

4. Enforcement Challenges in Countering Illicit Trade in Free Trade Zones (FTZ)

This chapter examines the role of FTZs in facilitating illicit trade and other illicit activities. It offers policy based analysis and understanding of the challenges posed by FTZs, and examines the implications for the institutional capacities to counter illicit trade.

4.1. Overview and conclusions

The benefits that FTZs can provide to economies are at risk when zones are used for criminal purposes; it is therefore important that governments take action to combat illicit activities. The benefits are particularly important for developing economies that are seeking to attract foreign investment and promote ports as logistics and trade hubs; for these countries, zones can help to strengthen their presence in global value chains (Siroën, 2017^[79]).

The analysis in this chapter draws significantly on findings from discussions among law enforcement experts of the Task Force on Countering Illicit Trade (TF-CIT).¹ In this context, experts recognised the economic benefits of FTZs as they represent a valuable tool in certain economies for enhancing global trade integration, global value chains and economic growth. FTZs can have a “catalytic effect”, attracting foreign direct investment, while boosting employment and providing other benefits. FTZs have also proven to be able to deliver tangible gains in terms of reduced clearance times for goods.

However, experts have also noted that the gains from reduced customs presence in FTZs can offer opportunities for illicit trade. There is a risk that, without additional transparency and oversight, the economic benefits from FTZs could be jeopardised. There is evidence from recent joint OECD-EUIPO research on counterfeit trade routes that counterfeit trade is often routed through economies that rely extensively on FTZs. In support of work on FTZs, customs administrations, multilateral law enforcement bodies and trade associations have provided information that highlights the growing body of evidence that certain FTZs are being used as routing, assembly and distribution hubs for illicit trade.

In addition to the significant participation from member countries and TF-CIT experts and stakeholders, the findings in this section also benefit from the 2016 OECD illicit trade survey (see Box 1.1 in Chapter one).

This chapter analyses the institutional capacities of governments to stop illicit trade both in domestic FTZs, and for goods arriving from foreign zones; it seeks to provide a global understanding of the legal and regulatory shortfalls that exist, and identify the policies and good practises (both international and national) that could be adopted to strengthen institutional capacity to combat the illicit trade.

Free Trade Zones facilitate trade by providing certain advantages to business with respect to tariffs, financing, ownership, taxes and other regulatory measures that would otherwise be applicable in the host country. The reduction in regulatory and legal burdens, “red-tape” and tariffs are key in this regard. Some FTZs have become major trade hubs and have attracted important foreign direct investment (FDI) (Yücer and Siroën, 2017^[80]). However, the rapid multiplication in the number of FTZs and the continued lack of a common set of standards, framework or definition has led to important challenges with respect to trade facilitation and security. This chapter shows that illicit trade, and other forms of criminality, such as fraud and money laundering, are relying on the opaque nature of FTZs to further the interest of bad actors, by allowing them to carry out illicit business, at lower risk. Without further actions from governments to increase transparency and oversight in FTZs, criminal elements will continue to infiltrate some of these zones to exploit shortcomings in institutional law enforcement capacities.

4.1.1. Definition

FTZs are designated areas that lie outside the customs jurisdiction in the economies concerned and are not subject to customs duties and taxes that would otherwise apply to imported merchandise (OECD, 2008_[2]). In addition FTZs often include exemptions from certain revenue regulations, labour laws and financial regulations (OECD, 2007_[81]).

The scope and nature of FTZs vary across countries, depending on the regime and the types of activities allowed within such zones. FTZs can, for example, also be referred to as, among other things, free zones, free ports, special economic zones, export processing zones, single factory export processing zones. This report uses the term “free trade zone” to refer to a broad range of designated areas which receive preferential customs treatment.

Table 4.1. Zone Typologies and Descriptions known to be Special Economic Zones

Type of Zone	Objective	Description	Markets	Examples
Free Trade Zone (FTZ)	Support trade	Also known as commercial free zones, these are clearly delimited areas (fenced-in, duty free), offering warehousing, storage and other services aimed at boosting import-export	Domestic, Re-Export	Colon FTZ, Panama; Jebel Ali FTZ, UAE
Export Processing Zone (EPZ)	Export and manufacturing	Industrial clusters offering incentives and facilitation of manufacturing and other activities for export	Mostly Export	Chittagong EPZ, Bangladesh
Freeport	Integrated development	Large territories that provide broad incentives and benefits that can also include residents on the site.	Domestic, internal and export	Aqaba Special Economic Zone, Jordan
Single Factory EPZ	Export manufacture	Incentives are provided to a specific company or enterprise, rather than a geographic location	Export market	Mexico Maquiladoras

Source: (OECD, 2017_[82]); (World Bank, 2008_[83]).

According to the World Bank, the rationale for establishing zones vary among countries; they may be set-up to support broad economic reforms, and may reflect a component of a strategy to diversify exports while maintaining other trade barriers for the host economy, which may continue to value protectionism. FTZs can also provide sources of employment for countries, and may serve as “experimental laboratories” to test out new policies without broader national consequences (Box 4.1). Finally, as mentioned above, FTZs can be used to attract FDI (World Bank, 2008_[83]). FTZs are also known to benefit economies through a “catalytic effect”, creating backward and forward linkages between the FTZs and the rest of the economy, and enhancing integration into the global value chains, and other spill-overs (Yücer and Siroën, 2017_[80])². The zones are also known to facilitate greater labour mobility and education, infrastructure improvements, and enhanced competition (OECD, 2007_[81]).

The most commonly identified regulatory exemption of FTZs is the indemnity or deferral from payment of duties and taxes. This can help to facilitate trade because they reduce costs and red tape for parties seeking to re-export the goods. Commercial trade activities permitted within FTZs vary; they can include manufacture, assembly, repackaging and re-labelling, and re-export (Daudpota, 2006_[84]). For trade in physical goods, the benefits of FTZs for host economies are generally seen as i) increasing emphasis on export-oriented growth, ii) increasing emphasis on FDI-oriented growth and/or iii) helping to promote a country’s integration into global value chains (OECD, 2007_[85]). Other activities related to

trade in services, banking, and even gambling take place in certain zones. Other FTZs are known to be storage warehouses for high value goods. It is generally acknowledged that while goods passing through FTZs are exempt from many policies, goods that subsequently enter into the economy of the host country are taxed and regulated accordingly. Examples of exemptions in FTZs (Torres, 2007_[86]) can include:

- Total exemption from import duties and taxes (often meaning no declaration is required or verified).
- Total exemption from direct taxes; exemptions from sales taxes and VAT.
- Exemption from national incorporation laws and regulations (including joint venture requirements and other FDI regulations).
- Exemption from certain labour laws and national standards.
- Exemption from financial reporting requirements.

Box 4.1. Impact of FTZs on the Western Balkans

A study completed by the OECD in 2017 on the impact of FTZs in the Western Balkans notes that these zones accounted for over EUR 2.2 billion of investment in Serbia, accounting for EUR 2.4 billion in turnover and employing 2,000 persons, while accounting for 17.8% of national exports in 2015. In the former Yugoslav Republic of Macedonia, FTZ exports accounted for 36.4% of all exports (OECD/EUIPO, 2017_[21]).

