

## 1. Key Institutional Capacities to Counter Illicit Trade

*This chapter provides an overview of the rationale for taking action to address more effectively the threat of illicit trade. It i) examines the adequacy and effectiveness of sanctions and penalties in deterring criminal activities involving illicit trade, ii) explores the role of small shipments, and iii) assesses enforcement challenges in countering illicit trade in free trade zone. Policy recommendations to enhance institutional capacities in these three areas are presented.*

The liberalisation of international trade and reductions in trade barriers has provided benefits for both business and consumers. The freer exchange of goods and services has, however, at the same time provided enhanced opportunities for parties engaged in trade in illicit products to pursue criminal activities. Criminal networks, operating in the shadows of globalisation, undercut the full benefits to be gained from openness to trade, exploiting the same global logistics networks as legitimate global enterprises, for their own illicit financial gain. Their activities are detrimental to countries, depriving governments of tax and related revenues, while also jeopardizing public health and security.

Governments have taken a range of actions to counter illicit trade, but their efforts have fallen short in many respects, as criminal networks are quick to adapt their operations to avoid detection and circumvent law enforcement. In response, governments need to enhance their efforts to counter the illicit trade, by, among other things, strengthening the capacities of law enforcement to share information across borders. They also need to closely examine the policies that may inadvertently create business opportunities for criminals, and they need to find ways to shrink the market for illicit products, by reducing consumer demand for such goods.

This report examines three areas where the strengthening of institutional capacities is urgently needed to improve efforts to counter illicit trade. It identifies actions that need to be taken to improve the ability of governments to assess the risk of illicit trade in various guises, and to target, deter, and eventually interdict the activities of criminal networks, which are converging. The assessment builds on existing OECD reports which helped to map the threats, providing recommendations for policies that could be developed to reduce and deter illicit trade.

### **1.1. Enhancing the effectiveness of penalties and sanctions for countering illicit trade**

The risk of interdiction, severity of the penalties and sanctions applied to trade in illicit products and the degree to which penalties and sanctions are applied, are factors that parties engaged in such trade take into account when pursuing their criminal activities. There is a shared understanding among policymakers that illicit actors will prefer to trade in goods where rewards are highest, and the risks of are lowest. The environment is one of a constantly evolving “interdiction-adaptation” cycle, where enforcement authorities and criminal networks respond to the changing tactics of each other to gain an upper hand. In addition, national and international policy-based strategies can be an important element of deterrence frameworks, to the extent that they raise the prospects of enforcement actions.

Certain illicit products are of strategic interest for criminal enterprises due to the low risk of detection and/or interdiction and the significant revenue base that this provides for actors engaged in these forms of trafficking. These include counterfeit products and wildlife trafficking, which go largely unpunished due to difficulties in coordinating effective responses, the impact of corruption in markets, lenient sanctions, and perceptions that these are “victimless” crimes that do not warrant significant action. Law enforcement instead tends to focus on more dangerous activities, such as trade in narcotics, and arms and human trafficking.

### 1.1.1. Legal frameworks for countering illicit trade

Legal frameworks for countering illicit trade include those concluded at the international level, as well as those developed and implemented at national levels.

#### *International framework*

International conventions, laws and agreements govern the global efforts to counter illicit trade. They provide a broad set of tools and guidance that can be applied to nearly all forms of illicit trade. Criminal activities are covered by cross-sectoral agreements, such as the United Nations Convention against Corruption (UNCAC), the United Nations Convention against Transnational Organized Crime (UNTOC) and the UN Convention on the Suppression of the Financing of Terrorism. The effective interpretation and implementation of these agreements can increase the effectiveness of prosecuting certain forms of illicit trade, by helping to increase sentences and to cut off important sources of funding to criminal networks.

