century heads towards implementation, awareness of the implications among investment policymakers and institutions remains very low. According to the UNCTAD IPA Survey, about 30 per cent of IPAs are not aware of the implications of the tax reform on FDI and about 50 per cent are aware but have not taken any systematic action. Almost two thirds of IPAs declared that they are not clear about the likely main implications of the minimum tax (figure 8). The level of awareness among SEZs is likely to be similarly low.

Engage, analyse, adjust, reshape: how SEZ managers can respond to Pillar II

Figure 9. Possible responses of SEZ managers to the tax reforms



Source: UNCTAD.

The global minimum tax is due to take effect in the next one or two years. So, the time for action for SEZ management is now. At this stage, a proactive attitude is preferable to opportunistic “wait and see” reactions. A proactive response to the challenges posed by the tax reforms should consist of several steps, ultimately leading to a shift in the focus of SEZs’ investment promotion strategies from fiscal incentives to other value propositions (figure 9).

Engage. Building awareness and knowledge is the first necessary step.

- The changes envisaged are profound and highly technical. Obtain expert tax advice and seek collaboration with institutions such as UNCTAD.
- The changes raise fundamental issues of tax policy and administration. Seek views and advice from the ministries of finance and tax administration.
- Investors will be wondering how their tax treatment will change and how to react. Engage with relevant stakeholders, including MNEs, to convey the message that serious evaluation is under way and that laws and regulations will be adjusted in a transparent way.

Analyse. Drawing on a thorough understanding of the mechanics and implications of Pillar II, assess the likely impact of the global minimum tax.

- Advocate for a comprehensive mapping of all tax incentives currently offered and the entities using them, including the extent of their activities and the revenue directly forgone as a result of the incentives.
- Identify all cases in which taxes paid are likely to be less than 15 per cent of an entity’s accounting profits, as adjusted under the GloBE rules.
- Assess, where the rate is less than 15 per cent, whether the increase in total tax payments implied by the global minimum is likely to be material for the investor.
- Identify all cases in which legal commitments have been made to provide incentives for some period of time, and obtain legal advice as needed (because, from the perspective of government revenue, their effects may be undesirable).

Adjust. The global minimum tax will change the rules of the tax competition game to attract FDI, raising the need to redesign the most effective tax incentive toolkit for investment promotion.

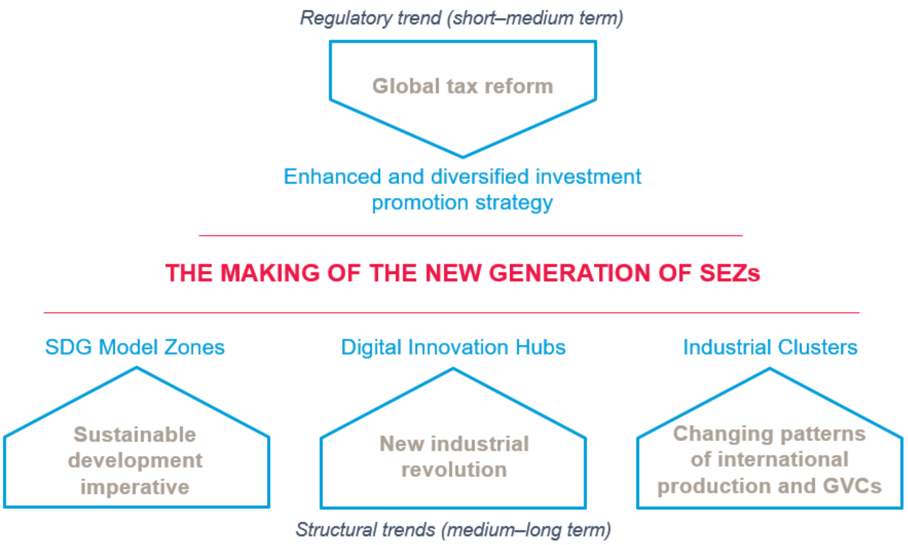
- Review the effectiveness of incentives in attracting investment relative to the revenue loss they imply. Independent expert advice is the most credible way to do this.
- Recognize that Pillar II will substantially reduce the benefit of tax incentives to investors. The rules of the investment promotion game will change fundamentally.
- Strengthen the overall governance of tax incentives. Make sure incentives are granted on the basis of a set of predetermined, objective, clear and transparent criteria.
- Consider and discuss with the finance ministry possible tax policy changes to support investment promotion: reviewing corporation taxes, reviewing other taxes not covered by the agreement (but only if there is evidence that doing so will affect investor costs) or restructuring taxes to be covered.
- Recognize that it may be inappropriate to restrict these changes to affected entities and too costly in revenue to extend them to all firms.
- Examine how the tax administration can provide greater certainty and predictability to investors.