Source: (OECD/EUIPO, 2017_[21])

4.1.2. Free Trade Zones' impact on Global Trade

The use of FTZs has expanded considerably over the past 50 years.³ In 1975 there were just 79 such FTZs; some estimates indicate that there may be over 3,500 currently, providing up to 68 million direct jobs and over USD 500 billion of direct trade-related value (UNEP, 2015_[87]) (FATF, 2010_[88]) (BASCAP, 2013_[9]). In an analysis by Siroën, of the top 20 economies with export processing zones, 47% were located in Asia-Pacific, and another 24% in Latin America (Siroën, 2017_[89]). Fewer than 10% of the zones are located in OECD economies. The United States, hosts more than 230 FTZs and the remaining OECD economies account for just 1% of the total number of FTZs known to be in operation. Of the OECD countries, just three countries host more than 10 FTZs (United States, Czech Republic, and Turkey); while eight do not have any FTZs at all. According to the OECD's 2016 illicit trade survey, FTZs are most commonly used to transfer and process products that are transported using maritime shipping, followed by air and rail shipping.

4.1.3. Conclusions and policy issues

The considerable number of criminal networks operating in FTZs highlights a clear and pressing need to address the risk of illicit trade in FTZs through a coordinated and coherent response by all economies affected by illicit trade. The harmful effects from counterfeits, tobacco smuggling, illegal wildlife trade, arms trafficking, illegal gambling, and numerous other forms of criminal activities that are taking place in FTZs need to be addressed through collective action to overcome the coordination failures associated with a lack of enforcement in FTZs.

There are presently no wide-reaching international frameworks that set out a series of rules or governing regulations for FTZs (including what activities may or may not take place and with what information or data sharing). Further domestic and international regulation is required in many FTZs. The absence of effective controls not only leads to diminished oversight, but also a misunderstanding among law enforcement of the risks of certain FTZs and the activities that take place therein.

Moreover, there are significant shortcomings in the management of zones that need to be addressed, including i) gaps in institutional capacities of relevant authorities to exercise oversight and conduct inspections in FTZs, ii) a lack of transparency, including inadequate availability of data and commercial information on activities within FTZs, iii) ineffective information sharing between customs administrations on goods departing FTZs and arriving in national territories and iv) low levels of effective private-public sector coordination on a broad level, including between zone operators, trade and logistics firms.

To address these issues, countries need to work together in the following areas to develop a common international framework or set of standards that enables greater transparency, and a subsequent mechanism to ensure compliance with these standards.

- *Definition.* There is no current consensus on an international legal framework for FTZs or the definition of an FTZ. The considerable growth of FTZs in size and number demonstrates a pressing need to include them in a formal and codified manner in international agreements. FTZs have so far not been addressed in international trade law within the WTO, for example.
- *Information.* This analysis identifies various useful forms of good practices that have been employed to mitigate known risks to pre-empt the exploitation of FTZs for the purposes of illicit trade by converging criminal networks. The use of restricted (high risk) goods lists, mandatory submission of electronic data, rapid free zone adjudication of violations and severe monetary fines for violations, as well as enhanced security screening, all represent good practises that should represent minimum requirements for FTZs.
- *Stakeholder cooperation.* Engaging the private sector is an invaluable step in ensuring more effective oversight of FTZs and enhancing institutional capacities. FTZ authorities (both private and publicly owned) should be encouraged to enter into voluntary codes of conduct. These can include guidelines for FTZ operators to promote better business practises and enhance supply chain security with certification style standards or other mechanisms that enable governments and business to distinguish “clean” FTZs from non-compliant zones that pose a significant risk for legitimate business. Governments can encourage the adoption of such codes by jointly committing to recognising such certification standards through memoranda and joint agreements, and by recognising that non-compliant zones pose a risk for illicit trade. At the same time, the development of FTZs must be accompanied by capacity building; governments and industry need to provide their expertise and guidance to provide support for this, which would include guidance on modernising zone infrastructure.
- *Zone management.* Government-led initiatives such as authorised economic operator (AEO) style certification schemes for FTZs may also be a useful model to ensure sounder operation of the zones. AEO certifications are already used for various operators in trade, and are considered an essential tool in trade facilitation. The AEO model could ensure higher rates of commercial compliance by

guaranteeing the rights or privileges of operating beyond customs control, covering, for example, accurate data recording and book-keeping, openness to customs audit and more stringent security standards for employees.

- *Enforcement (including customs)*. While there are zones in OECD countries, the vast majority are in developing and middle-income economies. The debate on FTZ issues must therefore include a wide range of countries, including those that seek to benefit from the increased levels of FDI and export-oriented growth often attributed to FTZs. For example, FTZs may be used in developing economies to circumvent lengthy and inefficient customs practises that add red tape and delays to processes. To reduce over reliance on the FTZ model, customs authorities need to continue to improve the facilitation of trade through for example, expansion of automated processes that, for example, increase possibilities for electronic submission of data. In addition, each country should ensure that it has adequate numbers of enforcement officials with *ex officio* authority to supervise or control all FTZs within their customs territory. As a best practice, this authority should include, at minimum, the power to detain suspected counterfeits, and when legally endorsed, the power to destroy counterfeit goods.

4.2. Current International Regulatory Frameworks for FTZs

Zones are governed principally by agreements reached in the World Customs Organization (WCO) and the World Trade Organization (WTO). In the case of the WCO, zones are specifically addressed in an annex to the Revised Kyoto Convention (RKC); while zones are subject to general WTO rules, they are not specifically mentioned in key texts.

4.2.1. World Customs Organization

The RKC has historically been the principal instrument promoting international harmonisation of customs practices for import and export procedures. Annex D of the convention is a comprehensive framework that sets forth a proposed framework for the regulation of FTZs and other strategically valuable customs warehousing tools. According to Chapter 2 of the annex, FTZs 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” (WCO, 2008_[90])⁴. However, the annexes of the RKC are not part of the core text to which contracting parties are bound, and have only been signed by a few economies: of the 110 signatories that are party to the RKC, just 24 are contracting parties to this chapter, with 6 countries indicating certain reservations to the text. This is indicative of the global lack of acceptance of a common standard for zone organisation. Moreover, as indicated below, there are few compliance mechanisms that can be used to enforce provisions (such as binding dispute resolution mechanisms).

The RKC distinguishes FTZs from bonded warehouses, which share some of the same characteristics as zones. Bonded warehouses are intended to facilitate imports, while FTZs have traditionally focused on the transit or export of goods. In contrast to FTZs, bonded warehouses remain under customs control, and all goods are eventually declared after an authorised time period. Bonded warehouses facilitate imports by offering the option of duty deferral until goods leave the designated bonded space and enter into the domestic economy. FTZs offer a duty free space as well, but often permit additional activities like processing and manufacture. FTZs don't require as much customs control

because the goods are intended for processing, and eventual (re)-export. Table 4.2 illustrates the differences between warehouses and zones.

Table 4.2. Key differences between FTZs and bonded warehouses

	Customs (Bonded) Warehouse	Free Trade Zone
Payment of Security (bond) for goods	Yes	No
Relationship to Customs Territory	Inside Customs Control	Outside of Customs Territory
Permissible Cargo	Foreign Goods only	Foreign and Domestic Goods
Transfer of Ownership Authorised?	Yes	Yes
Customs Declaration Required?	Yes	No
Domestic Goods authorised entry?	No	Yes
Authorisation to Repack, group, sort (etc.) goods:	Yes	Yes
Authorisation to Manufacture	No	Yes (if approved)
Time Limits on goods to remain	No	Can be set by Customs (min 1 year)

Source: (WCO, 2008^[91]).