In addition to these conventions, a number of agreements are in place that concern specific sectors:

- *Tobacco.* The WHO's *Framework Convention on Tobacco Control* (FCTC) is an agreement that is limited in scope as it does not address illicit trade, instead stipulating the conditions for the legal trade in tobacco. Unlicensed tobacco remains outside of the scope of the FCTC and presently member countries are not required to seize unlicensed tobacco. A separate WHO agreement, the *Protocol to Eliminate Illicit Trade in Tobacco Products*, has only been ratified by 26 countries; ratification by 40 is required to bring it into force.
- *Counterfeit goods in transit.* The WTO's *Agreement on Trade-Related Aspects of Intellectual Property Rights* (TRIPS) leaves it to its members to determine what sanctions, if any, are to be applied to counterfeit goods transiting their territories. National legal frameworks can, for example, provide for the seizure of counterfeits in transit or prior to commercial declaration, or not. With respect to counterfeit and pirated goods imported into or located within WTO Member States, they "shall provide for criminal procedures and penalties to be applied at least in cases of willful trademark counterfeiting or copyright piracy on a commercial scale. Remedies available shall include imprisonment and/or monetary fines sufficient to provide a deterrent, consistently with the level of penalties applied for crimes of a corresponding gravity." (see TRIPS Art. 61)
- *Narcotics.* The UN's *Single Convention on Narcotic Drugs* stipulates that narcotics are illegal under international law and as such must be seized at any and all points in the trade chain by ratifying members. Two additional UN instruments are also relevant in the sector: the *Convention on Psychotropic Substances* and the *Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances*.
- *Counterfeit pharmaceuticals.* The *Council of Europe Convention on the counterfeiting of medical products and similar crimes involving threats to public health* (or *MEDICRIME* convention) is a multilateral convention of the Council of Europe aiming at prevention of counterfeiting medical products. Its purpose is threefold): a) providing for the criminalisation of certain acts; b) protecting the

rights of victims of the offences established under the Convention; c) promoting national and international co-operation. The treaty entered into force on 1 January 2016

- *Wildlife trafficking.* The Convention on International Trade in Endangered Species of Wild Fauna and Flora classifies species according to their level of threat for extinction. Controls on importation and exportation are established for each category. In the absence of compliance, trade in species under any three of these categories is banned. When wildlife products are traded in violation of CITES rules, states are required to use sanctions to punish actors. Penalties are administered in the form of civil or criminal penalties, as fines, imprisonment or other actions to be determined by the state in question.

The scope of international instruments is more comprehensive for certain forms of illicit trade than others. Institutional capacities are generally less comprehensive, for example, in the case of illicit goods that cannot be easily distinguished visually from legal items (such as illicit tobacco or counterfeit clothing). Trade in illicit goods is further complicated by the actions that parties take to exploit regulatory gaps found in transit hubs, such as free trade zones and complex transit arrangements.

Regional agreements also govern efforts to counter illicit trade. In the European Union, Directive (EU) 2017/1371 of the European Parliament and of the Council of 5 July 2017 establishes the legal framework for fighting criminal fraud that affects the Union's financial interests (OJ L 198/29 of 27.07.2017).

#### *National penalties and sanctions*

National penalties and sanctions comprise those that are directed at specific forms of illicit trade, and those that can be applied more generally to criminal activity. *Principal legislation*, for example, would cover drug trafficking, illegal tobacco trade, importing counterfeits, and importing and selling prohibited wildlife products. In addition to civil and administrative penalties, traders could be subject to criminal sanctions. Table 1.1 summarises the maximum incarceration sentences in six selected countries.

**Table 1.1. Summary of maximum incarceration in selected countries**

	Belgium	Brazil	Canada	France	United Kingdom	United States	Average
IPR infringements (incl. infringement of trademarks and copyrights)	5 years	1 year	5 years	5 years + customs penalties (up to 10)	10 years	10 years	6 years
Narcotics trafficking	15 years	15 years	10 years	10 years <sup>3</sup>	Up to life sentence	Up to life sentence	25 years <sup>1</sup>
Wildlife trafficking (of CITES products)	5 years	none	5 years	2 years	5 years	5 years	3.5 years
Contraband / illicit tobacco smuggling (or fraud)	2 years (fraud)	n/a <sup>2</sup>	5 years	7 years (fraud)	7 years (fraud)	5 years	5 years

*Notes:* <sup>1</sup> In calculating the average, life sentences are approximated at 50 years; <sup>2</sup> Not available; <sup>3</sup> Or life sentence in certain cases.

More general, *ancillary legislation*, however, can also be applied in some instances if specific crimes include money laundering, handling or possessing the proceeds of crime, corruption and embezzlement, or organised crime or racketeering. These penalties are generally higher than those applicable to illicit trade in specific products. While ancillary laws require principal criminal charges or predicate offences to be brought against the perpetrators, they can have a multiplier effect on the impact of the principal penalty by tackling the greater criminal networks, financing of crime, and other practices associated with the crime.

