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# **‘Extraterritoriality’ of Free Zones: The Necessity for Enhanced Customs Involvement**

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## **Abstract**

The expansion of Free Zones has been mainly driven by political decisions closely affiliated with national economic development strategies. In some countries Customs is the primary governmental authority that regulates and governs Free Zones, while in others Free Zones are governed by other authorities, with less involvement from Customs. Depending on the institutional set-up, the scope and degree of Customs control in Free Zones and the economic operations carried out there varies considerably from one Free Zone to another.

It has been pointed out by existing literature that Free Zones attract not only legitimate business but also illicit trade or other illicit activities that take advantage of the regulatory exemptions of Free Zones.

The objective of this paper is to provide an analysis of the current situation regarding Customs procedures/controls related to Free Zones.

## **Key words**

Free Zones, Special Customs Zones, Free Trade Zones, Special Economic Zones, Export Processing Zones, Free Ports, Revised Kyoto Convention, Customs procedure and Customs control.

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## Introduction

There has been a multitude of publications written on the topic of Free Zones by international organizations and business organizations, and academics. Many of them, such as those produced by the FIAS (2008), Gari (2011), or Tiefenbrun (2013), have dealt with this issue from an economic development perspective, typically identifying economic incentives offered by Free Zones and describing their impact on national economies.

Numerous papers have outlined the risks associated with Free Zones, along with economic benefits. Most of them, such as Crescoff et al. (2009) or Shadikhodjaev (2011), have dealt with the legality of Free Zones policies, particularly in relation to export subsidies as governed by the WTO Agreement. Several other papers, such as those produced by the FATF (2010), the ICC (2013), Viski et al. (2016), or the OECD (2018), have dealt with illicit activities that have been perpetrated by exploiting characteristics of Free Zones. Such illicit activities include money laundering, tax-evasion and trade in counterfeit goods or other illicit goods.

This paper deals with Customs-related aspects of Free Zones, considering both the associated benefits and risks. The risks primarily concern illicit trade that exploits key aspects of Free Zones.

Literature that focuses on risks associated with Free Zones, particularly illicit trade or other illicit activities, have several things in common. They tend to highlight the fact that supervision over cargoes/companies in Free Zones is somewhat relaxed in comparison with other parts of the national territory. The following factors have been pointed out or quoted, although details are rarely provided due to the technical nature of the topic.

- Relaxed controls inside Free Zones
- Insufficient Customs' involvement in the operation of Free Zones
- Ease in setting up companies inside Free Zones
- Insufficient integration of Information Technology(IT) systems by governmental agencies inside Free Zones

This paper's key observations fall in line with those outlined above. This paper describes the low-level involvement of Customs in monitoring cargo movement and companies' activities inside Free Zones. This includes Customs' low-level involvement at the establishment phase of Free Zones, at the approving companies permitted to operate in Free Zones phase, and during the day-to-day monitoring of cargoes in Free Zones. Limited Customs' authority inside Free Zones is also mentioned. This paper touches upon relaxed Customs procedures/controls related to Free Zones and observes that they stem from Customs' limited involvement and limited authority inside Free Zones. These limitations, combined with insufficient integration and utilization of IT, result in a lack of the requisite data concerning cargoes inside Free Zones, and render Customs' risk-management-based controls - conducted for the purpose of preserving security and compliance without hindering legitimate cargo flows - virtually useless.

The author considers the concept of 'extraterritoriality' concerning Free Zones, stemming from a misinterpretation of the definition of Free Zones contained in the WCO Revised Kyoto Convention (RKC), to be behind the aforementioned limited involvement by and limited authority of Customs. The definition within Annex D, Chapter 2 of the RKC does not state that Free Zones are geographically outside the Customs territory. The definition means that the Free Zone itself falls within the Customs territory. 'Goods' located in Free Zones are considered as being outside the Customs territory for duty/tax purposes only.

In addition to examining open-source resources, this paper offers an exclusive overview of the Customs-related features of Free Zones, based on the following sources:

- (i) Exclusive data on illicit trade cases related to Free Zones, reported by WCO Members through the Customs Enforcement Network (CEN)
- (ii) WCO workshops held on this issue: a regional workshop held in the Dominican Republic in August 2018 (South, North and Central America and the Caribbean region), a regional workshop held in Morocco in January 2019 (North of Africa, Near and Middle East region), and an inter-regional workshop held in May 2019 in Kazakhstan (Europe region, and Asia, Australasia and the Pacific Islands region)
- (iii) Fieldwork conducted between August 2018 and May 2019 in Customs administrations and Free Zones in a total of 11 countries located across six WCO regions
- (iv) A WCO online survey conducted in June 2018 with the objective of understanding the current situation of Customs procedures/controls related to Free Zones. The survey was addressed to WCO Members and resulted in responses by 61 Members.

For confidentiality reasons, the cases described in this paper will not be attributed to specific countries.

The first section of this paper outlines the definitions, characteristics and economic benefits of Free Zones from a Customs perspective.

The second section addresses the risks posed by Free Zones. The risks primarily concern illicit activities perpetrated by exploiting certain aspects of Free Zones perhaps unbeknownst to policy makers. In addition to illicit activities, such as money laundering, this paper will present some cases of illicit trade and describe their global and interregional nature. The effects of illicit activities on policies are also referenced.

The third section offers a detailed analysis of the current situation. The section describes the perceived 'Extraterritoriality' of Free Zones, which is a misinterpretation of the definition embedded by the RKC, and then outlines the resulting reduction in Customs' involvement and the insufficient authority they wield as a consequence, and the 'relaxed' Customs controls that pertain to Free Zones.

## 1. Characteristics and economic benefits of Free Zones

### 1.1 Definition and terminologies

The number of Free Zones in the world is considered to amount to thousands and to be increasing. The Facility for Investment Climate Advisory Services (FIAS) (2008) points out that the number of 'special economic zones' was only 79 in 1975, across 25 countries and has drastically increased to over 3,000 in 135 countries as of 2008. The International Labour Organization (ILO) (2014) reports that there were more than 3,500 'export processing zones' in the world as of 2014, and The Economist (2015) states that there were 4,300 'free trade zones' as of 2015. The WCO online survey, conducted in 2018 with 61 WCO Member respondents<sup>1</sup>, showed that the number of Free Zones adds up to over 2,300 in respondents' countries.

#### ***Definition and terminologies in existing publications***

A range of terminologies has been used to denote 'Free Zones' (hereinafter 'FZs') in existing publications and news reports, including 'free trade zones', 'special economic zones', 'export processing zones', 'free ports', 'special Customs zones', 'special Customs supervision areas', 'foreign trade zones', etc.

For example, the FIAS (2008) employs the general term, 'special economic zones', meaning 'geographically delimited areas administered by a single body, offering certain incentives (generally duty-free importing and streamlined Customs procedures, for instance) to businesses that physically locate within the zone'. The FATF (2010) and the OECD (2018) use the general term - 'free trade zones', and the ILO (2014) refers to the 'export processing zones'.

The FIAS (2008) categorises the term 'special economic zones' into four types:

- 'free trade zones': small, fenced-in, duty-free areas, offering warehousing, storage, and distribution facilities for trade, transshipment and re-export operations.
- 'export processing zones': industrial estates offering special incentives and facilities for manufacturing activities aimed mostly at export markets.
- 'free ports': this is a broader concept and accommodates all types of activities including not only trading, logistics, manufacturing but also tourism, retail sales, and residing.
- 'enterprise zones': intended to revitalize distressed urban or rural areas through provision of tax incentives and financial grants.

#### ***Definition in the Revised Kyoto Convention***

The only international convention that formally defines and procedurally regulates FZs is the 'International Convention on the Simplification and Harmonization of Customs Procedures', known as the 'Revised Kyoto Convention' (hereinafter called the 'RKC'), one of the WCO's flagship international conventions. The Specific Annex D, Chapter 2 of the RKC (hereinafter 'SAD2 of the RKC') offers the following definition:

*"free zone" means a part of the territory of a Contracting Party where any goods introduced are generally regarded, insofar as import duties and taxes are concerned, as being outside the Customs territory.*

To rephrase: 'goods' located in FZs are regarded as being outside the Customs territory<sup>2</sup> solely with respect to import duties/taxes.

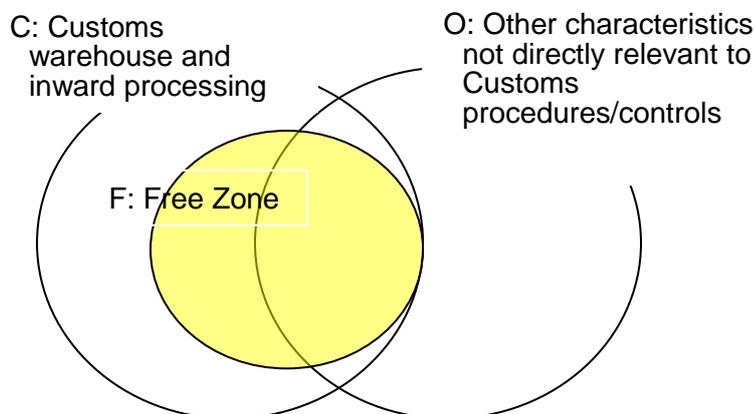
<sup>1</sup> The number of WCO Member Customs administrations as of August 2019 stands at 183.

<sup>2</sup> Chapter 2, General Annex of the RKC provides that 'Customs territory' means 'the territory in which the Customs law of a Contracting Party applies'.