As the table illustrates, the key differences are borne out in the different authorities over the zones. For example, while a bonded warehouse is considered a customs-controlled area, in the free trade zone, customs is only empowered, for example, to conduct inspections in FTZs for enforcement and security reasons.

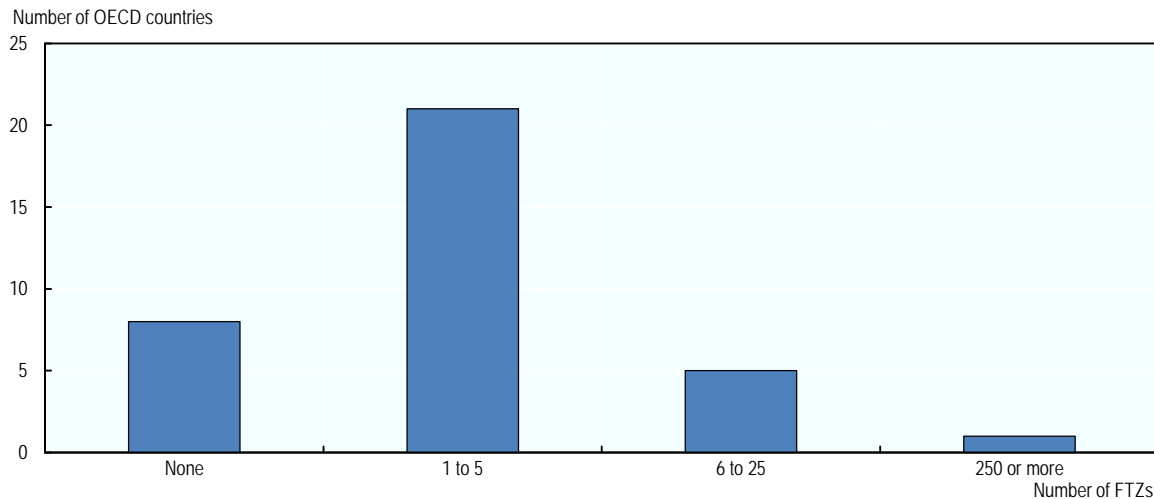
4.2.2. World Trade Organization

The WTO makes no specific mention of FTZs in its principal agreements, providing no definitions of FTZs or export processing zones. However, in some instances, WTO has made reference to FTZs as a potential risk for state subsidies, insofar that the “structure of some free-zone schemes exposes them to claims of providing export subsidies” under the WTO Agreement on Subsidies and Countervailing Measures (ASCM) (Torres, 2007^[92]). In principle, however, there is no current indication that the status of agreements such as TRIPS and the enforcement of related WTO rules, are not applicable within FTZs, but no official WTO text has formally confirmed this.

4.3. National and Regional Legislative Frameworks for FTZs

4.3.1. OECD countries and FTZs

Certain OECD countries have legislated permission for implementation of FTZs while some other economies rely extensively on other instruments, such as bonded warehouses and duty deferral, to enable trusted traders and other economic operators to transfer, treat and re-export goods in a preferential environment that facilitated exports (Figure 4.1).

Figure 4.1. Number of FTZs in OECD countries

Source: OECD Country Survey (2016) (see Box 1.1).

Findings from the 2016 OECD TF-CIT survey and desk research indicate there are a total of 340 FTZs in OECD countries. Over two-thirds of these zones are located in the United States. Excluding the United States, which has 230 designated “Foreign-Trade Zones”, there are on average four designated FTZs in every economy that uses this export model. Eight member countries do not have FTZs; countries such as Canada and Belgium prefer to use existing regulatory frameworks for customs bonded warehouses as an alternate solution to facilitate export-oriented trade, transit and duty deferral. Japan eliminated legal provisions for FTZs in recent years.

4.3.2. European Union

The European Union has established a series of defining terms under the Union Customs Code that establish the common requirements for FTZs. Under a 2008 revision to the code, the Modernised Customs Code enables the creation of FTZs in member states in order to minimise the administrative burden of customs regulations (EC, 2008_[93]). Goods are considered to be outside the community if they are not imported into a member country and remain inside the FTZs; however these zones are specifically noted to be under the responsibility of customs and any activities taking place in these zones must be reported to customs in advance. The 2008 modernised code specifies that customs is granted the right to refuse or restrict certain activities in the zones for safety and security considerations or national laws. Furthermore, the code notes “Goods brought into a free zone shall be presented to customs and undergo the prescribed customs formalities (...) where they are brought into the free zone directly from outside the customs territory of the Community” (EC, 2008_[93]).

The European Union also makes provision for type I and type II FTZs, depending on the ability to fence-off or secure the perimeter. In the latter, goods must be declared in a similar fashion to customs bonded warehouse, whereas in the former, no declaration is required, provided these are secured and not entering into the economy (EU, 2013_[16]). Today, there are over 70 FTZs of type I and type II classification.

Entry into the EU market appears to have reduced several economies' reliance on FTZs. The Czech Republic, with exports accounting for over 80% of GDP, has seen reductions in total trade moving through its 11 FTZs (DOS, 2017^[94]) Other EU members such as Hungary and the Slovak Republic have eliminated the legal provisions for FTZs entirely. However, for countries on the periphery of Europe, FTZs may still provide certain benefits (Box 4.2).

Box 4.2. Port of Rijeka free trade zone in Croatia

Due to its geographic location, the Croatian Port of Rijeka is an important entry and transit point into mainland Europe. Under EU law an area of this port is operated as a free zone. As noted, under EU law, the FTZ is a part of territory of the Republic of Croatia which is fenced-off, and where economic activities are carried out under certain restrictions and under customs authority. In Croatia, FTZs can be established in the area of a seaport, river port, airport and at any other area where conditions may justify their placement. This is done on the basis of approvals from the government. Authorised activities include storage, wholesale trade, and the refining of goods. The economic advantages of these FTZs include unlimited storage time, no customs bond requirements, and ease of transmission of electronic data directly to customs. Despite exemptions from duties, these zones are not exempt from taxes, including taxes on equipment and labour.

The activities in such zones are closely controlled by customs with stringent documentary requirements. All goods descriptions must be relayed automatically and electronically for customs, exclusively through a data interface with customs. When exiting the zones, exit declarations must also be made, and outgoing manifests and the like must also all be compliant with customs requirements. Measures including physical controls of goods are also common.

Source: Presentation of Croatia Customs to the OECD Task Force on Countering Illicit Trade, March 2017 (OECD, 2007^[81]).

In a 2013 Report, the European Parliament noted that, in the absence of adequate checks and balances, FTZs are vulnerable to abuse from organised criminal networks and risk transforming these zones into hubs for illicit trade, and that, “Free Zones are sometimes feared to function like off-shore jurisdictions” (EP, 2013^[95]). The report cites in particular the risks from organised crime and counterfeiters, taking advantage of lax regulation and oversight to conduct business and to “sanitise” shipments that would otherwise be flagged for irregularities, and the affixation of counterfeit trademarks to unfinished products.

