

Research Paper
'Extraterritoriality' of Free Zones:
The Necessity for Enhanced Customs
Involvement

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WORLD CUSTOMS ORGANIZATION

Resource

- Publications consulted
- CEN data (2011 Jan. ~ 2018 Aug.)
 - Seizures made at FZs
 - Seizures of goods coming from another country's FZs
- Workshops/Field studies (Aug. 2018 ~ May 2019)
 - Regional workshops in AMS region (Aug. 2018), MENA region (Jan.2019), Europe and A/P region (May 2019)
 - Field studies to 11 countries covering 6 WCO regions
- WCO online Survey (Jun. 2018)
 - 61 responding Members from 6 WCO regions. 44 members have FZs, in total 2,320 FZs

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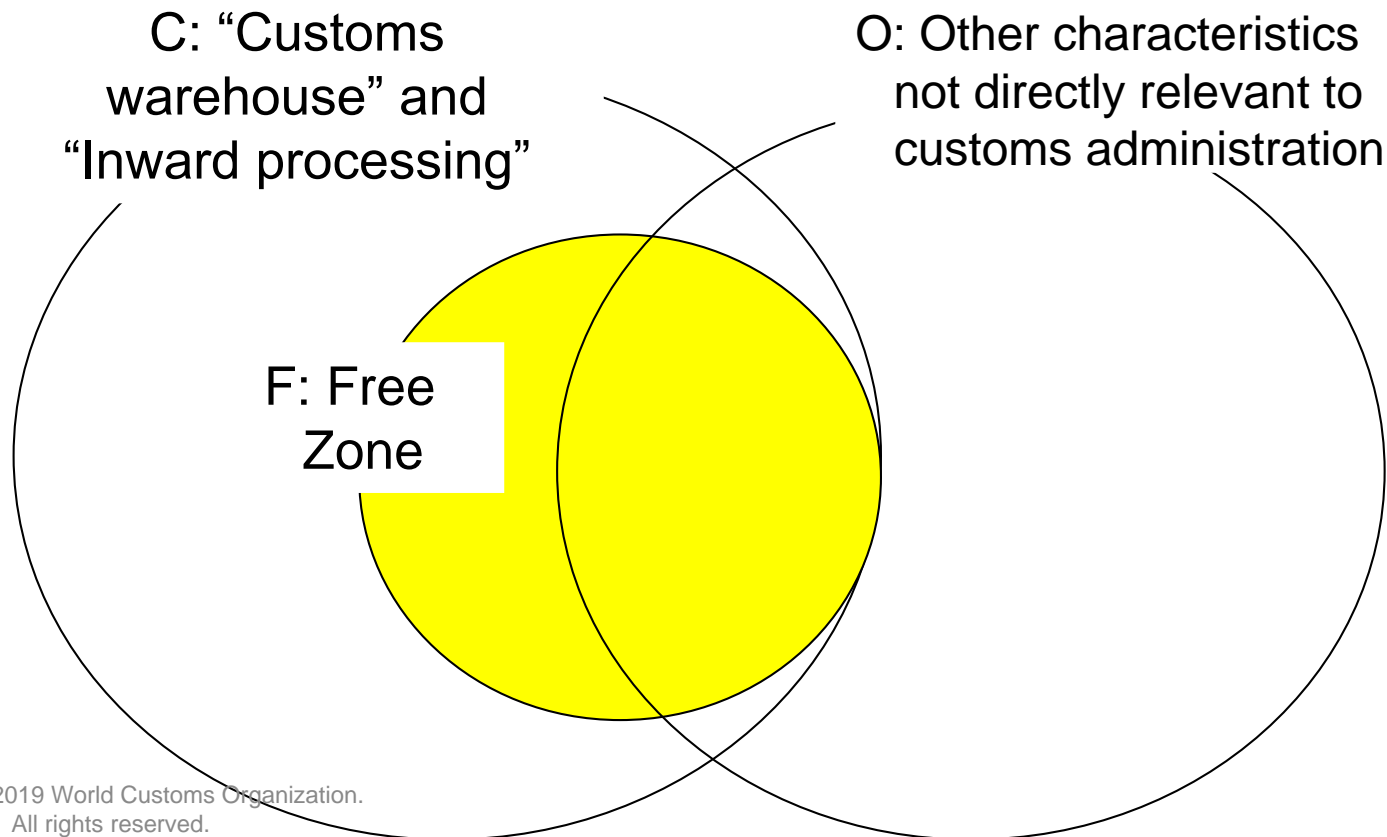
III. Observation and analysis