## 1.2 Characteristics of Free Zones

FZs are characterized by certain features directly related to Customs procedures/controls, and others that are not directly related to them. The former comprise the characteristics derived by 'Customs warehouse' and 'Inward processing' (C in Figure 1-1) and the characteristics unique to 'Free Zones' under SAD2 of the RKC (F in Figure 1-1).

Figure 1-1: Categorization of the characteristics of zones



### ***Characteristics of 'Customs warehouses'***

To classify the characteristics of FZs directly related to Customs procedures/controls, the author selected the 'Customs warehouse' nomenclature. In this concept, import duties and other indirect taxes for goods brought into the zone from abroad are suspended as long as the goods stay inside the zone. Only when the goods are taken out of the zone into the domestic market or when the goods are consumed inside the zone, will importation be deemed to have occurred and the goods be subject to import duties or other indirect taxes. When the goods are taken out of the zone and moved abroad, duties/taxes will not be applied. This concept of deferral of indirect tax is set out in Specific Annex D Chapter 1 of the RKC ('Customs warehouse').

### ***Characteristics of 'Inward processing'***

Under the 'Inward processing' concept, import duties and other indirect taxes for goods brought from abroad/domestic market into the zone are exempted, on the condition that the goods are intended for specific processing and actual subsequent exportation of the processed goods (compensating products) abroad. This concept is outlined in the Specific Annex F, Chapter 1 ('Inward processing') of the RKC.

### ***Characteristics of 'Free Zones' under SAD2 of the RKC***

The characteristics of 'Free Zones' ('F' in Figure 1-1) could be interpreted as a developed form of the aforementioned concepts. They are outlined in Specific Annex D Chapter 2 of the RKC. SAD2 of the RKC lists 21 standards covering a wide range of Customs procedures related to the operations of FZs. Notable characteristics that are considered unique to FZs are listed below. (Table 1-2)

The first notable characteristic is that 'goods' inside FZs are regarded as being 'outside the Customs territory' in terms of import duties and taxes (definition in SAD2 of the RKC), whereas neither goods in Customs warehouses nor goods under the inward processing procedure are regarded as being 'outside the Customs territory'.

The second notable characteristic is that when goods are admitted into the zone, duty/tax is exempted without the fact or intention of actual exportation abroad and without provision of financial security (Standards 7 and 8, and Recommended Practice 10 of SAD2 of the RKC). In contrast, the Customs warehouses or inward processing concepts provide for a suspension of duty/tax based on the condition of the fact or intention of actual exportation, and sometimes based on the condition of a form of financial security (bond).

Internal indirect taxes are immediately exempted when cargoes enter into FZs on account of these two characteristics; there is no need to wait until exportation abroad takes place (Standard 8 of SAD2 of the RKC). The sale of goods by an entity in the domestic market to an entity inside FZs is regarded as an 'export' in terms of duties and taxes. This leads to FZs being recognized as 'tax free areas'.

It is noteworthy that goods in FZs are defined as 'being outside the Customs territory' beyond the duty/tax aspect in accordance with the provisions of certain national legislation. Such national legislation explicitly states that a sale by an entity in a domestic market to an entity contained within FZs is formally defined as an 'export'.

The third notable characteristic is that goods can stay for an unlimited duration inside the zone (Standard 14 of SAD2 of the RKC). In contrast, goods in Customs warehouses or undergoing Inward processing procedures are subject to a limited duration. This characteristic carries significant meaning when a high-value asset is stored for a long period of time and its ownership is frequently transferred without the payment of internal indirect taxes.

The fourth notable characteristic is that, in addition to logistics operations, processing/manufacturing operations typically take place inside FZs (Standard 12 and 13 of SAD2 of the RKC). For example, in addition to logistics operations such as storing, repacking, or relabeling, companies may bring in external materials and manufacture products. Accordingly, the scope of duty/tax exemption inside FZs covers materials and capital goods (equipment) consumed inside the zone.

### ***Characteristics not directly related to Customs procedures/controls***

Often economic incentives that are not directly related to Customs procedures/controls are included with FZs. The FIAS in its 2008 paper pointed to corporate income tax reductions, tax holidays, unrestricted repatriation of capital and profits, and unrestricted management of foreign exchange earnings as just some of the additional economic incentives associated with FZs. Similarly, Shadikhodjaev (2011) lists similar such incentives including:

- Fiscal incentives, such as tax holidays, rebates, reduced tax rates on corporate income profits, often linked to the export performance of companies or the share of exports in total production
- Relaxed legal and regulatory requirements on, for example, foreign ownership, labour, environment, foreign exchange, and lease/purchase of land
- Streamlined administrative services, such as single window or one-stop government services, and simplified licensing procedures
- Enhanced physical infrastructure such as enhanced access to logistical networks, telecommunications networks and utility services, residential housing, and service institutions

Table 1-2: Examples of notable characteristics of FZs and related zones

Types of characteristics	Examples of characteristics
C: Characteristics of 'Customs warehouse' consistent with Specific Annex D Chapter1 of the RKC (Customs warehouses)	Import duties and other indirect taxes on goods brought from abroad/domestic market into the zone are suspended, as long as the goods stay inside the zone. Suspension is typically based on provision of financial security (bond) to Customs.
C: Characteristics of 'Inward processing' consistent with Specific Annex F Chapter1 of the RKC (Inward processing)	Import duties and other indirect taxes on goods brought from abroad/domestic market are suspended if the goods are intended for manufacturing/processing and actual subsequent exportation of the processed goods (compensating products)
F: Characteristics unique to 'Free Zone' consistent with Specific Annex D Chapter2 of RKC (Free Zones)	Goods inside the zone are regarded as being 'outside the Customs territory' only in terms of duty/tax aspects (definition)
	Duty/tax exemption is applied upon entry into zone (Standard 8) - The entry of goods from domestic market to inside zone is regarded as an 'export' in terms of duty/tax - The fact or intention of actual exportation abroad is not prerequisite for duty/tax exemption
	Provision of financial security (bond) to Customs is not required when goods are admitted into the zone (Recommended Practice 10)
	Processing/manufacturing operations are allowed (Standard 12) Typically, exemption of duty/tax for materials and capital goods consumed inside the zone (Standard 13)
	Unlimited duration for goods to stay inside the zone (Standard 14)
O: Other notable benefits (not directly relevant to Customs procedures/controls)	Exemption of direct taxes, such as income tax or real estate tax
	Unrestricted use of foreign currency
	Unrestricted transfer of money abroad
	Unrestricted use of foreign workers

### 1.3 Economic benefits of Free Zones

The establishment and operation of FZs, typically accompanied by additional economic incentives, is an important part of the economic/industrial development policy of many countries.

Among the many papers outlining the economic benefits of FZs, the FIAS (2008) highlights: employment generation; export development and diversification; attracting foreign direct investment; increasing foreign exchange earnings; industrial upgrading and technology transfer; and workforce upgrading and skills development.

To cite another example, White (2011) outlines the economic benefits of FZs by dividing them into direct and indirect economic benefits, as follows.

- Direct benefits: directly and quantitatively affect current account and public finance developments of the host country, via employment generation, export growth, foreign exchange earnings, foreign direct investment, and increased government revenue.
- Indirect benefits: include organizational benefits (testing field for wider economic reforms, demonstration effect, export diversification), and technological capabilities and know-how (skills upgrading, technology transfer, and enhancing trade efficiency of domestic firms).

These economic benefits are just some of the positive aspects and expected outcomes of FZs policies.

## **2. Risks related to Free Zones**

If the economic incentives offered by FZs are well-known and oft discussed, so too are the negative aspects, which have been highlighted by many experts.

### **2.1 Use of export subsidy instrument**

According to academic papers, such as those by Torres (2007) or Creskoff et al. (2009), the economic incentives conferred by FZs may constitute an export subsidy, which is prohibited/actionable under the WTO Agreement on Subsidies and Countervailing Measures (ASCM).

The FZs' typical characteristics of deferral of import duties and indirect taxes for production materials do not constitute prohibited/actionable export subsidies because of the ASCM's explicit provision.<sup>3</sup> However, certain features of FZs, such as exemption of direct taxes (income taxes) or deferral of import duties and indirect taxes for capital goods (equipment) consumed inside FZs may be regarded as a prohibited/actionable export subsidy under the ASCM if such an exemption is specifically associated with the company's export performance.<sup>4</sup>

Since criteria for granting licences to companies to operate in FZs as tenants are typically based on the company's export value or percentage, such tax incentives may be contingent on export performance. This could entail a legal challenge mounted by importing countries or the imposition of countervailing duties on exported goods by importing countries if damage can be proven.

Although actual dispute cases involving FZs in this context are rare<sup>5</sup>, at least one case exists whereby the characteristics of a Free Zone were alleged to constitute an export subsidy as regulated under the ASCM, and the case has led to the establishment of a WTO panel<sup>6</sup> to investigate further.

### **2.2 Illicit activities related to Free Zones documented by various organizations**

There are inherent risks associated with the establishment of FZs, and although these might have escaped the attention of policymakers, they are now making headlines internationally. Civil society, international and commercial organisations have repeatedly claimed that FZs are not only utilized by legitimate economic actors for legal economic activities but also occasionally misused for illicit activities.

The International Chamber of Commerce (ICC)'s report from 2013 documented several anecdotal cases and alleged that FZs were being used as distribution/manufacturing facilities for counterfeit goods. The report revealed that, particularly in the context of transit and transshipment, the repacking/relabeling operations within FZs in combination with relaxed regulatory oversight were enabling the proliferation of counterfeit goods.