Despite the gathering of additional evidence, the number of cases that directly links or implicates FTZs in the European Union remain relatively scarce. In a Europol/OHIM report published in 2015, FTZs are noted to have become significant enablers of counterfeiting activities; the report identifies counterfeiters as the primary “abusers” of FTZs (Europol/OHIM, 2015^[53]). In an updated 2017 report, cases were mentioned that involved organised crime, including narcotics trafficking, illegal ivory trade, people smuggling and counterfeiting, in particular for counterfeit pharmaceuticals in transit via an FTZ in the United Arab Emirates (Europol/OHIM, 2015^[53]). The report notes “the limited enforcement powers within FTZs remain especially challenging”.

4.3.3. *United States*

Established under a 1934 law, US foreign-trade zones were created to provide tariff benefits and facilitate customs-entry procedures for the promotion of investment in US manufacturing, and distribution, and to boost employment and exports. The law lays out the framework to ensure “[a]ll zone activity is subject to public interest review” and goes on to state “[f]oreign-trade zone sites are subject to the laws and regulations of the United States as well as those of the states and communities in which they are located” (CBP, 2017_[96]). Today, there are over 230 such zones (and 400 sub-zones) in 50 states, employing over 420,000, and accounting for over 10% of US exports, and 5% of US imports. Main industries operating in zones include automotive, pharmaceuticals, petroleum and electronics firms (NAFTZ, 2017_[97]).

US laws permit the establishment of FTZs at or near ports, and are technically considered to be outside of the US customs territory (NAFTZ, 2017_[98]). Goods are exempt from duties and taxes unless these are imported into the country thereafter. To obtain certification and authorisation to operate as an FTZ, a port or warehouse operator must provide documentation to the Customs and Border Protection (CBP) authority using electronic data interchange, while meeting other security requirements. The US laws establishing FTZs lay out the framework to ensure “[a]ll zone activity is subject to public interest review” and goes on to state “[f]oreign-trade zone sites are subject to the laws and regulations of the United States as well as those of the states and communities in which they are located” (CBP, 2017_[96]).

Within such zones, the Customs and Border Protection (CBP) authority is responsible for enforcing all applicable laws and regulations, including those pertaining to intellectual property rights, wildlife, and food and drugs, on behalf of other agencies and government bodies (e.g. the Department of Justice, International Trade Commission and the Food and Drug Administration). US FTZs impose a relatively higher level of scrutiny and compliance burden on the importers and operators in such zones than outside the zones, and necessitate a more frequent level of interaction with authorities.

Before production or activities in a zone may commence, the following steps must be taken:

- A zone operator must file an application with the CBP describing the processes that would be put in place for ensuring that laws and regulations are followed.
- CBP must approve the application, conduct a physical review of the facilities, undertake background checks of key employees and review the activities to be conducted in the zone.
- Before activities commence an operator must identify variances in invoiced, received, and entered quantities on 214 admission and annual reconciliation filings.

All products arriving in zones must be accounted for electronically in advance to the CBP, which targets all suspect shipments. Similar to other countries’ practices, the FTZ can only accept low-risk goods that for example do not pose health and safety risks, or goods imported on a regular basis. Furthermore, other agencies in addition to CBP have the authority to conduct reviews and audits for safety and compliance reasons.

The FTZ system in the United States is operated in a similar manner to AEO programmes for importers, insofar that it provides incentives to enhance compliance, in exchange for lower tariff burdens on a temporary or deferred basis. FTZs in the United States are different from other zones, as they are not off limits for enforcement actions. However,

the difference is motivated by the fact that a significant percent of the goods imported via FTZs are subsequently declared for importation into the US customs territory, exposing the country to greater risks from domestic illicit trade. The US zones offer a narrower and more clearly defined set of tax advantages than is the case for other zones.

4.3.4. Turkey

A free trade zone programme was established in Turkey in 1985 to promote export-oriented investment and production, as well as to accelerate foreign direct investment (FDI) and access to technology (Turkey Ministry of Economy, 2017^[99]). Over 2,000 companies operate in zones, in over 18 FTZs across the country, accounting for over USD 19 billion annually in trade in 2016.

FTZs are afforded exemption from duties and VAT; manufacturing operations are permitted, as is transshipment of goods. FTZs are designed to treat goods as “non-imports” from a customs perspective. Authorities have identified illicit trade, illegal transfers of goods, and tax evasion as three principal risks associated with the use of FTZs.

The Turkish authorities have established the following systems, regulatory controls, and legislation to manage risks associated with illicit trade:

- **FTZ Computerised Implementation Program (SBBUP).** A centralised government-operated database collection system automatically produces reports on information provided on a mandatory basis for all zone transactions (covering both movements into and out of zones). Information collected includes warehouse stock data and information on persons employed in the FTZs. The system is maintained by the Ministry of Economy and information is shared with regional customs offices and other relevant authorities via a single window initiative.
- **Enhanced regulatory controls and sensitive goods circular.** Certain products known to be associated with illicit trade or tax evasion and recognised to pose risks to health, safety and security, are banned from entering or transiting Turkish FTZs, or are heavily controlled. A sensitive goods list was first published in 2005. The list was developed in an effort to pre-empt attempts to exploit FTZs. The sensitive goods circular (list) is confidential; it contains, however, goods such as scrap metal, which is subject to a full ban. Some sensitive goods are allowed, but under the payment of a bond or collateral that varies according to levels of risk.
- **Legislation governing FTZs:** Article 14 of the governing regulations of the Turkish Ministry of Economy establishes punitive consequences for wrongful or illegal activities in FTZs; these range from suspension of operational licenses for economic operators, to cancellation of rights to operate in FTZs. The use of sanctions under this article can be applied outside court, and in parallel to (and exclusive of) legal proceedings for the same offences, thereby permitting immediate action against non-compliant actors.
- **Empowering and clarifying customs authorities:** The Ministry of Customs and Commerce of Turkey has the legal authority to conduct inspections, audits and interventions throughout all FTZs and remains the principal law enforcement agency operating in FTZs on behalf of courts and police, acting on intelligence and international tip-offs.

Using the above mentioned systems has resulted in a number of interdictions of illicit products moving through these zones.