Reshape. Explore the potential for non-tax measures to reshape SEZs' investment promotion strategy.

- Prioritize investment facilitation measures, including information provision, transparency on rules and regulations, and streamlined administrative procedures for investors.
- Focus on spending on local infrastructure (such as energy supply and transport facilities) and development of local human capital.
- Invest on support for improved tax services, such as the speed with which value added tax refunds are paid and tax disputes resolved.

Conclusions: the international tax reforms in the context of the broader process of modernization of SEZs

Figure 10. Trends shaping the new generation of SEZs



Source: UNCTAD.

This note highlights how historic changes taking place in international tax rules will have major implications for SEZ activity. Although it is difficult to make predictions on timing, these implications may fully materialize over the next one or two years. One of the objectives of this publication is to raise awareness among SEZs of the need to be prepared for the upcoming changes and to indicate some general directions for optimizing SEZs' responses.

Yet, international tax reforms are not the only challenge SEZs face. They add to challenges posed by ongoing structural trends, including in particular (a) the heightened focus on sustainable development, (b) the unfolding of the Fourth Industrial Revolution and (c) changes in patterns of international production (figure 10). In this broader perspective, a transformational regulatory change such as the international tax reforms may represent an opportunity for SEZs to reshape their value proposition wholesale, acting as an accelerator of the process of transformation from the traditional model of SEZ to a modern one, better equipped to address the challenges (and leverage the opportunities) of the ongoing changes. In recent years, even before the major developments in the global tax reforms leading to the Pillar II agreement, UNCTAD has repeatedly urged SEZs to engage in such a transition (UNCTAD, 2019; UNCTAD, 2021).

a. Sustainable development. The sustainable development agenda increasingly drives MNEs' strategic decisions and operations and should be reflected in the value proposition that SEZs and IPAs market to investors. Laxer social and environmental rules or controls are not viable long-term competitive advantages for attracting investment in zones. On the contrary, they can lead to failure when an SEZ becomes associated with labour or human rights abuses, projecting a negative image that discourages investment. Shared services related to sustainability, such as common health and safety services, waste management installations and renewable energy sources, will become increasingly important. SEZs that market their environmental performance (ecozones) are already emerging (UNCTAD, 2019), and the enforcement and active promotion of high ESG standards will become a key feature of SEZs.

The 2030 agenda to achieve the United Nations Sustainable Development Goals (SDGs) could provide an opportunity to develop an entirely new type of SEZ: an SDG model zone.

Conceptually, such zones would be built around three key elements:

- A strategic focus on attracting investment in SDG-relevant activities
- The highest levels of ESG standards and compliance
- Promotion of inclusive growth through linkages and spillovers

b. New industrial revolution. The new industrial revolution – the adoption across industries of digital technologies, advanced robotics, 3D printing, big data and the Internet of Things – is changing manufacturing. The declining importance of labour costs as a locational determinant for investment will have fundamental implications for SEZs. SEZ development programmes will need to adapt their value propositions to include access to skilled resources and high levels of data connectivity as well as relevant technology service providers, potentially through partnerships with platform providers. Digital service provision by SEZ operators, e.g. through online single windows for administrative procedures, will gain importance as signals to potential investors. At the strategic level, SEZs may have new opportunities to target digital firms and orient their strategic strengths in logistics facilitation towards the distribution activities of e-commerce firms. SEZs could follow the incubator model and promote clustering and linkages with local digital start-ups within and outside their confines, transforming SEZs into digital innovation hubs. To pursue such opportunities and see new SEZ models succeed, national digital policy – e.g. on privacy, data storage and security – will become an area to integrate with the SEZ regulatory and institutional framework.