The Financial Action Task Force (FATF) (2010) introduced several money-laundering cases involving illicit trade. The report outlined several cases whereby bank accounts belonging to companies operating inside FZs were used for laundering proceeds of drug trafficking etc., and that the companies within FZs were involved. The report identified several

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<sup>3</sup> Annex II of the ASCM.

<sup>4</sup> For example, Torres, R. (2007), Creskoff, S., et al (2009), Shadikhodiaev (2011), OECD (2018)

<sup>5</sup> Shadikhodjaev, S. (2011).

<sup>6</sup> In this case (WT/DS541/1), the zone called 'special economic zone' is at issue.

factors as enabling FZ-related money laundering, including cash transactions inside FZs, lack of integration between FZ authorities and Customs’ IT systems, and lack of due diligence and compliance record checks at the initial admission phase of companies into FZs.

INTERPOL (2014), exploring several historical cases of tobacco smuggling, observed that a lack of clarity regarding the jurisdiction of Customs inside FZs, their responsibility and control inside FZs, and the relative ease with which legal entities inside FZs were established all contributed to making of the FZs an appealing ‘haven’ for illicit tobacco trafficking. The World Economic Forum (2012) raised the issue of FZs on its agenda and reiterated the need to combat money laundering and illicit trade. The United Nations Office on Drugs and Crime (2013) referenced several cases where FZs were misused for illegal wood products or electrical and electronic waste.

The Economist (2018) established indices index for assessing countries’ vulnerability to illicit trade and called it the ‘global illicit trade environment index’. Of the four indices, one index focused on ‘free trade zones’, based on case studies of five prominent FZs.

A partnership between the OECD and the European Union Intellectual Property Office in 2018 marked the first attempt to deliver a quantitative analysis regarding the relationship between FZs and counterfeit goods. The report’s analysis was based on data on seizures of counterfeit goods during the period 2011-2013, made by Customs primarily located in the European Union and the United States. The regression analysis used s180-336 observations as samples. The report outlined the positive correlations between the ‘export value of counterfeit goods’ as the dependent variable and the ‘existence of an EPZ’, ‘number of EPZs’ and ‘number of firms operating in EPZs’, meaning that each of these variables increased the export value of counterfeit goods. The report demonstrated that the correlations were statistically significant and robust, even excluding outlier data on China from which very large amounts of export value of counterfeit goods were observed<sup>7</sup>.

**Money laundering and its relationship to organized crime and terrorism**

Cases of money laundering related to FZs, or even involving organized crime or terrorist organizations, have been reported in existing literature. The FATF (2010) revealed nine cases where trade-based money laundering was perpetrated (Table 2-1). At least three reportedly involved companies operating inside FZs whose bank accounts served as receptors for laundered money used for terrorist financing. These cases further signify the importance of combating illicit activities exploiting FZs.

Table 2-1: Examples of cases mentioned by the FATF (2010)<sup>8</sup>

Summary of investigation findings
For proceeds of <u>cocaine sales by a Colombian drug syndicate to Hezbollah (Extremist organization) in Lebanon, bank accounts of several companies inside a FTZ (Colon Free Zone) were used as receiving point of the proceeds and laundering illicit money.</u> The report points out that the maintenance of import/export records was carried out manually and that there was a lack of integration between FTZ authorities and Customs’ IT systems-making detection even more difficult.
Tobacco worth US dollars (USD) 1 million in total, which had been brought from abroad and stored and repacked by company A inside FTZ I, was transferred to company B inside FTZ I, transported by sea to FTZ II, and then secretly imported into the domestic market without paying import duties. The proceeds were laundered through the purchase of real estates in the domestic market. The case involved forged trade documents and the 12 people <u>convicted turned out to be also involved in weapons and drug distribution associated with the Abu Sayyaf Group, a terrorist organization</u> based in the Philippines.
A key suspect in Euskadi Ta Askatasuna (ETA), a designated terrorist organization based in northern

<sup>7</sup> OECD (2018), p.50-51.

<sup>8</sup> Summary of cases is the author’s own work. The report uses the word ‘free trade zones’ (FTZ).

Spain, created a company based on electronics trading which operated inside a FTZ in Costa Rica. The company's bank account had been utilized for laundering the proceeds of illicit activities. The company had very little real trading activity, yet it received/sent money up to as much as 3 million euro within a 6-months period.

A company X was a textile trader operating inside a FTZ in Curacao and selling clothes to a company in Venezuela. It turned out that the company X's bank account was being used for laundering money for the proceeds of drug trafficking. The investigation resulted in the confiscation of millions of USD and euro in cash, which was not reflected in the company X's books, and revealed the use of a legitimate business as a receptor for drug-trafficking proceeds.

## 2.3 Cases of illicit trade related to Free Zones and reported by Customs

### *Detection and seizure cases related to FZs*

Cases of illicit trade in relation to FZs have also been reported to the WCO's Customs Enforcement Network (CEN) database<sup>9</sup>.

It is important to highlight that WCO Member administrations report seizure data to the CEN database on a voluntary basis. There might be many reasons a Customs administration may choose not to report certain portions or details of their data, including the need to maintain secrecy over ongoing investigations. From January 2011 to August 2018, 48 countries reported over 600 seizures in relation to FZs (over 1,300 when including an outlier) (Table 2-2)<sup>10</sup>. This is statistically insignificant to derive any robust conclusions, and the figures from the CEN database in this paper do not depict a comprehensive view of trends in illicit trade. Nevertheless, a few trends become notable even with such a restricted sample size :

Table 2-2: Reported seizures inside FZs: sorted by WCO regions to which the seizure country belongs\* (unit: no. of seizures)

Region	Seizure Country (FZs)						Total
	AMS	MENA	WCA	ESA	Europe	A/P	
	308	58	15	20	201	23	626

(source) WCO CEN data (Jan.2011- Aug.2018)

\* After excluding one unusually-large reporting country

Abbreviations:

'AMS': South America, North America, Central America, and the Caribbean region

'MENA': North of Africa, Near and Middle East region

'WCA': West and Central Africa region

'ESA': East and South Africa region

'Europe': Europe region

'A/P': Far East, South, and South East Asia, Australasia, and the Pacific Islands region

### *Global nature of illicit trade related to FZs*

<sup>9</sup> The WCO CEN was developed to assist the global Customs enforcement community in gathering data and information for intelligence purposes. This database acts as a central depository for enforcement-related information and depends on the voluntary steady flow of quality data provided by WCO Members. (for more information, please refer to:

<http://www.wcoomd.org/en/topics/enforcement-and-compliance/instruments-and-tools/cen-suite/cen.aspx>)

<sup>10</sup> Put more precisely, these are the cases whose seizure location was at a so-called 'free trade zone'.

The first notable trend observed is that seizures related to FZs are global in nature. Table 2-3 shows the number of seizures made at FZs of the reporting countries (seizure countries), sorted by departure country and seizure country. As can be seen from the table, seizures are globally distributed in that there are not only intra-regional seizures where departure country and seizure country belong to the same WCO region, but also multi-regional seizures where the departure country and seizure country belong to different regions. In more than 200 seizures, goods coming from AMS region were seized at FZs of AMS region, serving as an example of intra-regional trafficking. Many such intra-regional seizures are seen in the Europe and MENA regions also. Goods coming from A/P region were seized at FZs in Europe or in AMS regions, serving as an example of multi-regional trafficking.

Table 2-3: Reported seizures inside FZs: sorted by WCO regions to which the departure country and seizure country belong\* (unit: no. of seizures)

		Seizure Country (FZs)						Total
		AMS	MENA	WCA	ESA	Europe	A/P	
Departure country	AMS	242	1			6		249
	MENA		20		1	3		24
	WCA		1	14			2	18
	ESA				13			16
	Europe	12				97		109
	A/P	34	29	2		90	16	170
	Unknown	20	7		3	5	5	40
Total	308	58	15	20	201	23	626	

(source) WCO CEN data (Jan.2011- Aug.2018)

\* After excluding one unusually-large reporting country

\* Highlighted part: Intra-regional seizures where departure country and seizure country belong to the same WCO region. non-highlighted part: multi-regional seizures

\* intra-regional seizures include seizures in which the departure country and seizure country are different and those in which the departure country and seizure country are the same

Abbreviations: same as in Table 2-2

Conversely, Table 2-4 shows the number of seizures of goods coming from another country's FZs, sorted by departure country and seizure country. Similarly, not only intra-regional cases of trafficking but also multi-regional ones are seen. For example, goods coming from the A/P region's FZs were seized in the MENA region. Goods coming from the MENA region were seized in the Europe region.