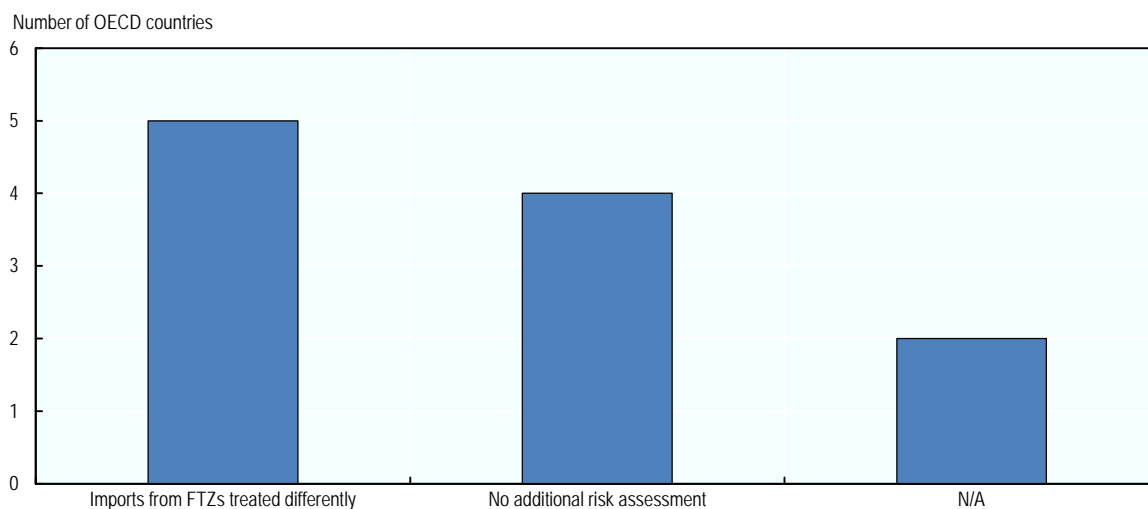
4.4. Industry-led initiatives

The World Free Zone Organization (WFZO) is a convening body for public and private sector entities that own, operate and manage FTZs, and all related economic zones for export processing. The WFZO is intended as a standard-setting organisation which aims to i) identify best practices among free zone operators, and ii) improve the current reputation and understanding of FTZs. The WFZO is presently working on the development of standards and codes of conduct (i.e. the “Safe Zone” programme). The programme relies on a FTZ certification system that could also serve as an AEO certification. The Safe Zone certification standard does not attempt to specifically define the parameters or definition of an FTZ, instead offering an “opt-in” programme for self-compliance.

4.5. Current Evidence on Illicit Trade in FTZs

The 2016 OECD TF-CIT survey on illicit trade solicited information on the greatest risks associated with FTZs, both domestic and international (Figure 4.2). In comparison to the earlier findings of the 2012 Financial Action Task force (FATF) study, the results seem to vary greatly from country to country. In terms of risk and risk-assessment of goods arriving from FTZs, several respondents indicated that imports are known to pose an elevated risk. In such instances, the provenance of goods from certain FTZs may then be targeted for examination. In discussions with customs administrations, this practice has been implemented for certain FTZs known to be associated with the export or transshipment of illicit goods that have been seized in the past.

Figure 4.2. FTZ experiences

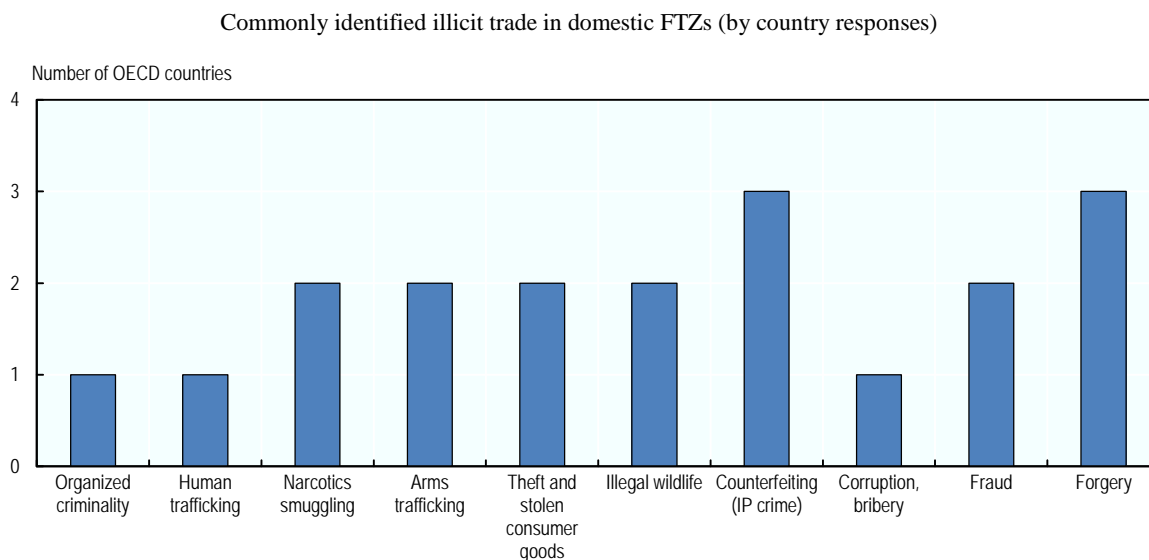


Source: OECD Country Survey (2016) (see Box 1.1).

Data on foreign and domestic FTZs was sought among OECD member countries. This survey question echoes the FATF questionnaire that was distributed in 2009; however the OECD questionnaire differentiated domestic zones from foreign ones. There is significant variance in the known risks from illicit trade between domestic FTZs and certain foreign

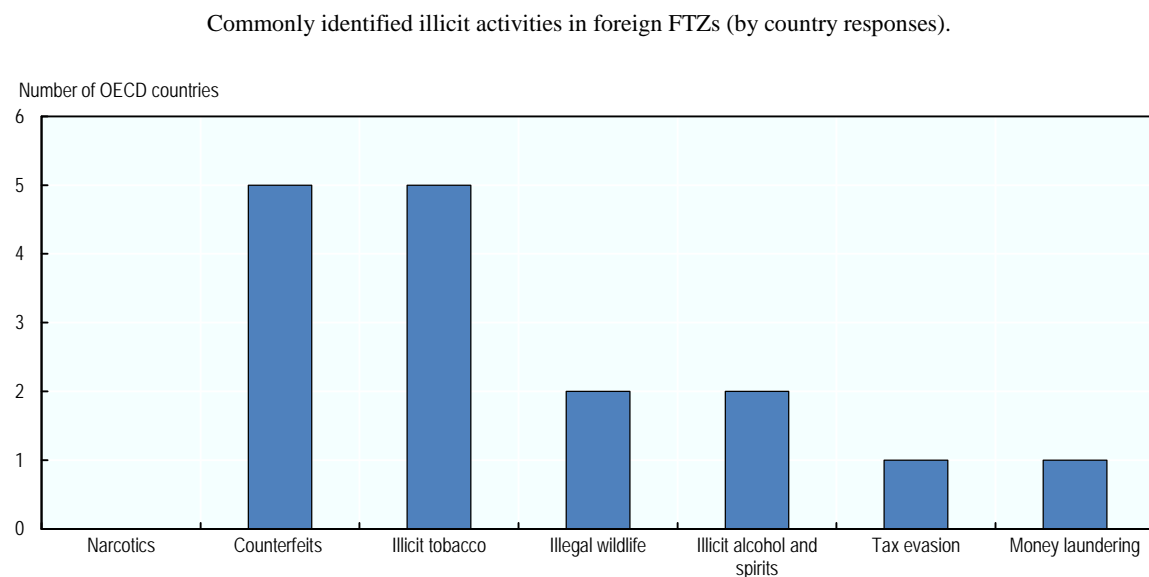
FTZs. In the case of domestic FTZs, there are no clear-cut indications of one particular form of illicit trade associated with these zones; instead they are dispersed across various categories of illicit trade. For foreign FTZs, the results are somewhat more homogenous. Respondents have indicated that the forms of illicit trade encountered focus on counterfeit products and illicit tobacco (Figure 4.3 and Figure 4.4). The FATF report from 2010 posed similar questions, but with different responses (Figure 4.5). However, the two surveys cannot be directly compared due to the differing membership among FATF countries, and the different forms of illicit trade identified.