**Table 1.2. Summary of maximum penalties for ancillary offences in selected countries**

Offence	Penalty	Country						Average
		Belgium	Brazil	Canada	France	United Kingdom	United States	
Money laundering	Incarceration (max)	5 years	10 years	5 years	5 years	14 years	10 years	8 years
	Fine (max)	EUR 5 million	USD 9 million	CAD 500,000	EUR 375,000	GBP 1 million and up	USD 500,000 or 2x value	
Tax evasion	Incarceration (max)	5 years <sup>1</sup>	n/a <sup>3</sup>	2-5 years <sup>2</sup>	3 years	5 years	5 years	5 years
	Fine (max)	EUR 500,000	300%	200%	200%	200%	USD 100,000	
Participation in organised crime / racketeering	Incarceration (max)	5 years	8 years	5 years	10 years	5 years	20 years - life	9 years
	Fine (max)	n/a <sup>3</sup>	n/a <sup>3</sup>	n/a <sup>3</sup>	EUR 75,000 or 10 times value of fraud	open	Up to USD 250,000	

Notes: <sup>1</sup> Belgium - Modification Art. 98 on revenue taxes [Code des impôts sur les revenus] 1992]; <sup>2</sup> Canada Excise Tax Act, R.S.C., 1985, c. E-15 ; <sup>3</sup> Not available.

### 1.1.2. National policies and programmes to punish and deter illicit trade

In addition to the international and national legal frameworks to counter illicit trade, institutional capacities to counter illicit trade depend on the use of policy-based initiatives to strengthen programmes and establish strategic priorities that inform police, customs and prosecutors of the high-level guiding principles and priorities that support their work. National strategies and policy statements can provide roadmaps and support coordination of multi-agency approaches to enhance prosecution and punitive efforts against illicit trade. The use of the ancillary national legislation described above is often informed or driven by national strategies.

Such policies and programmes targeting priority areas can include a whole-of-government approach to address a particular form of illicit trade via the key agencies and ministries concerned. They can highlight what ancillary laws are to be used and what levels of inter-governmental cooperation are expected to achieve goals. In addition, these strategies may invoke international (intra-governmental) coordination and may encourage the use of bilateral treaties, such as mutual assistance agreements, to enhance the

institutional capacities to counter illicit trade across borders. Finally, these strategies can encourage the use of stronger sanctions for the principal offence, calling for the added weight of maximum sentences for egregious offences, citing the social or economic harm as a justification for such sanctions.

### *1.1.3. Use of criminal and civil penalties and sanctions*

Governments impose penalties through administrative (civil) action and criminal proceedings. Criminal proceedings are generally associated with heavier punitive sanctions than administrative sanctions. Criminal cases seek to punish parties engaged in criminal activity, through financial penalties, incarceration and/or deprivation of certain rights and freedoms. The scope of criminal actions is greater than in civil actions, as they can include investigations, supported by search warrants, which can explore and uncover dealings beyond the narrow body of evidence revealed by the offence in question.

Both civil and criminal courts are used in the case of illicit trade and other related offences. In addition to administrative penalties, civil courts can also be used in cases where an offence is deemed to cause harm or damages, but the damages do not require criminal or severe charges. Civil procedures can be initiated by plaintiffs to sue for compensation and restitution, including damages and, in some cases, punitive damages to deter further infringements.

Evidence suggests that national policies and practises towards illicit trade are bringing the two forms of penalty systems closer together in their use and interchangeability. Policy discussions on the relative costs of using criminal procedures and relative ease of imposing administrative penalties have led some governments to use civil penalties more broadly. Moreover, an increased focus on trade facilitation and cost reduction has created a push for corrective (administrative) action rather than punitive ones.