Table 2-4: Reported seizures of goods coming from another country's FZs: sorted by WCO regions to which the departure country and seizure country belong \* (unit: no. of seizures)

		Seizure Country						Total
		AMS	MENA	WCA	ESA	Europe	A/P	
Departure country (FZs)	AMS	36				1		37
	MENA		13			3		16
	WCA			7				7
	ESA				1			1
	Europe		1			10		11
	A/P		9			2	2	13
Total	36	23	7	1	16	2	85	

(source) WCO CEN data (Jan.2011- Aug.2018)

\* Highlighted part: intra-regional seizures where the departure country and seizure country belong to the same WCO region. Non-highlighted part: multi-regional seizures

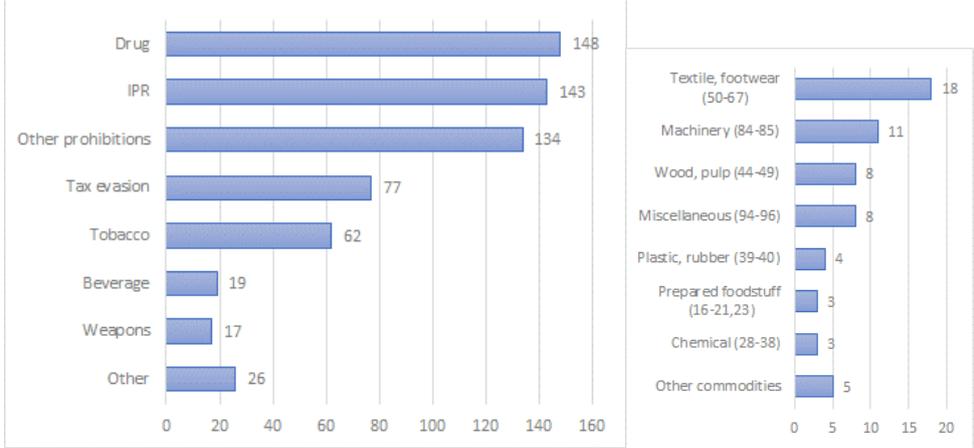
\* Intra-regional seizures include only seizures in which the departure country and seizure country are different

Abbreviations: same as in Table 2-2

**Variety in types of illicit trade related to FZs**

The second notable trend is that the types of illicit trade; these are not limited to tax evasion or IPR infringements, but are much more multifaceted. Figure 2-5 and Figure 2-6 show the aforementioned seizures reported to the CEN database and sorted by types of goods. Whether the illicit goods were seized at FZs of the reporting country (Figure 2-5) or seized for goods coming from another country's FZs (Figure 2-6), we can see various types of illicit trade ranging from tax evasion to smuggling of IPR-infringing goods, tobacco, drugs, weapons, CITES protected flora and fauna etc. Tax evasion cases, even excluding tobacco and beverage, encompassed various commodities.

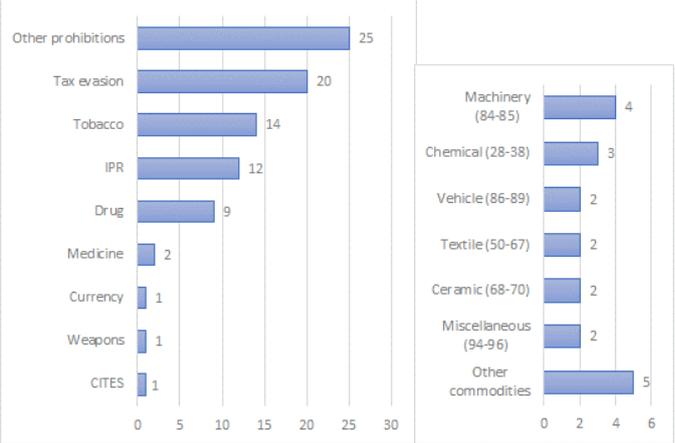
Figure 2-5: Reported seizures inside FZs (total of 626 seizures\*) (unit: no. of seizures)



(Breakdown of 'Tax evasion') \*

\* The numbers in brackets refer to the HS Chapters to which the commodities belong. (Source) WCO CEN data (Jan.2011- Aug.2018)

Figure 2-6: Reported seizures of goods coming from another country's FZs (total 85 seizures) (unit: number of seizures)

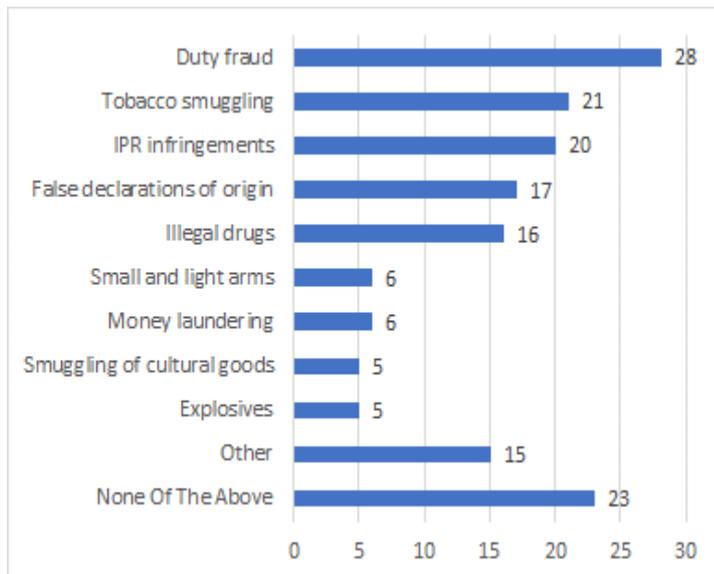


(Breakdown of 'Tax evasion') \*

\* The numbers in brackets refer to the HS Chapters to which the commodities belong. (Source) WCO CEN data (Jan.2011- Aug.2018)

Figure 2-7 shows part of the results of the WCO online survey conducted in 2018 addressed solely to WCO Members, to which 61 Members replied. Existence of illicit trade reported by the WCO Members was similarly various and consistent with the CEN data, ranging from duty fraud, drugs, IPR-infringements, origin fraud, drugs, arms, money laundering and smuggling of cultural objects.

Figure 2-7: WCO online survey (unit: no. of responding Members)



Question: 'What kinds of detection or seizure of illegal goods related to SCZs have you performed?'  
(respondents: 61 Members)

(Note) The term 'Special Customs Zones (SCZs)' is used to mean 'Free Zones' under SAD2 of the RKC  
(Source) WCO online survey conducted in June 2018

### ***Anecdotal examples of illicit trade***

Table 2-8 provides a description of reported cases. The cases listed here feature examples that were made available to the WCO Secretariat in the course of the online survey, WCO workshops and meetings, and field studies carried out in Customs administrations throughout 2018-2019.

Notably, not only commercial fraud such as tax-evasion or IPR-infringements, but also goods posing a safety and security threat such as drugs or pneumatic weapons were detected, as can be seen in cases A-15(drugs), A-16(drugs), A-17(drugs), A-18(pneumatic weapons), and B-4 (pneumatic weapons). Cases of IPR-infringing goods or fake tobacco are also demonstrated.

As can be seen in cases A-1 to A-6, instances of 'missing cargo' inside FZs are frequently observed. As an import declaration is required and duty/tax is levied when the goods exit the FZs to the domestic market, there is an incentive for traders to secretly bring the goods out of FZs into the domestic market without import declaration. This is especially true for goods for which high rates of import duties or indirect taxes are applicable. Occurrence of tax-evasion cases exploiting FZs is natural because import duties and taxes for goods located inside FZs are exempted/suspended.

In cases of A-15 and A-17, illicit drugs bound for consignees inside FZs were detected at entry to those FZs. These cases serve as a reminder of the importance of Customs' intelligence and monitoring of cargoes and companies inside FZs.

Notably, in the case of A-14, due to obfuscation as to which governmental agencies have responsibility over FZs, the right holders sought enforcement for goods that entered the domestic market. This fact deepens the complexity of FZs - 'segregated' as they are from other parts of the national territory - and necessitates the involvement of multiple governmental agencies.

In the cases of A-8, A-9, A-18, A-19, B-4, and B-5, three or more countries were involved in the chain of transit/transshipment operations, which underpins the complexity and

global nature of this issue and the necessity for intelligence sharing and international cooperation among Customs administrations.

The case of A-20 involved the manufacture of illicit goods (fake tobacco). In the case of A-7, where cargo stayed inside FZs and remained there until anti-dumping duties were lifted, a principal feature of FZs - unlimited duration for cargo - was exploited.

Table 2-8: Examples of actual cases<sup>11</sup>

	Types	Description	Source
A. Case at a FZ			
1	Tax evasion (Missing cargo)	Chemical manufacturers operating in an FZ had inventory of pesticide for re-export. At inspection, it turned out that the <u>pesticide had been replaced by water</u> and had been smuggled into the domestic market without an import declaration.	WCO workshop
2	Tax evasion (Missing cargo)	Companies operating in an FZ stored food supplement boxes. It turned out they had been <u>replaced</u> by beans, rice, and other tablets, and that they had been smuggled into the domestic market without a declaration. The tariff difference between the commodities was significant at 5-60%.	WCO workshop
3	Tax evasion (Missing cargo)	<u>Shortage of weight</u> of tobacco from a check of the balance of a plant's account book, which led to fines of over USD40,000. An on-site visit and comparison between the account book and physical inventory revealed the missing inventory.	WCO workshop
4	Tax evasion (Missing cargo)	Goods inside FZs were <u>found to be missing</u> after a routine Customs inspection of unreported processing/waste account books. The tax evaded was over USD 700,000.	WCO Member
5	Tax evasion (Missing cargo)	<u>Unauthorized removal</u> of raw materials of finished products to domestic market.	WCO online survey
6	Tax evasion (Missing cargo)	It turned out that the company <u>removed inventories of machine-parts from the FZ secretly</u> . This was detected through Customs' check utilizing previously-reported records kept in the Customs IT system. Duty/tax of over 70,000 USD were about to be evaded.	WCO workshop
7	Tax evasion (Anti-dumping duties)	A company brought goods from abroad and <u>stored them inside FZs to wait until anti-dumping duties were lifted</u> , without importation to the domestic market. The company <u>exploited the FZ's characteristic of unlimited duration for a cargo's storage in FZs</u> .	WCO workshop
8	Tax evasion (Tobacco)	Tobacco in a container coming from the Middle East, arrived at an FZ in Asia, bound for Europe. Risk analysis and intelligence exchange led to seizure of undeclared tobacco at a European country's Customs.	WCO Member
9	Tax evasion (Beverage)	<u>Unmanifested liquors</u> (combined with other commodities) were found. The good was detected in transshipment country A's FZ in Asia.	WCO Member
10	Tax evasion (Other)	The importer pretended to be a consumer eligible for a preferential rate of Customs duty/VAT for cross-border e-commerce*. Conspiracy between companies outside and inside the FZ. * In the country, cross-border e-commerce business utilizing the characteristic of suspension of import duties and indirect taxes may be conducted only in FZs.	WCO Member
11	IPR	Inspection and risk analysis led to the seizure of IPR (trademark)-infringing footwear inside FZs, totaling 25,000 pairs and USD 250,000.	WCO online survey
12	IPR	Detected entry of <u>counterfeit goods</u> infringing IPR or consumer-protection standards.	WCO online survey
13	IPR	<u>IPR-infringing</u> toothpaste and tobacco seized in FZs.	WCO workshop
14	IPR	Counterfeit machine-parts, which were manufactured in country A in Asia, came through an FZ in country B in the Middle East	IPR right holder