c. International production. Changing patterns of international production and GVCs, as overseas operations shift towards intangible and asset-light forms, make the traditional physical production advantages offered by SEZs less relevant (UNCTAD, 2017; Casella and Formenti, 2018; UNCTAD, 2020). This trend is likely to result in greater numbers of zones specializing in services, on the one hand, and smaller-scale manufacturing (for example digital twins), on the other. Both developments can potentially lead to higher technology and intellectual property content in production in SEZs, requiring SEZ incentives to foster contributions to industrial upgrading and skills development. Smaller-scale manufacturing investments could provide opportunities for enhanced linkages with firms outside SEZs. Changing patterns in international production are also driven by policy factors. MNEs constantly adjust GVCs in response to new trade barriers or changes in preferential market access. The return of protectionist tendencies, slow progress in international trade policymaking, and new regional trade and investment agreements can thus significantly affect SEZ competitiveness. The trend towards more regional rather than multilateral economic cooperation is likely to give further impetus to the development of regional zones, cross-border zones and other forms of international cooperation zones.

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Annex

Annex table FHTP Reviews since 2015 (OECD, 2023a)

Country	Regime	Type of zone	Review outcome
Armenia	IP	Free economic zones	Potentially harmful due to ring-fencing and lack of substantial activity requirements – will be addressed
Armenia	Distribution and service center	Free economic zones	In the process of being amended – potentially harmful features will be addressed
Aruba	IP	Free Zone	Abolished
Aruba	Distribution center and service center	Free zone	Not harmful following amendment – ring-fencing removed and substance requirements (non-IP) in place.
Cape Verde	Distribution center and service center	Maio SEZ	Not harmful (subject to the adoption of final legislation), new regime designed in accordance with FHTP standards.
Costa Rica	Distribution center and service center	Free trade zone	Not harmful following amendment to include substance requirements.
Curacao	Distribution and service center	E-Zone	Out of scope – benefits for income from geographically mobile activities removed.
Dominican Republic	Distribution center and service center	Free trade zones	Out of scope – benefits for income from geographically mobile activities removed.
Eswatini	IP	SEZs	In the process of amendment to eliminate potentially harmful features.
Eswatini	Distribution center and service center	SEZs	In the process of being amended to address potentially harmful features.
Gabon	Distribution center and service center	SEZ	In the process of amendment to address potentially harmful features.
Georgia	Distribution center and service center	Free industrial zone	Out of scope – no benefits for income from geographically mobile activities.
Georgia	Distribution center and service center	Virtual person zone	Potentially harmful but not actually harmful – due to ring-fencing and substantial activities factor implicated, but no harmful economic effects in practice. This regime is subject to annual monitoring.
Honduras	IP	Free Zones (ZOLI)	In the process of elimination/amendment to address potentially harmful features.
Honduras	Distribution center and service center	Free Zones (ZOLI)	In the process of being eliminated/amended to address the potentially harmful features
Honduras	IP	Employment and economic development zones	Abolished
Honduras	Distribution center and service center	Employment and economic development zones	Abolished
India	Non-IP	Special provisions in respect of newly established units in SEZs	Not harmful