I. Characteristics and economic benefits of FZs (Publications consulted)

- Multitude of publications written on topic of FZs by international organizations, business organizations, and academics.
- Many of them have dealt with this issue from an economic development perspective, typically identifying economic incentives offered by FZs and describing their impact on national economies. (e.g., FIAS (2008), Gari (2011), or Tiefenbrun (2013))

I. Characteristics of FZs

- FZs has ***characteristics directly relevant to Customs*** procedure/controls (C, F), and often in addition, ***characteristics not directly relevant to Customs*** procedure/control (O)



C: characteristics of "Customs warehouse" (Annex D 1 of RKC) and "Inward processing" (Annex F1 of RKC)

F: characteristics unique to FZs (Annex D2 of RKC) : ***a developed form of "Customs warehouse" "Inward processing"***

O: Other characteristics (e.g., Exemption of income tax, Unrestricted use of foreign currency/worker, Unrestricted transfer of money abroad)

I. Characteristics of FZs: directly relevant to Customs procedures/controls

	Examples of characteristics
C: characteristics of “Customs warehouse” (RKC SA D1)	<u>Suspension of import duties and other indirect taxes</u> on goods brought from abroad/domestic market into the zone. Typically based on provision of financial security (bond) to Customs.
C: characteristics of “Inward processing” (RKC SA F1)	<u>Suspension of import duties and other indirect taxes</u> on goods brought from abroad/domestic market, if the goods are intended for manufacturing/processing and actual subsequent exportation of the processed goods.
F: characteristics unique to FZs (RKC SA D2)	<p>Goods inside the zone are regarded as being ‘outside the Customs territory’ only in terms of duty/tax aspects (definition)</p> <p><u>Duty/tax exemption</u> is applied upon entry into zone (Standard 8)</p> <ul style="list-style-type: none"> - 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 <p><u>Provision of financial security (bond) to Customs is not required</u> when goods are admitted into the zone (Recommended Practice 10)</p> <p><u>Processing/manufacturing operations are allowed</u> (Standard 12)</p> <p>Typically, <u>exemption of duty/tax for materials</u> and capital goods consumed inside the zone (Standard 13)</p> <p><u>Unlimited duration for goods to stay inside the zone</u> (Standard 14)</p>

I. Economic benefit of FZs

Based on the both characteristics (directly and not directly relevant to Customs procedure/control), it is assumed that FZs generate economic benefits, including trade facilitation.

e.g., FIAS (2008) points to:

- Export development and diversification
- Employment generation
- Attracting foreign direct investment
- Increasing foreign exchange earnings
- Industrial upgrading and technology transfer
- Workforce upgrading and skills development

II. Risks pertaining to FZs: Illicit activities (Publications consulted)

- Various publications have pointed out illicit activities exploiting FZs
e.g. OECD & EUIPO (2018), The Economist (2018), Viski et al. (2016), INTERPOL (2014), ICC (2013), FATF (2010) etc.
- Publications focusing on illicit activities have several things in common; tend to highlight the fact that *supervision over cargoes/companies in FZs is relaxed in comparison with other parts of the national territory*, including the following factors :
 - Relaxed controls in FZs
 - Insufficient Customs' involvement in the operation of FZs
 - Ease in setting up companies inside FZs
 - Insufficient integration of IT systems by governmental agencies in FZs
- E.g., in EU, the allegations (by mass media reports etc) led to designation of FZs as a new “Risk Factor” for money laundering. *EU parliament report even proposed “urgent phasing out” of FZs.*)