<sup>11</sup> This does not necessarily mean that the seizure took place during 2018-2019.

		and came to another FZ in country B for storage, were detected by Customs based on intelligence provided by the right holder. Due to <u>the obscurity in location of responsibility among governmental agencies inside the major FZs</u> , the right holder tend to give up enforcement on goods in the major FZs and tend to seek enforcement on goods in other parts of the country.	
15	Drug	Over 30kg of <u>heroin</u> was found from cargo at a port which was intended to enter a FZ next to port	WCO Member
16	Drug	80,000 tablets of <u>MDMA</u> tablets were seized inside an FZ	WCO Member
17	Drug	Over 100,000 pieces of medicines containing narcotic substances were seized. The consignee was a company inside a FZ.	WCO workshop
18	Pneumatic weapons	<u>Airsoft guns</u> from <u>country A</u> , having transited in a FZ of <u>country B</u> and bound for <u>country C</u> , were seized in <u>country B</u> . The goods were declared as another cargo.	WCO Member
19	CITES	Live animals under CITES regulation came from <u>country A</u> in Africa, transhipped at <u>country B</u> in Asia, and bound for <u>country C</u> in Asia, were seized at country B's FZ.	WCO Member
20	Manufacturing (Tobacco)	Genuine tobacco and <u>fake tobacco</u> (mixing wood carpentry) <u>manufactured in an FZ</u> were seized in the FZ. Half (genuine tobacco) was bound for the domestic market with tax-evasion intentions, while the other half (fake tobacco) was bound for export.	WCO Member
21	Disguising origin	<u>A bill of lading was reissued</u> and the shipment pretended to be originating in the FZs, thus the <u>real cargo flow was cut and masked, and origin was disguised.</u>	WCO workshop
B. Seizures of goods coming from another country's FZs			
1	Tax evasion (Tobacco)	Country A faces occasional cases of tobacco smuggling coming from an FZ in country B.	WCO Member
2	Tax evasion (Origin)	Goods transiting through a country's FZs sometimes obtain Certificate of Origin under the Greater Arab Free Trade Area (an international free trade agreement), <u>without substantial processing</u> , and thus free rides on the GA FTA preferential tariffs when imported.	WCO workshop
3	Tax evasion (Origin)	Fish exported from a country's FZs with a Certificate of Origin issued for preferential tariffs under the Economic Community of West African States (ECOWAS) FTA often does <u>not meet origin criteria</u> (fish obtained by ships registered in non-Party countries) and thus free rides on the ECOWAS FTA.	WCO meetings
4	Pneumatic weapons	Nearly 200 <u>pneumatic weapons</u> (air/gas) were detected at <u>country C</u> . The goods were stored in <u>country A's</u> FZ, came through <u>country B</u> via land border, and were bound for an importer operating in country C.	WCO Member
5	Other	Chicken originating in <u>country A</u> , and stored in a FZ of <u>country B</u> , came to an FZ in <u>country C</u> , where the packaging was changed and the expiry date was extended before being exported to <u>country D</u> (unsecure area). The goods were detected in the FZ of country C.	WCO Member

## 2.4 Effects of illicit activities on Free Zones policies

In Europe, the issue of FZs is particularly prominent. The business of providing secure storage facilities for high-value cultural objects exists by benefiting from the FZs' characteristics of duty/tax exemption and unlimited duration of stay for cargoes. The context is the diversification of private investors' portfolios in the wake of the global financial crisis and the nature of cultural objects as financial assets with transactions taking place regardless of their physical location. It has been reported that high-value cultural objects are stored on a permanent basis in several FZs and that ownership is easily transferred to subsequent owners and, according to mass media reports, some transactions have been used for

laundering illicit proceeds.<sup>12</sup> Additionally, it has been pointed out that such cultural objects include those that were stolen and smuggled from conflict areas.<sup>13</sup>

In light of the allegations of money laundering, illicit trafficking of cultural objects, and other illicit activities exploiting FZs, the European Commission's July 2019 report explicitly designated FZs<sup>14</sup> as one of the new risk factors for money laundering and terrorist financing. Furthermore, a report from the European Parliament published in March 2019 outlined that the motivation for using FZs included a high degree of secrecy and deferral of import duty and indirect taxes. The report even proposed the 'urgent phasing down' of the system of FZs in the European Union.<sup>15</sup>

It is not only the European Union where illicit activities in FZs affect policies. Switzerland, to cite but one example, amended its Customs Act in 2007 and strengthened supervision by Customs over goods stored in FZs, given the allegations that FZs in the country had been utilized for stolen cultural property.<sup>16</sup>

It is not only Europe; one country in Asia, which is not a Contracting Party of SAD2 of the RKC, following several tax-evasion cases in FZs typical characteristics of FZs have changed. The unlimited duration of stay of cargoes inside FZs became 'limited', and the frequency of transfer of ownership of cargoes inside FZs became reduced in order to prevent such misuse of FZs.

### **3. Observation and analysis**

Given the occurrence of illicit activities exploiting FZs, possible enabling factors for illicit trade or illicit activities need to be examined.

#### **3.1 Limited explicit recognition of Free Zones by international legal frameworks for countering illicit trade**

In general terms, FZs have not been explicitly captured by existing international conventions which substantively regulate illicit trade.

As can be seen in Figure 3-1, international conventions for countering illicit trade have not typically made explicit provision for goods inside FZs be covered by the scope of the regulations. Although such illicit goods may be captured by certain existing regulations on transit/transshipment operations, still, not all international conventions are regulating transit/transshipment of illicit goods.

One peculiar example is the United Nations Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, which entered into force in 1990, and which explicitly captures FZs as being within its scope of regulation<sup>17</sup>. The convention's explicit provision is unique in that it states that measures to be adopted inside FZs should be 'no less stringent' than measures to be adopted in other parts of the national territory.<sup>18</sup>

There are other examples of international conventions explicitly encompassing FZs within their regulatory scope, such as the Anti-Counterfeiting Trade Agreement, or the Intellectual Property chapter of the Comprehensive Progressive Trans-Pacific Partnership

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<sup>12</sup> See for example, EPRS (2018) and Gisler, J. (2016).

<sup>13</sup> See for example, Gisler, J. (2016).

<sup>14</sup> The report dated 24 July 2019. The report uses the word 'free ports'.

<sup>15</sup> Paragraph 211 of the report dated 26 March 2019. The report uses the word 'free ports'.

<sup>16</sup> Gisler, J. (2016).

<sup>17</sup> The words 'free trade zone' and 'free port' are used in the legal text without definitions.

<sup>18</sup> Article 18.

Agreement (Table 3-1), however, they are either not yet in force or still involve a limited number of Contracting Parties.

The situation, whereby FZs have not been explicitly addressed in international conventions, i.e. international binding agreements, is also true for the international non-binding agreements. Among the four major international non-binding agreements which regulate dual-use goods possibly used for the proliferation of weapons of mass destruction (WMD)<sup>19</sup>, only the Wassenaar Arrangement explicitly captures FZs in its guidelines. Others do not directly address FZs although they do refer to transit and transshipment.<sup>20</sup>

There has been a recent exception, however, to this situation. The Protocol to Eliminate Illicit Trade in Tobacco Products (Table 3-1), which has entered into force in 2018, explicitly provides for effective controls over illicit tobacco in FZs. It is notable that the convention uses the definition of FZs contained in the RKC.

Table 3-1: Examples of international conventions regulating specific types of illicit trade

Convention	EIF <sup>21</sup>	CP <sup>22</sup>	Regulate Import	Regulate Export	Regulate Transit/Transshipment	Regulate activities in FZs
UN Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances	1990	190	O	O	O	O
Arms Trade Treaty	2014	102	O	O	O	X
CITES (Convention on International Trade in Endangered Species of Wild Fauna and Flora)	1973	149	O	O	O	X
Basel Convention on the Control of the Transboundary Movement of Hazardous Wastes and their Disposal	1992	187	O	O	O	X
UNESCO 1970 Convention on the means of prohibiting and preventing the illicit import, export and transfer of ownership of cultural property	1972	137	O	O	X	X
Stockholm Convention on persistent organic pollutants	2004	182	O	O	X	X
TRIPS (Agreement on Trade-Related Aspects of Intellectual Property Rights)	1995	163	O	O (voluntary)	X	X
ACTA (Anti-Counterfeiting Trade Agreement)	-	11	O	O	O (voluntary)	O
Intellectual Property chapter of CPTPP (Comprehensive and Progressive Agreement for Trans-Pacific Partnership)	2018	11	O	O	O	O
ITP (Protocol to Eliminate Illicit Trade in Tobacco Products)	2018	52	O	O	O	O

<sup>19</sup> The four major international non-binding rules on WMD referred to here are the Nuclear Supplier's Group, the Australia Group, the Wassenaar Arrangement, and the Missile Technology Control Regime.