Figure 4.3. Illicit trade in domestic FTZs

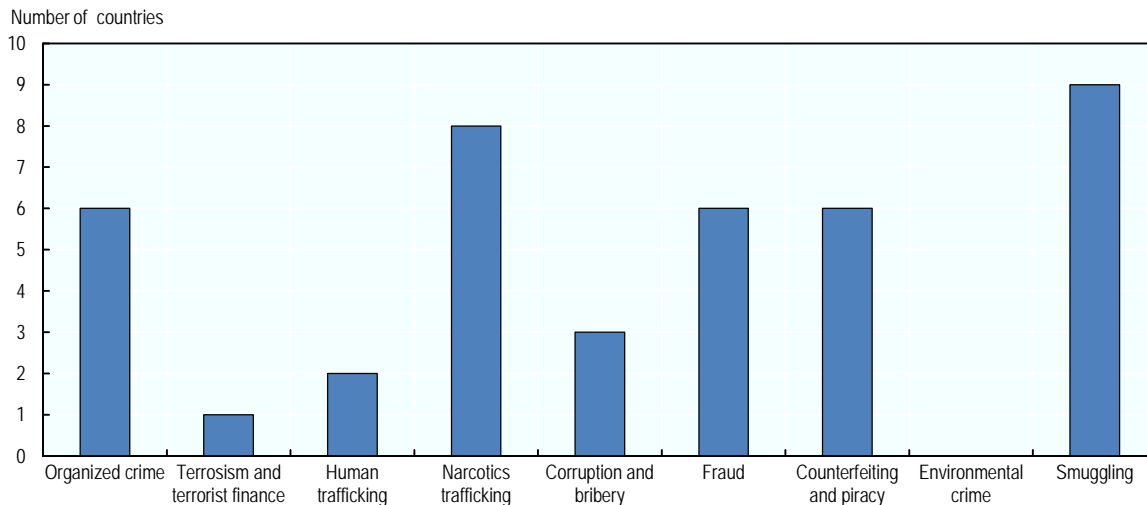


Source: OECD Country Survey (2016) (see Box 1.1).

Figure 4.4. Illicit activities in foreign FTZs



Source: OECD Country Survey (2016) (see Box 1.1).

Figure 4.5. Commonly identified forms of criminality in FTZs

Source: (FATF, 2010_[88]).

The FATF responses indicate that fraud; smuggling, counterfeiting offences and organised criminal activities were the most common recorded forms of illicit trade and activities undertaken in FTZs. The FATF report also provides a series of case studies to inform typologies of illicit trade in FTZs. These include bulk cash smuggling, trade-based money laundering, customs fraud, contraband tobacco smuggling, and other operations facilitated by the lack of adequate supervisory capacities in FTZs (FATF, 2010_[88]).

Case studies by various international bodies and authorities have illustrated the problems concerning FTZs and illicit trade. The studies below indicate some examples and highlight case studies that have been established in recent years on the forms of illicit trade associated with FTZs.

4.5.1. Trade-based money laundering and FTZs

The FATF identifies FTZs as posing a high risk for money laundering and a threat to the integrity of global financial regulatory standards. In the report, informed by a member country questionnaire, FATF outlines the lack of adequate oversight, inadequate standards for business registration practices, and inadequate (or a lack of the) use of anti-money laundering practices in certain FTZs. The report also notes that inadequate documentary requirements for imports and exports can lead to the exploitation of such zones for fraudulent use and trade-based money laundering operations. The research conducted among various countries also points to the common interpretation that FTZs are either explicitly or implicitly perceived as outside the customs territory.

The report identifies, for example, the use of the Colon Free Trade Zone in Panama as playing an instrumental role in the laundering of billions of dollars in Colombian narcotics sales by trade-based money laundering schemes in Miami and other areas across the Americas. The absence of transparency regulations in the zone is attributed with the ability of criminal actors to syphon bulk amounts of cash directly into these zones for fraudulent purchases and sale of commodities that are then registered as legitimate transactions to “clean” the proceeds of crime. The report also identifies various other

cases, for example the use of FTZs in the Caribbean islands (such as Curacao) that are used to launder money from crime syndicates operating in Venezuela (FATF 2010). The report calls for:

- Enhancing awareness among relevant stakeholders including the private sector, customs and financial intelligence units on the risks from FTZs.
- Improving coordination between national and international authorities on the regulation of FTZs.
- Increasing transparency on the operations taking place in FTZs.

4.5.2. Tobacco and FTZs

FTZs can be used for the production and fraudulent smuggling of “illicit whites”. FTZs identified in the United Arab Emirates, such as the Jebel Ali Free Trade Zone, have become well known sources of illicit whites to authorities. The FTZs are identified as strategic vulnerabilities to stop illicit trade as little information is known on the origin or destination of goods entering or exiting these zones.

Singapore customs has also identified illicit trade of tobacco via its FTZs. In 2014, Singapore Customs identified and seized several shipments of tobacco in its Kepek and Changi FTZs. It notes that specific operations and enforcement mechanisms such as surprise audits and inspections within the FTZs have been effective in countering illicit trade in these zones (Singapore Customs, 2015_[100]). However, a recent INTERPOL report highlights that the Singapore Free Trade Zone remains a regional and global transit hub for illicit tobacco (INTERPOL, 2014_[8]).

A recent report published by the International Tax and Investment Center (ITIC) also provides evidence on the exploitation of FTZs by criminal networks specialising in illicit tobacco trade, particularly for unlicensed and duty-unpaid cigarettes (“illicit whites”). The research conducted by ITIC confirms the other notable positions cited above, that FTZs are exploited to hide origin and destination as transshipment hubs, that they are used as manufacturing bases for illicit goods (including tobacco) and are also a cause of “leakage” of undeclared and illicit products into the local and international economy (ITIC, 2013_[101]).

Policy considerations are summarised as follows:

- Mandatory record keeping for FTZs to provide documentary evidence to foreign customs
- Adequate anti-money laundering legislation and suspicious transactions reporting
- Greater multilateral cooperation among partner enforcement agencies in economies that i) host FTZs and ii) receive goods from foreign FTZs.

4.5.3. Counterfeiting

In addition to the 2017 OECD report on counterfeit trade routes described in Box 4.3, the 2016 OECD-EUIPO Report on Counterfeiting and Piracy shows the market for fakes is supported by a series of global export hubs in and across Asia, many of which are identified as FTZs (OECD/EUIPO, 2017_[35]). As indicated in the surveys, FTZs are a hub for the global supply chains for counterfeit products. Europol’s recent Situation Report on Counterfeiting also identifies several instances of FTZs being involved directly in the transshipment and even production of counterfeit goods (OECD/EUIPO, 2017_[35]). FTZs are in some cases infiltrated by organised crime groups that transship, label and obscure

the ports of origin of counterfeits. The report also looks ahead to future potential threats, such as the opening of new ports on the Mediterranean coast in Morocco that are being established as FTZs. FTZs such as this one are ideally located geographically to access European markets, and are noted by Europol to pose important future threats for counterfeits, due the known lax governance structures and oversight capacities within such FTZs.