II. Risks pertaining to FZs: Illicit activities (Publications consulted)

	Main points made
OECD & EUIPO (2018)	<ul style="list-style-type: none"> quantitative analysis on relationship between FZs and counterfeit goods. outlined the <u>positive correlations</u> between the <u>'export value of counterfeit goods'</u> as the dependent variable and the <u>'existence of a FZ', 'number of FZs' and 'number of firms operating in FZs'</u>, meaning that each of these variables increased the export value of counterfeit goods.
The Economist (2018)	<ul style="list-style-type: none"> established indices for assessing countries' vulnerability to illicit trade. Of the four indices, one index focused on 'free trade zones', based on case studies of five prominent FZs.
Viski et al. (2016)	<ul style="list-style-type: none"> among the four major international non-binding agreements which regulate dual-use goods possibly used for proliferation of WMD, most do not explicitly capture FZs in its guidelines (except Wassenaar arrangement) outlined several historical cases of illicit trade
Interpol (2014)	<ul style="list-style-type: none"> exploring historical cases of tobacco smuggling, pointed out a <u>lack of clarity regarding the jurisdiction of Customs inside FZs</u>, their responsibility and control inside FZs, and <u>relative ease with which legal entities inside FZs were established</u>
ICC (2013)	<ul style="list-style-type: none"> documented anecdotal cases and alleged that <u>FZs were being used as distribution/manufacturing facilities for counterfeit goods.</u> 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.
FATF (2010)	<ul style="list-style-type: none"> introduced <u>cases in which tenants in FZs were related to money laundering or even terrorism.</u> identified several factors as enabling FZ-related money laundering, including cash transactions inside FZs, <u>lack of integration between FZ authorities and Customs' IT systems</u>, and <u>lack of due diligence and compliance record checks at the initial admission phase of companies into FZs.</u>

II. Risks pertaining to FZs: Seizures reported to CEN

- In WCO CEN database too, existence of illicit trade is observed.
- **Over 600 reported seizures made at FZs (over 1,300 after excluding an outlier) during the period of 2011~ 2018 Aug.**
 - *Depend on reporter's ticking the word 'free trade zone' when reporting seizures
- Unable to derive robust conclusion with this statistically insignificant data; the CEN reporting is for intelligence purpose
- However, even with this restricted sample size, **Global nature and Variety of illicit trade associated with FZs are notable**

Unit: Number of cases

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

II. Risks pertaining to FZs: Seizures reported to CEN

- Seizure made at FZs
- Global nature is observed: not only Intra-Regional seizures, but also **Multi-Regional seizures***

*Seizure for goods coming from outside the region where the seizure country belongs

Unit: Number 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: CEN data (2011 ~ 2018 Aug.)

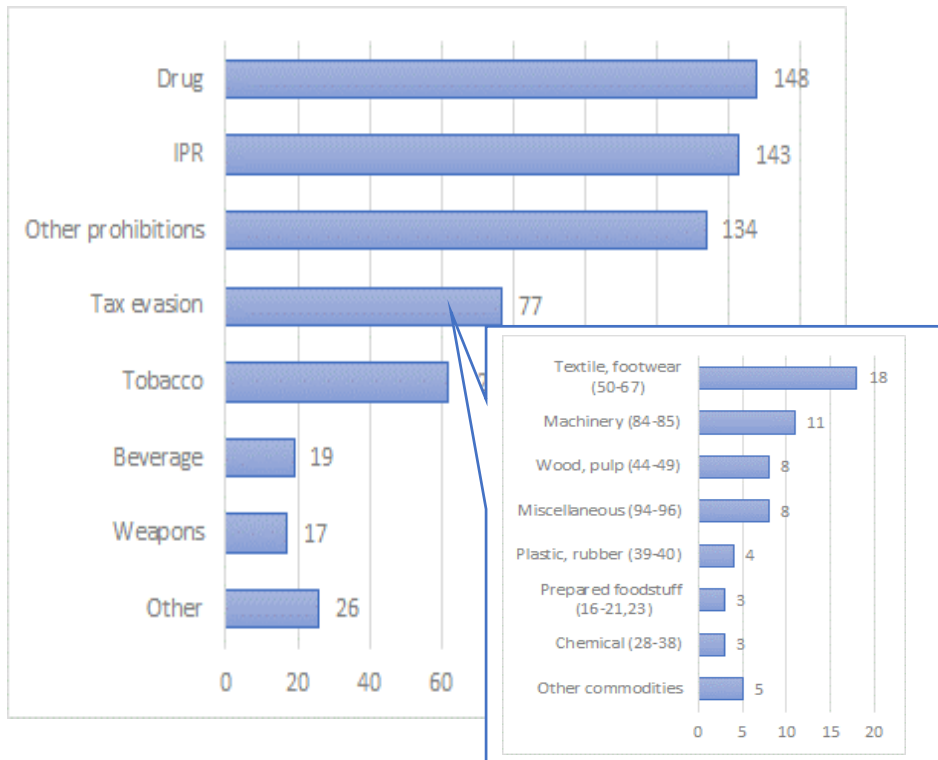
II. Risks pertaining to FZs: Seizures reported to CEN