<sup>20</sup> Viski, A. et al. (2016).

<sup>21</sup> Year of entry into force of the convention.

<sup>22</sup> Number of Contracting Parties as of June 2019.

### **3.2 Non-adherence to Chapter 2, Specific Annex D of the Revised Kyoto Convention**

When it comes to international conventions and procedural aspects of FZs, the RKC is the sole international convention regulating the Customs procedures pertaining to FZs.

The RKC, currently numbering 119 Contracting Parties, is a blueprint for modern Customs procedures and is aimed at developing predictable and transparent Customs procedures based on the use of information technologies, risk management, and a coordinated approach to controls along with other governmental agencies, and partnerships with trade, among other things. The RKC consists of three parts: the text, a General Annex with 10 Chapters, and 10 Specific Annexes. The entire General Annex is binding on Contracting Parties and no reservations are possible with respect to its implementation. Specific Annexes of the RKC consist of Standards and Recommended Practices. Contracting Parties may accept one or more of the Specific Annexes as well as submit reservations to Recommended Practices.

Provisions under the RKC carry significant weight; not only is the RKC the sole international convention extensively covering Customs procedures, but also its provisions or definitions have also been extended to and thus copied by other international conventions and domestic legislations.

SAD2 of the RKC lists 21 Standards covering a wide range of Customs procedures related to operations on FZs. Among them are several provisions – the implementation of which is particularly important. For example, Standard 4 stipulates that Customs ‘shall have the right to carry out checks at any time on the goods stored in FZs.’ Its Recommended Practice 6 stipulates Customs controls on goods in FZs and operations on the grounds of public morality, public security, public hygiene or health, and veterinary or phytosanitary considerations, or the protection of patents, trademarks and copyrights. While the Recommended Practice 6 leaves the Contracting Parties room for interpretation of these operations, it does cover the major aspects of the regime of prohibitions and restrictions. If controls are exercised by another agency on behalf of Customs, they should not be neglected.

Standard 4 is to be interpreted together with Standard 3, which states that ‘the Customs shall lay down the arrangements for Customs control, including appropriate requirements as regards the suitability, construction and layout of free zones.’ The engagement of Customs authorities from the early stages in developing the FZs concept is necessary to ensure safety, security, efficiency and trade facilitation within the zone.

Currently, out of the 119 Contracting Parties to the RKC, only 26 are Contracting Parties to SAD2. Out of those 26, some 20 are fully adhering to SAD2, and 6 are adhering to SAD2 with reservations concerning several Recommended Practices. Participation by Customs administrations in SAD2 is important, particularly to ensure necessary Customs controls related to FZs, as has been pointed out by several existing papers<sup>23</sup>.

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<sup>23</sup> See for example, ICC (2013), Viski, A. et al. (2016), The Economist (2018).

### 3.3 The concept of Free Zones being ‘outside Customs territory’: misinterpretation of the RKC

In SAD2 of the RKC, FZs are defined as ‘a part of the territory of a Contracting Party where any goods introduced are generally regarded, insofar as import duties and taxes are concerned, as being outside the Customs territory.’

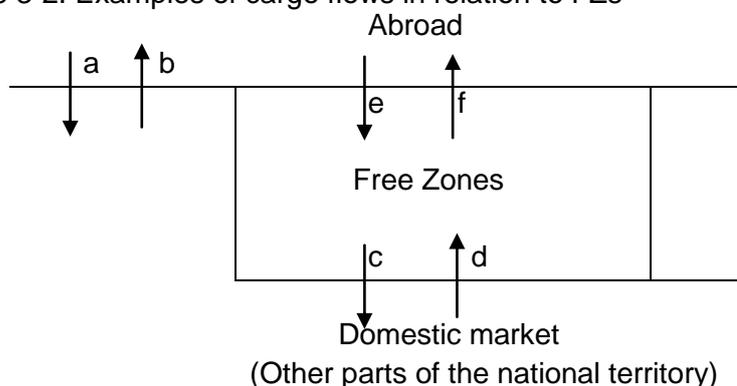
Notably, the definition does not state that FZs are geographically outside the Customs territory. The definition indicates that a FZ itself falls within the Customs territory where Customs law applies, and this is similar to some national/regional legislations, such as the European Union’s legislation<sup>24</sup> to cite one example.

The definition contained in the RKC specifies that ‘goods’ located in FZs are regarded as being outside the Customs territory solely for the purpose of applying import duties and taxes. This is the idea behind one of the main characteristics of FZs, as previously explained in 2.2, that internal indirect tax is exempted immediately upon cargo’s entry into the FZs from the domestic market without waiting until actual exportation abroad.

The FZs’ denomination pertains exclusively to the duty/tax exemption aspect. The correct meaning of the definition under SAD2 of the RKC is that FZs form part of the Customs territory where Customs law applies and that all non-tariff Customs activities, such as border control functions, including inspections, document-examinations, audits and seizures, should be preserved and enforced.

It has been observed that, in the national legislation of several countries, FZs are formally defined as being ‘outside the Customs territory’ without being limited to duty/tax application. In such countries, sales by entities in the domestic market to entities in FZs (‘d’ in Figure 3-2) tend to be formally defined as ‘Exports’ (and defined as ‘Import to Free Zones’ in several countries). Similarly, it is common in many countries that sales by entities in FZs to entities in the domestic market (‘c’ in Figure 3-2, import for consumption) are defined as ‘Imports’ (and defined as ‘Export from Free Zones’ in several countries). In several countries’ national legislation, the application of usual Customs controls over goods in FZs is explicitly excluded.

Figure 3-2: Examples of cargo flows in relation to FZs



Interpreting FZs as being ‘outside the Customs territory’ is a misinterpretation of the definition of FZs under SAD2 of the RKC. Likewise, interpreting that goods inside FZs are considered as being outside the Customs territory altogether, and not only in terms of duty/tax application, is also a misinterpretation. Although this misunderstanding may initially appear unproblematic, it has broader implications.

<sup>24</sup> For example, article 243 of the Union Customs Code provides ‘Member States may designate parts of the customs territory of the Union as free zones’.

The concept of a FZ's own 'extraterritoriality' and 'segregation' from the Customs territory actually seems to be leading to the concept of an 'extraterritorial free-area' which is free from, and where there is a rejection of, usual Customs controls. This could result in reduced Customs' involvement in monitoring cargo movements inside FZs and relaxed Customs controls inside FZs, as will be explained in 3.4 and 3.5.<sup>25</sup>

Indeed, for example in Switzerland, as was outlined in 2.4, in the wake of allegations that FZs were being used for storing stolen cultural heritage, the amended Customs Act in 2007 defined FZs as being 'part of the Customs territory', even though FZs had been excluded from the Customs territory prior to the introduction of the amendment.

**3.4 Customs' insufficient involvement and authority**

***Low level of Customs' involvement***

FZs are established and operated from an economic/industrial policy perspective. Typically, ministries governing economic/industrial development or zone authorities play a leading role in establishing the zone or approving the companies starting to operate in the zone. Customs are usually less involved.

According to the WCO online survey conducted in June 2018 (Table 3-3), almost 40% (36%) of Member administrations are not involved in the establishment of FZs, and more than 40 % (43%) of Member administrations are not involved in approving the applications by companies that apply to operate inside the FZs.

Table 3-3: WCO online survey result (respondents: 61 Member administrations)

Questions	Number of the responses
Do you have SCZs in your country?	Yes: 44
What administrative body governs the SCZ regimes?	Customs administration: 21 (47.7%) Others (special body governing SCZs or ministry for economic development): 21 (47.7%)
Is the Customs administration involved in the approval process of SCZs and/or their operating body?	Yes: 27 (61.4%) No: 16 (36.4%)
Is your Customs administration involved in the approval process of companies which will conduct daily business activities in SCZs?	Yes: 23 (52.3%) No: 19 (43.2%)
Are there any partnership programmes such as Authorized Persons/Authorized Economic Operators (AEO) applicable to the operating bodies or companies conducting business activities in the SCZs?	Yes: 19 (43.0%) No: 21 (47.7%)

(Note) The term 'Special Customs Zones (SCZs)' is used to mean 'Free Zones' under SAD2 of the RKC (source) WCO online survey, June 2018.

Consistent with such statistics, Customs' insufficient involvement in establishing FZs or approving companies that operate in FZs was actually observed in many instances during WCO workshops and field studies conducted in 2018-2019. In many countries, Customs - an administration that would certainly have expertise on configuring the appropriate layout/construction inside FZs in terms of smooth and secure cargo flows in FZs - is not represented at the stakeholders' table with regard to the establishment of FZs. Customs

<sup>25</sup> For example, under several countries' national legislation, goods prohibited for importation ('c' in Figure 3-2) are not always regulated with regard to bringing goods into FZs ('e' in Figure 3-2) or placing goods inside FZs, especially with respect to goods which are not absolutely-prohibited at import and which can be imported with licences.

administrations, with expertise and experience in monitoring cargo movements and companies' activities without hindering legitimate cargo flow based on risk-management techniques, are not involved in approving companies that operate in FZs. Even in countries where Customs is endowed with sufficient authority to reject approval of companies hoping to operate in FZs, it is rare in reality that Customs conducts substantive record checks of applicants and rejects applications.