Box 4.3. OECD/EUIPO Study on Mapping the Routes of Trade in Fake Goods and Free Trade Zones (2017)

The OECD EUIPO study on the trade routes for counterfeits identifies several Free Trade Zones as common transit points for the illicit trade in fakes around the world. Zones such as the Jebel Ali Free Trade Zone (JAFZA) have grown considerably in size. JAFZA today operates with over 7,000 companies registered within, and represents 32% of the United Arab Emirates' total foreign direct investment, offering employment for over 144,000 people. JAFZA includes benefits that include 0% corporate tax, 0% duties, 0% personal tax, no currency restrictions, the ability to operate a bank or financing company, and no capital controls, among various other benefits. The report notes that the characteristics of such zones make them attractive to businesses, but the same attributes can make them as attractive to counterfeiters as well. These include:

- The capacity to obscure the real origin of cargoes
- The ability to manipulate (i.e. manufacture, assemble, package) counterfeit products
- The light regulation of zone businesses.

The report further notes the economy of origin “deception” in FTZs may also help to undermine the targeting systems of customs administrations in their effort to detect counterfeit good. The report notes that counterfeit products can be imported into the zones with relative impunity, and subsequently manipulated or even manufactured with little to no oversight. Beneficial ownership is common, and the names and information of the persons registering these companies are not adequately checked. The report concludes that additional analysis is required to link the data on counterfeits more effectively to the activities of counterfeiters, and that a dearth of existing information on transit points contributes to difficulties in computing the total value of counterfeits passing through FTZs.

Source: (OECD/EUIPO, 2017^[35]).

A Business Action to Stop Counterfeiting and Piracy (BASCAP) report on FTZs and illicit trade notes that offences such as fraud, and smuggling of counterfeit products via FTZs are frequent and subject to significant gaps in oversight, regulation and law enforcement. The BASCAP report provides a series of case studies that involve the exploitation of FTZs in the Gulf, particularly in the United Arab Emirates. Rights holders have reported that various offences, including counterfeit pharmaceuticals and counterfeit clothing have been known to transit through FTZs such as the Jebel Ali Free Trade Zone and the Ras-Al-Khaimah free zone, with limited scope to interdict or stop such goods. Unclear delegation of authorities, laws and regulations have prevented the seizure of counterfeits or the prosecution of the offenders in various instances (BASCAP, 2013^[9]). The report notes that the transit of counterfeits via FTZs, even in Europe, can fall within a

“grey zone”. For instance, the European Court of Justice “confirmed that goods in transit [i.e. within an FTZ] could not be classified as counterfeit goods or pirated goods for the purposes of EU law” in the absence of evidence that these goods were to be put on the EU market (BASCAP, 2013^[9]). The report presents a series of policy recommendation for Intellectual Property Rights (IPR) protection. These recommendations include a broadening of the international regulatory and legal frameworks for FTZs. This includes proposals that governments should:

- Empower national customs authorities to exercise their jurisdiction over FTZs.
- Promote WCO RKC provisions that include FTZ interpretations to be within the national legal framework for illicit trade.
- Provide model FTZ legislation and best practices.
- Develop systems of Authorized Economic Operator (AEO) for FTZs.
- Frame FTZs into international trade law (via WTO).
- Foster greater cooperation between customs authorities.

4.5.4. Risks to environment and health

Zone legislation reviewed for several OECD members, indicates that national laws for hazardous goods and other safety regulations still apply to FTZs. Such laws include health and safety regulations and other requirements (such as phyto-sanitary restrictions for plant and animal products). However, FTZs can leave important gaps in institutional capacities of governments to effectively enforce these controls if adequate resources are limited.

In many OECD countries, customs authorities are in charge of enforcing not only the collection of duties and taxes, but are also required to conduct various other verifications on behalf of other national authorities (such as health agencies and environmental bodies). If the customs authorities are not provided with the information to assess duties, it likely will not be privy to information to assess if these goods pose additional risks to health, safety and security. For example, if national legislation prevents the import of specific products deemed to pose a threat to the environment (such as ozone-depleting substances, hazardous goods, or invasive species), but such specific information is not reviewed by customs, then customs is unlikely to be in position to limit or impose regulations on the goods. There may therefore be important gaps in the ability of customs to enforce the ban or restriction of these goods into and out of the zones; moreover, there may be an elevated risk of unintended release into the national territory (Box 4.4).

Box 4.4. The 2015 Tianjin FTZ explosions

In July, 2015, an explosion in a factory at the Tianjin FTZ in China led to over 170 fatalities, and caused widespread damage to the port and surrounding industrial zones. The FTZ of Tianjin had been launched several months earlier in 2015, and attracted businesses by providing lower regulatory hurdles and greater flexibility for leases and other equipment. With growth rates of over 9.4%, Tianjin represented mainland China's fastest growing economic zone. The FTZ's growth was principally driven by the automotive and petrochemical industries.

The blast led to significant economic losses at local factories, crippling supply chains of several large multinational automotive firms' supply chains. The cause of the blast was attributed to the unlawful and unregulated storage of industrial chemicals on a large scale. The subsequent investigation revealed that several thousand tonnes of improperly stored ammonium nitrate and sodium nitrate alongside over 700 tonnes of cyanide (the latter volume representing over 70 times legal storage capacity limits) fuelled a local fire that created explosions that caused nearly USD 1 billion in damage. The investigations showed that the authorities and port officials had effectively stopped conducting documentary audits or inspections for health and safety requirements since the conversion of the port into an FTZ earlier that year. Over 120 officials were arrested after the investigation into the blast.

Sources: (Berhmingham, 2015_[102]); (Yang, 2015_[103]).

4.5.5. Arms and controlled goods

A recent report by Viski and Michel in the Strategic Trade Review published in 2016 highlights another important risk arising from the strategic trade control vulnerabilities of FTZs. The zones are seen as undermining anti-proliferation efforts. For example, the report highlights a case where controlled goods that were subject to an embargo were shipped to Iran from Germany via FTZs in the United Arab Emirates, using false declarations to avoid scrutiny. The report notes the trade in such goods includes products such as uranium enrichment machinery, weapons and small arms, and dual use goods. Goods shipped to high risk countries benefit from FTZs when they are used as transshipment points to avoid sanctions regimes and arms control agreements (Viski and Michel, 2016_[104]).

The authors recommend:

- Greater multilateral attention in international fora (through bodies such as the WCO).
- Further security measures, to be adopted by customs administrations that play host to FTZs and receive goods from foreign FTZs.
- Amendments to the international legal framework, in particular to the WCO RKC to include binding section on FTZs, and to create common definitions of FTZs and typologies; sharing of best practices and efforts to better understand the risks of FTZs.

- Empowerment of customs via awareness raising and capacity building programs (including training) for developing countries on the risks and responses for FTZs to reduce proliferation.

4.5.6. Wildlife

No current case studies have confirmed the use of FTZs as a transshipment hub for wildlife products, and few results from the illicit trade surveys have indicated that wildlife trafficking is taking place in such zones. However, no reports or research has been pursued to determine the risks that FTZs might pose for such trafficking and environmental crime. Given the geographic location of various large FTZs, and the known routes of illegal wildlife trade, it is likely several such FTZs are being used to link supply markets in sub-Saharan Africa to demand hubs in and across Southeast Asia and in the Gulf. For example, the port of Hong Kong, which hosts numerous FTZs is known to be one of the largest transshipment points for illegal ivory to mainland China (Dubarry and Ametova, 2014_[105]).