Country	Regime	Type of zone	Review outcome
Indonesia	Non-IP	SEZ regime	Out of scope since no income from geographically mobile activities involved.
Jamaica	Distribution center and service center	SEZ Regime	Not harmful following amendment – substance requirements (non-IP) in place.
Japan	Non-IP	Special zones for international competitiveness development	Not harmful
Jordan	IP	Aqaba Special Economic Zone	In the process of amendment – harmful features will be addressed
Jordan	Distribution center and service center	Aqaba Special Economic Zone	In the process of amendment – harmful features will be addressed
Jordan	IP	Development Zone	Not harmful following amendments – substance requirements in place.
Jordan	Distribution center and service center	Development Zone	Not harmful – ring-fencing removed, substance requirements in place.
Jordan	Distribution center and service center	Free trade zones	Abolished
Kazakhstan	IP	SEZs	Not harmful following amendment - substance requirements are in place.
Kazakhstan	Distribution center and service center	SEZs	Not harmful following amendment – substance requirements in place.
Kenya	IP	SEZ	Not operational
Kenya	Distribution and service center	SEZ	Not operational
Kenya	Headquarter Regime	SEZ	Not operational
Kenya	Distribution center and service center	Export processing zone	Out of scope – no benefits for income from geographically mobile activities.
Korea	Distribution center and service center	Foreign investment zone	Out of scope – no benefits for income from geographically mobile activities.
Korea	Distribution center and service center	Free economic zone/free trade zone	Out of scope – no benefits for income from geographically mobile activities.
Latvia	Non-IP	Special Economic Zones	Disadvantaged areas regime – subject to monitoring to ensure continued low risk of BEPS.
Lithuania	IP	Free economic zone taxation regime	Disadvantaged areas regime – subject to monitoring to ensure continued low risk of BEPS.
Lithuania	Distribution center and service center	Free economic zone taxation regime	Not harmful – no harmful features
Malaysia	Distribution center and service center	Special economic regions	Not harmful following the removal of ring-fencing, substance requirements in place.
Mauritius	Distribution center and service center	Freeport zone	Out of scope – benefits for income from geographically mobile activities removed.
Mongolia	IP	Free trade zones	Abolished

Country	Regime	Type of zone	Review outcome
Mongolia	Distribution center and service center	Free trade zones	Abolished
Morocco	Distribution center and service center	Free trade zones	Out of scope – no benefits for income from geographically mobile activities.
Morocco	Headquarter Regime	Banks and holding companies in offshore zones	Abolished
Nigeria	Banking and Insurance	Free trade zones	Not operational
Nigeria	Distribution center and service center	Free trade zones	Out of scope – no benefits for income from geographically mobile activities
North Macedonia	IP	Technological Industrial Development Zone	Not harmful following amendment – substance requirements in place
North Macedonia	Distribution center and service center	Technological Industrial Development Zone	Not harmful following amendments – substance requirements in place.
Panama	IP	City of knowledge technical zone	Not harmful following amendment – substance requirements (nexus approach) in place.
Panama	Distribution center and service center	Colon free zone	Out of scope – no benefits for income from geographically mobile activities.
Panama	Distribution center and service center	Panama-Pacifico SEZ	Not harmful following removal of ring-fencing and non-IP substance requirements in place.
Paraguay	Distribution center and service center	Free zone	Out of scope – no benefits for income from geographically mobile activities.
Peru	Distribution center and service center	SEZ 2 (Zofratacna)	Not harmful – no harmful features found.
Peru	Distribution center and service center	SEZ 1 (Ceticos/ZED)	Out of scope – no benefits for income from geographically mobile activities.
Qatar	IP	Free Zone at the Science and Technology Park	Not harmful following amendments – substance requirements in place
Qatar	IP	Free Zone Areas	Not harmful following amendments – substance requirements in place
Qatar	Distribution center and service center	Free Zone at the Science and Technology Park	Not harmful following amendment – substance requirements (non-IP) in place.
Qatar	Distribution center and service center	Free Zone Areas	Not harmful following amendment – substance requirements (non-IP) in place.
Seychelles	IP	International trade zone	Abolished.
Seychelles	Distribution center and service center	International trade zone	Out of scope – benefits for income from geographically mobile activities removed
Trinidad and Tobago	Distribution center and service center	Free trade zones	Harmful – due to ring fencing and exchange of information factors implicated.
Turkey	IP	Technology development zones	Not harmful following amendments to introduce substance requirements.
Uruguay	IP	Free zones	Not harmful following amendment to include substance requirements (nexus approach).

Country	Regime	Type of zone	Review outcome
Uruguay	Distribution center and service center	Free zones	Not harmful following amendment – ring-fencing removed and substance requirement in place (non-IP).
Vietnam	IP	Export processing zone	Out of scope – no benefits for income from geographically mobile activities.
Vietnam	Distribution center and service center	Export processing zone	Out of scope – no benefits for income from geographically mobile activities.
Vietnam	Distribution center and service center	Economic zones	Out of scope – no benefits for income from geographically mobile activities.
Vietnam	Distribution center and service center	Industrial parks/zones	Out of scope – no benefits for income from geographically mobile activities.

Source: UNCTAD, based on OECD (2023a).

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