The ease of setting up entities inside FZs has been highlighted by several existing papers<sup>26</sup> as one enabling factor for illicit trade or other illicit activities. Customs' failure to conduct risk-based controls and failure to conduct checks for non-compliance records of applicants could become a significant enabling factor for illicit trade related to FZs. Particularly given the fact that organized crime or even terrorist organizations have been involved in illicit activities inside FZs as was mentioned in 2.3, Customs involvement at the stage of approval of companies is of critical importance.

One possible method of efficiently managing cargoes and companies inside FZs could be by applying the concept of 'Authorized Economic Operators (AEO)'. According to the WCO online survey, 43% of administrations are applying AEO frameworks to companies operating inside FZs, but such administrations number less than half of respondents. In one country, Customs has not applied an AEO framework to companies inside FZs because the ministry in charge of commerce has jurisdiction and the situation is deemed different to that of other companies in other parts of the country.

### ***Limitation of Customs' authority inside FZs***

There is one important provision in SAD2 of the RKC in terms of Customs' authority. Namely, 'The Customs shall have the right to carry out checks at any time of the goods stored in a free zone' (Standard 4). Customs has authority of this kind in many countries. According to the WCO online survey (Table 3-4), among the respondents that have FZs on their territory, 100% of the respondents answered that they have the authority to physically inspect goods inside of FZs.

However, discussions during WCO workshops and observations during the course of field studies revealed the actual situation of limited Customs' authority inside FZs. In several countries, Customs officers cannot even enter FZs without obtaining prior approval from a FZ authority. In several countries, Customs officers cannot even enter FZs without a concrete suspicion of illicit trade. In one country, which is a Contracting Party to SAD2 of the RKC, Customs has no authority to revoke companies' rights to operate in FZs, particularly those accused of perpetrating smuggling activities within FZs, which would be the authority naturally endowed to Customs in the case of Customs warehouses.

Customs' insufficient authority can be inferred and observed from the findings of the WCO online survey (Table 3-4). Although the number of respondents is small, approximately 20% of responding Customs administrations have no authority to obtain periodical reports from companies in FZs. Approximately 20% of responding Customs administrations have no authority to audit companies inside FZs.

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<sup>26</sup> FATF (2010).

Table 3-4: WCO online survey result (respondents: 61 Members)

Questions	Number of the responses
Do you have SCZs in your country?	Yes: 44
Does the Customs administration have the authority to carry out the following in SCZs? (Physical inspection of goods in SCZs)	Yes: 44 (100%)
Does the Customs administration have the authority to carry out the following in SCZs? (Detection or seizure of illegal goods in SCZs)	Yes: 38 (86.4%) No: 6 (13.6%)
Does the Customs administration have the authority to carry out the following in SCZs? (Requiring of periodical reports from companies in SCZs)	Yes: 35 (79.5%) No: 9 (20.5%)
Does the Customs administration have the authority to carry out the following in SCZs? (Audit of companies conducting business activities in SCZs)	Yes: 34 (77.3%) No: 10 (22.7%)

(Note) The term 'Special Customs Zones (SCZs)' is used to mean 'Free Zones' under SAD2 of the RKC (source) WCO online survey in June 2018.

### 3.5 Relaxed Customs procedures/controls and insufficient IT integration

#### *Relaxed Customs procedure/control inside FZs*

In several open-source publications, it has been pointed out that relaxed Customs procedures/controls inside FZs are the possible enabling factors for illicit activities inside FZs<sup>27</sup>. The following is the interpretation by the author on Customs procedures/controls related to FZs.

The first interpretation is that Customs has authority to inspect cargo only at entry to and exit from FZs. Customs has no authority to inspect cargo movement inside FZs or has no authority to monitor companies' activities inside FZs, as was outlined in 3.4. As a consequence, Customs are inevitably unaware about certain important pieces of information, such as what cargo is coming in/going out/being left, and who the companies are. As a result, Customs controls, which are primarily based on risk management will lose their effectiveness and become more relaxed.

The second interpretation is simplified declaration/reporting requirements imposed for cargo entry coming from abroad to FZs ('e' in Figure 3-2) or cargo exit from FZs going abroad ('f' in Figure 3-2). In several countries, as the entry of cargo from abroad to FZs does not yet constitute importation, a goods declaration for such cargo movement is not required, as was explained in 3.3. This is considered to be a common situation in several countries, as SAD2 of the RKC assumes such reduced declaration requirements and recommends that no goods declaration is required for the entry of cargo from abroad to FZs as long as information is already available on other trade documents<sup>28</sup>.

During the WCO workshops and field studies conducted in 2018-2019, it was observed that such declaration/reporting requirements ('e' and 'f' in Figure 3-2) vary significantly country-by-country and varies depending on the geographical location of FZs and ports. In numerous countries, a goods declaration to Customs is not required for a cargo's entry from abroad to FZs ('e' in Figure 3-2) and exit from FZs to abroad ('f' in Figure 3-2), in contrast to the case of Customs warehouses entry/exit for which declaration is required. In one country, for cargoes entering to FZs from abroad ('e' in Figure 3-2), a goods declaration to Customs is required only when cargo comes from a land border, and a goods declaration is not required when cargo enters FZs from the sea, apart from the cargo manifest submitted by carriers.

<sup>27</sup> See for example, ICC (2013), Viski, A. et al. (2016), OECD (2018),

<sup>28</sup> Recommended Practice 9 of SAD2 of the RKC provides that 'No goods declaration should be required by the Customs in respect of goods introduced into a free zone directly from abroad if the information is already available on the documents accompanying the goods.'

Several Members, during the course of WCO workshops and field studies, positively evaluated the current provision of exemption of goods declaration requirements for goods' entry to FZs from abroad ('e' in Figure 3-2), as this is critical for trade facilitation. On the other hand, it is noteworthy that one country in the European Union came to require goods declarations for these cargo movements ('e' and 'f' in Figure 3-2) based on its national legislation in response to alleged illicit activities perpetrated inside FZs.<sup>29</sup>

In addition to reduced goods declaration requirements, other procedures are also simplified, compared with goods in Customs warehouses or under inward processing, in a manner that is unique to each country. (Table 3-5).

Table 3-5: Examples of simplified Customs procedures/practices inside FZs

Types of characteristics	Examples of characteristics of FZs (in comparison with goods in Customs warehouses or under the inward processing procedure)
Notable characteristics of FZs under SAD2 of the RKC	<u>Goods declaration is not required for the cargo's entry from abroad to FZs/exit from FZs to abroad as long as cargo information is available from trade documents</u> (Recommended Practice 9 and 18 of SAD2)
	<u>Security is not required for the cargo's entry to FZs</u> (Recommended Practice 10 of SAD2)
	<u>Bookkeeping (stock-keeping and accounting) for cargo movement is not required inside FZs</u> , while required inside Customs warehouses (Standard 4 of SAD1 of RKC) *Standard 4 of SAD1 of RKC 'The arrangements for storage of goods in Customs warehouses and for stock-keeping and accounting shall be subject to the approval of the Customs.'
	<u>Unlimited duration for goods to stay inside FZs</u> (Standard 14 of SAD2 of the RKC)
Characteristics unique to each country (simplification of Customs procedure/practice)	<u>Reduced frequency</u> , or 'bundled' nature, of <u>import declaration</u> for companies operating inside FZs compared with the other companies
	<u>For entry from abroad to FZs ('e' in Figure 3-2) and exit from FZs to abroad ('f' in Figure 3-2), declaration to Customs is not required</u> . On the other hand, when it comes to entry into/exit from Customs warehouses, declaration to Customs is required.
	<u>Simplified supervision of inventory bookkeeping</u> : contract-level bookkeeping (which is usual for goods in Customs warehouses or under the inward processing procedure) is not required (only company-level book-keeping is required). Once reported as a whole, raw materials consumption in every consumption phase is not required
	<u>Simplified supervision of inventory bookkeeping</u> : registration of expected per-unit material consumption (which is usually required in for goods in Customs warehouses or under the inward processing procedure) is not required inside FZs
	<u>Simplified supervision of inventory bookkeeping</u> : bookkeeping is required only for designated sensitive goods, while required for all goods in Customs warehouses
	Final products or materials <u>can be selected as taxable standard</u> in case of manufacturing inside FZs and import into domestic market
	E-commerce business utilizing the characteristic of suspension of import duties and indirect taxes may be conducted only inside FZs
	Employing a specified expert* (which is mandatory in case of Customs warehouses) is not required *Accredited expert called 'bonded goods caretaker' unique to the country

The third interpretation is that there is no limit on the duration of stay for cargoes inside FZs.

As was outlined in 1.2, a cargo can stay inside FZs for an unlimited duration without paying duties and indirect taxes, even if the cargo is transferred from one company to another and the transfer-chain continues repeatedly, as long as the cargo stay within the FZs physically. Coupled with Customs' inability to build a profile on companies inside FZs, this might affect Customs control negatively. In one country which is not a Contracting Party to SAD2 of the RKC, due to illicit trade cases exploiting this characteristic, the duration for cargo

<sup>29</sup> EPRS (2018).

stay inside FZs became limited in 2016 and even the frequency of transfer of cargo became restricted, as was explained in 2.4.