4.5.7. Illegal gambling and sports betting

A report on FTZs and gambling by the International Centre for Sport and Security (ICSS) notes the broader range of illicit activities carried out in FTZs. The use of FTZs in countries across Southeast Asia were noted in this regard as they have been known to foster illegal gambling operations (ICSS, 2017_[106]). The lack of financial oversight of financial authorities in several of these zones has also led FTZs that operate casinos to become prime targets for money-laundering operations. The ICSS report highlights several instances of the abuse of FTZs by criminal networks to launder funds throughout Southeast Asia's casinos and betting centres located inside FTZs (see case study in Box 4.5).

Box 4.5. Study on illegal gambling and sports betting in FTZs (2017)

Free Trade Zone (FTZ) areas quickly evolved from their origin as trade-based and manufacturing-based areas (1st and 2nd generation) to service-based areas (3rd generation) from the late 1960s to the 1970s, thereby expanding the original focus on trade to include services such as banking, insurance, gambling and tourism. Since the early 2000s the global relevance of the betting and gambling industry within FTZs has experienced an exponential growth; an ever-increasing number of online betting and gambling operators, including key ones in global terms, are licensed in and operate from poorly regulated FTZ jurisdictions, primarily, but not exclusively, located in South Pacific Asia.

The report published by the International Center for Sport and Security (ICSS) shed some light upon concerns about the fast development of the betting and gambling industry in FTZs. The report highlights how this fast-paced growth has contributed to the creation of an opaque environment that is positioned to support an illicit global financial network. In this space, illegal enterprises operate in parallel to regulated enterprises in the banking and financing industries. The report notes that “the licit and the illicit worlds are so intertwined [and are] accessible to (and effectively manipulated by) transnational organised crime syndicates” thus, undermining any regulative responses by the concerned national governments. “During the last decade, as the relative weight of the gambling industry within these FTZs grew in parallel with the development of a mostly unregulated global online betting and gambling industry, many governments engaged in a race to attract foreign investment to develop their local gambling industries”. Zones in the Philippines, South Korea, and Russia, are given as three major examples. The report highlights several key factors that have facilitated the abuse of FTZs in the gambling sector:

- Opacity of ownership (registration and beneficial ownership).
- Presence of parties with links to organised crime, which use gambling as a conduit for corruption.
- The use and abuse of cryptocurrencies, closely linked to fintech and widely accepted as payment methods in FTZs.

The report concludes that FTZs are an emerging threat with respect to illegal gambling and gaming. The combination of a lack of global betting regulation, illicit financial flows, transparency and accountability, coupled with government corruption and criminal high tech capabilities exploiting crypto-currencies, form a perfect storm that might help in consolidating a new style of multiple illicit offshore banking havens.

Source: (ICSS, 2017_[106])

4.6. Conclusion and policy considerations

The considerable number of criminal networks operating in FTZs highlights a clear and pressing need to address the risk of illicit trade in FTZs through a coordinated and coherent response by all economies affected by illicit trade. The harmful effects from counterfeits, tobacco smuggling, illegal wildlife trade, arms trafficking, illegal gambling,

and numerous other forms of criminal activities all taking place across numerous FTZs must be addressed through collective action that aims to overcome the coordination failures associated with a lack of enforcement in FTZs. The policy recommendations noted above in this report address some of these issues. The adoption of several such measures, notably a common definition of FTZs, enhanced transparency measures, partnering with businesses and port operators, and implementing automated information exchanges with customs for FTZ operators, will enable governments to enhance their institutional capacities to counter illicit trade.

Policy considerations

- There is no current consensus on the international legal framework or definition of an FTZ. The considerable growth of FTZs in size and number demonstrates a pressing need to include these into the formal and codified international framework of international trade. FTZs have so far not been addressed in international trade law within the WTO. Governments should highlight the growing importance of FTZs in the global economy as a justification for why these should be included in international trade law.
- This study identifies various useful forms of good practices that have been employed to mitigate known risks to pre-empt the exploitation of FTZs for the purposes of illicit trade by converging criminal networks. The use of restricted (high risk) goods lists, mandatory submission of electronic data, rapid free zone adjudication of violations and severe monetary fines for violations, as well as enhanced security screening all represent good practises that should represent minimum requirements for FTZs.
- Engaging private sector is an invaluable step in ensuring greater regulation of FTZs and enhancing institutional capacities. FTZ authorities (both private and publicly owned) should be encouraged to enter into voluntary codes of conduct. These can include guidelines for FTZ operators to promote better business practises and enhance supply chain security with certification style standards or other mechanisms that enable governments and business to distinguish “clean” FTZs from non-compliant zones that pose a significant risk for legitimate business. Governments can encourage the adoption of such codes by jointly committing to recognising such certification standards through memoranda and joint agreements, and by recognising that non-compliant zones pose a risk for illicit trade. .
- Government-led initiatives such as Authorized Economic Operator (AEO) style certification schemes for FTZs may also be a useful model to ensure the sound operation of these zones on domestic territories. AEO certifications are used for various operators in the trade chain, and are considered an essential tool in trade facilitation. The AEO model ensures higher rates of commercial compliance by guaranteeing the rights or privileges of operating beyond customs control under certain conditions. These conditions can include accurate data recording and book-keeping, openness to customs audit and more stringent security standards for employees, financial reporting and other practices.

- While there are zones in OECD countries, the vast majority are in developing and middle-income economies. The debate on FTZ issues must therefore include a wide range of countries, including those that seek to benefit from the increased levels of FDI and export oriented growth often attributed to FTZs. For example, FTZs may be used in developing economies to circumvent lengthy and inefficient customs practices that add red tape and delays to processes. To mitigate over reliance on the FTZ model, customs must continue to build adequate facilitation measures (such as electronic submission and risk-assessment of records for Customs). Similar to trade facilitation measures, the development of FTZs must be accompanied by capacity building commitments from donor countries and industry contributions through expertise and guidance to modernise infrastructure for fast, effective and safe trade via FTZs.

Notes

¹ The Task Force met most recently in the context of an OECD-EUIPO Joint Experts Meeting on Enhancing Transparency in FTZs, in Alicante, Spain in September 2017; conference participants included public, private and non-governmental stakeholders.

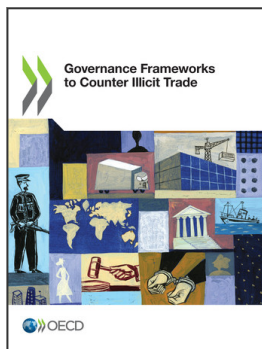
² The evidence that suggests that FTZs are in fact an economic boon to the host economies is however somewhat mixed. FTZs can be considered to be an application of a “second-best” option from a policy perspective (Siroën, 2017_[79]). In a 2017 analysis on Trade Performance in EPZs, it was demonstrated that these zones do not increase economic activities or integration into the global value chain in a significant manner. This finding suggests that globally, these zones are intended to offset internal barriers to trade, and often at the expense of other non-zone national businesses (Yücer and Siroën, 2017_[80]).

³ The Shannon Free Trade Zone in Ireland is recognised as the first modern Free Trade Zone, set up in 1959. The relative success of this zone has inspired replication among other zones, notably in Asia (Taipei in 1965, Korea in 1970, and Malaysia in 1971).

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