- Variety in types of illicit trade is also notable: e.g., tax evasion, IPR, drugs, weapons, cultural goods, money laundering

CEN data

Reported seizures made at FZs (total 626 seizures*)(unit: # of seizures)

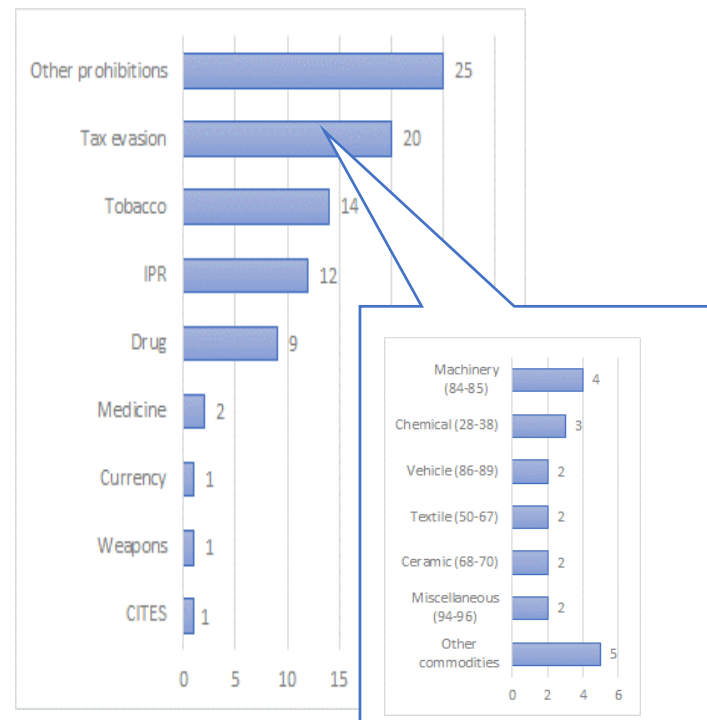
*After excluding one unusually-large reporting country



Source: CEN data (2011 ~ 2018 Aug.)

CEN data

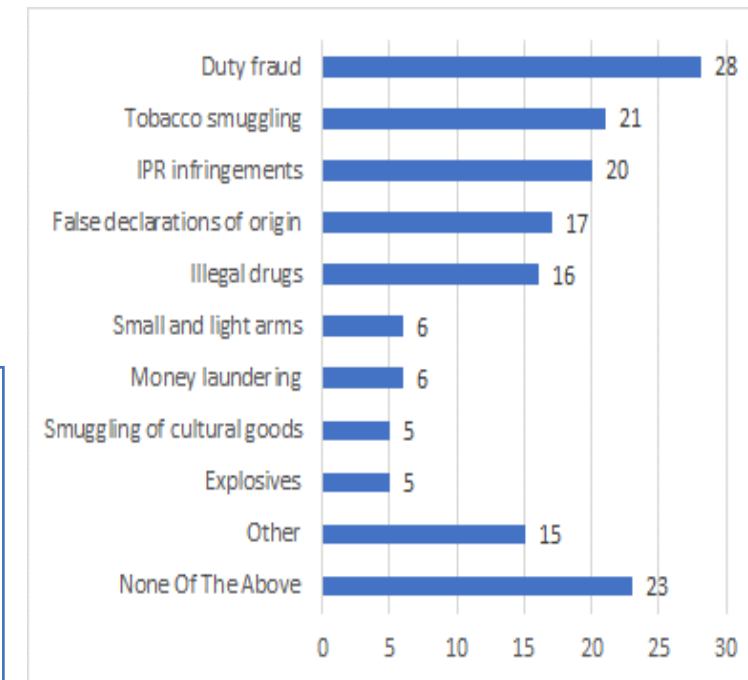
Reported seizures of goods coming from another country's FZs (total 85 cases)(unit: # of seizures)



Source: CEN data (2011 ~ 2018 Aug.)