The fourth interpretation is an undisclosed practice that might be implemented by Customs or the FZ authority. Typically countries offer significant economic incentives to companies in FZs such as income tax exemption, as explained in 1.2. Such a favourable attitude to investors in FZs might be affecting practice-level policies by Customs or the FZ authority, such as reduced frequency of inspection, audit or verification when companies operating inside FZs are involved. These practices are usually kept confidential and not disclosed.

### ***Insufficient Information-Technology integration/utilization***

When FZs are governed by authorities other than Customs, Customs usually have limited access to the cargo management system which is operated by FZ authorities. A shortage of data on cargo movements and company operations inside FZs will hinder Customs' risk management, which is reliant on data. It would be desirable that Customs have full access to such data managed by FZ authorities, and that it be integrated with Customs' existing data stored in the Customs' own IT system, and create an environment where Customs can utilize data to conduct effective controls over cargoes and companies to preserve security and compliance without hindering legitimate cargo flows.

Furthermore, a sufficient level of IT-utilization should be in place on the same basis as in other parts of the national territory. Without question, electronic processing of reporting/declarations is important, because that will provide the audit trails and enhance traceability on the government side, which will, in turn, prove more convenient for traders. During the course of the various WCO workshops and field studies, the necessity for processing, and keeping records of, declarations and reporting of trade documents in electronic formats for both Customs and traders was emphasized. Paper-based processing was observed in particular in some small-sized FZs where the number of operating companies was limited. This also pertains to the point made by several publications<sup>30</sup> that cash transactions inside FZs is one enabling factor of illicit activities.

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<sup>30</sup> See for example, FATF (2010).

## Conclusions

FZs are an important part of the economic development policy of the host countries, and legitimate businesses have enjoyed the economic benefits offered by FZs. By contrast, instances of misuse of FZs by illegitimate businesses, or illicit trade or illicit activities perpetrated inside FZs, have been reported. Strengthening security and compliance inside FZs, while maintaining the benefits of FZs, is crucial.

Customs' involvement in the operation of FZs tends to be low-level. At the inception stage, Customs is not sufficiently involved in the establishment of FZs, and is not sufficiently involved in approving companies that operate in FZs from the compliance point of view. In the day-to-day operations of FZs, due to Customs' insufficient possession and utilization of data and the resultant weakened risk management, Customs controls inside FZs inevitably becomes 'relaxed'. As the basis of Customs' enforcement in FZs, Customs' authority inside FZs tend to be limited. In some countries, Customs' role is to conduct enforcement only at entry to/exit from FZs and it is not even allowed to enter FZs without concrete suspicion of illicit trade.

Behind Customs' insufficient involvement in the operation of FZs prevails the perception of 'extraterritoriality' of FZs. If the definition of FZs under SAD2 of the RKC, namely 'a part of the territory of a Contracting Party where any goods introduced are generally regarded, insofar as import duties and taxes are concerned, as being outside the Customs territory' is simply interpreted as meaning that the FZ itself is 'outside the Customs territory', then this is a misinterpretation. Additionally, if the definition is interpreted as meaning that goods located in FZs are considered as being 'outside the Customs territory' altogether, including non-duty/tax aspects, this is also a misinterpretation. The definition laid down by the RKC merely states that 'goods' located in FZs are regarded as being outside the Customs territory solely for the purpose of applying import duties and taxes, and means that an FZ itself falls within the Customs territory, where Customs law should apply, and the usual Customs controls should therefore be applicable and be fully enforced.

It would be necessary for such misinterpretations be cleared up, for the sake of safe and secure FZs and their healthy development. It would also be appropriate that further discussion on possible international tools on Customs procedures/controls be based on the correct understanding of the definition and other findings of this paper.

Additionally, even though Customs possesses little information at present due to its limited involvement, at operational level, it would be appropriate for Customs to endeavour to obtain the necessary information for controlling the movement of goods. It would be appropriate that international cooperation among Customs administrations towards sharing of available intelligence related to FZs and its utilization for risk management be further strengthened, including reporting cases of illicit trade through the WCO CEN.

## Annex 1: Abbreviations

AEO	Authorized Economic Operator
CEN	Customs Enforcement Network
EPZ	Export Processing Zone
FATF	Financial Action Task Force
FIAS	Facility for Investment Climate Advisory Services
FTZ	Free Trade Zone
FZ	Free Zone
HS	Harmonized Commodity Description and Coding System
ICC	International Chamber of Commerce
IPR	Intellectual Property Rights
OECD	Organization for Economic Co-operation and Development
RKC	Revised Kyoto Convention (International Convention on the Simplification and Harmonization of Customs Procedures)
SAD2 of the RKC	Chapter 2, Specific Annex D of the Revised Kyoto Convention
ASCM	Agreement on Subsidies and Countervailing Measures
SCZ	Special Customs Zone
WCO	World Customs Organization
WTO	World Trade Organization

### (Abbreviations for WCO regions)

A/P	Far East, South, and South East Asia, Australasia, and the Pacific Islands region
AMS	South America, North America, Central America, and the Caribbean region
ESA	East and South Africa region
Europe	Europe region
MENA	North of Africa, Near and Middle East region
WCA	West and Central Africa region

Annex 2: Provisions of Chapter 2, Specific Annex D (SAD2) of the RKC

Category	Article No.	Text of provisions
-	Definition	'free zone' is 'a part of the territory of a Contracting Party where any goods introduced are generally regarded, insofar as import duties and taxes are concerned, as being outside the Customs territory.'
1.Principle	Standard 1	The Customs regulations applicable to free zones shall be governed by the provisions of this chapter and, insofar as applicable, by the provisions of the General Annex.
2.Establish-ment and Control	Standard 2	National legislation shall specify the requirements relating to the establishment of free zones, the kinds of goods admissible to such zones and the nature of the operations to which goods may be subjected in them.
	Standard 3	The Customs shall lay down the arrangements for Customs control including appropriate requirements as regards the suitability, construction and layout of free zones.
	Standard 4	The Customs shall have the right to carry out checks at any time of the goods stored in a free zone.
3.Admission of Goods	Standard 5	Admission to a free zone shall be authorized not only for goods imported directly from abroad but also for goods brought from the Customs territory of the Contracting Party concerned.
	Recomm-ended Practice 6	Admission to a free zone of goods brought from abroad should not be refused solely on the grounds that the goods are liable to prohibitions or restrictions other than those imposed on grounds of : <ul style="list-style-type: none"> <li>- public morality or order, public security, public hygiene or health, or for veterinary or phytosanitary considerations; or</li> <li>- the protection of patents, trade marks and copyrights,</li> </ul> irrespective of country of origin, country from which arrived or country of destination. Goods which constitute a hazard, which are likely to affect other goods or which require special installations should be admitted only to free zones specially designed to receive them.
	Standard 7	Goods admissible to a free zone which are entitled to exemption from or repayment of import duties and taxes when exported shall qualify for such exemption or repayment immediately after they have been introduced into the free zone.
	Standard 8	Goods admissible to a free zone which are entitled to exemption from or repayment of internal duties and taxes when exported shall qualify for such exemption or repayment after they have been introduced into the free zone.
	Recomm-ended Practice 9	No Goods declaration should be required by the Customs in respect of goods introduced into a free zone directly from abroad if the information is already available on the documents accompanying the goods.
	4.Security	Recomm-ended Practice 10
5.Authorized operations	Standard 11	Goods admitted to a free zone shall be allowed to undergo operations necessary for their preservation and usual forms of handling to improve their packaging or marketable quality or to prepare them for shipment, such as breaking bulk, grouping of packages, sorting and grading, and repacking.
	Standard 12	Where the competent authorities allow processing or manufacturing operations in a free zone, they shall specify the processing or manufacturing operations to which goods may be subjected in general terms and/or in detail in a regulation applicable throughout the free zone or in the authority granted to the enterprise carrying out these operations.
6.Goods consumed within the free zones	Standard 13	National legislation shall enumerate the cases in which goods to be consumed inside the free zone may be admitted free of duties and taxes and shall lay down the requirements which must be met.
7.Duration of stay	Standard 14	Only in exceptional circumstances shall a time limit be imposed on the duration of the stay of goods in a free zone.
8.Transfer of Ownership	Standard 15	The transfer of ownership of goods admitted to a free zone shall be allowed.
9.Removal of Goods	Standard 16	Goods admitted to or produced in a free zone shall be permitted to be removed in part or in full to another free zone or placed under a

		Customs procedure, subject to compliance with the conditions and formalities applicable in each case.
	Standard 17	The only declaration required for goods on removal from a free zone shall be the Goods declaration normally required for the Customs procedure to which those goods are assigned.
	Recomm-ended Practice 18	Where a document must be produced to the Customs in respect of goods which on removal from a free zone are sent directly abroad, the Customs should not require more information than already available on the documents accompanying the goods.
10.Assess-ment of Goods	Standard 19	National legislation shall specify the point in time to be taken into consideration for the purpose of determining the value and quantity of goods which may be taken into home use on removal from a free zone and the rates of the import duties and taxes or internal duties and taxes, as the case may be, applicable to them.
	Standard 20	National legislation shall specify the rules applicable for determining the amount of the import duties and taxes or internal duties and taxes, as the case may be, chargeable on goods taken into home use after processing or manufacturing in a free zone.
11.Closure of free zone	Standard 21	In the event of the closure of a free zone, the persons concerned shall be given sufficient time to remove their goods to another free zone or to place them under a Customs procedure, subject to compliance with the conditions and formalities applicable in each case.

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