WCO Online Survey

(unit: # of responding Members)



Question: 'What kinds of detection or seizure of illegal goods related to FZs have you performed?' (responses out of 61 responding Members)

III. Observation & analysis

Exploring enabling factors for illicit trade:

- Limited explicit recognition of FZs by international rules
- Non-adherence to SAD2 of RKC
- The concept of “Extraterritoriality” of FZs: misinterpretation of RKC
→ The incorrect impression results in situation observed as below
- Customs’ low-level involvement and insufficient authority related to FZs
- Relaxed Customs controls related to FZs; and insufficient IT integration/utilization

III. Observation & analysis: “Extraterritoriality” misconception

- In several countries, FZs are formally regarded as outside the Customs territory; although this itself may initially appear unproblematic, it has broader implications
- In several countries’ legislation, application of usual Customs controls over goods in FZs is even explicitly excluded

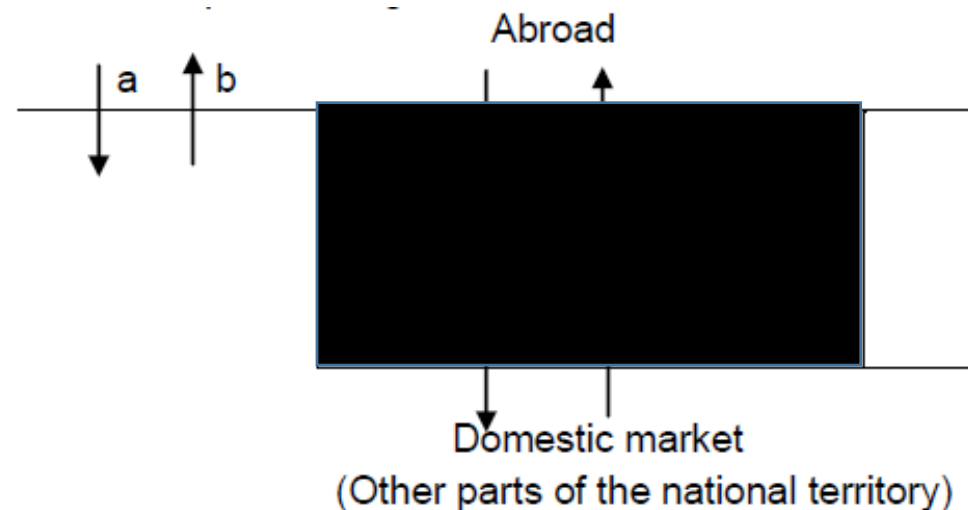
→ If goods in FZs are considered as “out of Customs controls” (including inspections, document examinations, audits, seizures) altogether due to the concept of “extraterritoriality”, then this will become problematic

Observation & analysis: Insufficient involvement & authority

- Customs' involvement related to FZs is at low-levels
 - Often Customs is ***not represented at a board to decide on establishment of FZs; not involved in approving/screening tenants*** starting to operate in FZs
 - Result of WCO online survey to Members:
 - Almost 40% are not involved in establishing FZs (16 out of 44), or in approving tenants in FZs (19 out of 44)
 - Half are not applying AEO-type program to companies in FZs (25 out of 44)
- Customs' authority related to FZs is insufficient
 - Sometimes ***with only authority to inspect at entry to/exit from FZs***; cannot enter FZs without concrete suspicion
 - Sometimes without authority to revoke license of tenants who perpetrated smuggling; FZs authority has such authority
 - Result of WCO online survey to Members:
 - More than 20% of members have no authority to require periodical reports from companies inside FZs (9 out of 44 respondents)
 - More than 20% of members have no authority to conduct audit on companies inside FZs (10 out of 44)

Observation & analysis: Implication

- Customs' authority is limited to only at entry to/exit from FZs
 - Customs are inevitably unaware of what cargo is coming in/going out/being left, and who companies are; missing requisite data for risk management; less opportunity for onsite check



If without requisite data for risk management, FZs might become a **“blackbox”**

Thank you

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- The research paper is available at:

http://www.wcoomd.org/-/media/wco/public/global/pdf/topics/research/research-paper-series/47_free_zones_customs_involvement_omi_en.pdf?la=en (English version)

- Please provide the comments for the Free zone guidance :

to

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