### *1.1.4. Policies to enhance the effectiveness of penalties and sanctions*

The maximum penalties and sanctions that can be applied for engaging in illicit trade are substantial, but the persistence and level of such trade suggest that more needs to be done to enhance deterrence. A number of actions could be taken by governments in three key areas to this end, as follows:

#### *Strengthen co-operation and expand the scope of international frameworks.*

International treaties governing narcotics, such as the United Nations Single Convention on Narcotics, seek to promote international cooperation between law enforcement authorities, with a view towards elevating transaction costs and risks for criminal networks. The growing size of illicit trade in other goods, such as counterfeits, tobacco and wildlife, demonstrate that urgent action is needed to strengthen international legal frameworks for these crimes as well. Countries need to work on enhancing prosecution of IPR related crimes in third party or transit economies, while continuing to develop and implement a comprehensive agreement on illicit tobacco smuggling that builds upon the existing framework convention.

Countries also need to work to apply other existing legal principles, including those embodied in the United Nations Convention against Corruption (UNCAC) and the United Nations Convention against Transnational Organized Crime (UNTOC), to a broader range of illicit activities. As it stands, these principles are used extensively for “conventional” forms of illicit trade such as narcotics smuggling, but often do not apply

to other areas, such as counterfeiting and wildlife trafficking, which are two forms of illicit trade that are closely associated with corruption and transnational organised crime.

*Raise the risk/reward ratio by expanding the scope of penalties to include ancillary legislation.*

Proceeds of crime legislation serve to reduce the profitability of crime by confiscating and thereby depriving criminals of their illicit gains. These penalties can be high; applying them more broadly would help to cut off funding of criminal actors, while addressing the root motivation of illicit actors, thereby lowering the incentive to commit illegal acts.

Extending proceeds of crime provisions to include, for example, tobacco and counterfeit products could have a significant impact on the risk-reward structure of actors in illicit trade; the process to build precedent and develop resilient institutional capacities to investigate and prosecute these crimes can, however, be difficult.

The legislation enabling authorities to freeze the proceeds of crime can be further strengthened by including provisions that, for example, reverse the burden of proof from enforcement authorities to the criminal parties, and extend powers of seizure to include illicit activities beyond the crime in question.

Investigations into criminal behaviour related to illicit transnational trade frequently have an international dimension, as financial transactions are conducted internationally and monies are often laundered via off-shore financial institutions, or employ trade based money laundering schemes so that illicit profits are portrayed as legitimate earnings that have been generated through legitimate trade. Multilateral cooperation through mutual legal assistance agreements and other vehicles is a valuable tool that can be used effectively to uncover and seize assets held abroad.

From a practical standpoint, resource constraints are commonly cited as reasons for limiting crime-fighting efforts. The prosecution of ancillary legislation, for example, can be complex and require significant financial support. The freezing and seizure of property and monies can thus be a challenging task, requiring close collaboration between customs, police and financial intelligence units or agencies responsible for forensic accounting. For example, money laundering offences require participation of specialised financial intelligence units and often call upon other branches of government and law enforcement, which may require significant coordination and resources. This demonstrates the need to develop targeted and impactful policies in a well-structured, efficient manner.

Checks and balances need to be in place to prevent undue application or mishandling of proceeds of crime acts so as to allay concerns about the use of sanctions to reach beyond the crime itself and into the other assets of the criminal actors. Strong transparency, internal controls, and oversight are thus necessary prerequisites to ensure the successful deployment of these tools.

*Develop and implement national strategies to counter illicit trade.*

The development of national policies and programmes to combat illicit trade can be achieved with greater ease than can the passage of new laws and the negotiation of international treaties. Such an approach has the potential to deliver quick and effective responses to challenges, and they can be useful in boosting inter-agency cooperation and

otherwise enhancing efforts to address illicit trade issues and deter and prosecute those engaged in such trade.

Generally, such strategies could include the use of specific principal and ancillary laws to prosecute offences and deter illicit trade in selected areas. However, the value of national strategies can be limited, to the extent international legal frameworks that aim at promoting international cooperation, which is key to success, are weak or absent. International frameworks are best when they complement national strategies. For example, the application and use of the UN conventions on organised crime, corruption, and criminal/terrorist finance can be instrumental to achieving national goals, which are increasingly reliant upon international cooperation for their success.

## 1.2. The increased role of small shipments in facilitating illicit trade

The growth of small shipments in international trade has been accompanied by their use as vessels for illicit goods such as narcotics, chemicals, weapons and counterfeits. The sheer quantity presents a significant challenge for customs and law enforcement authorities. Capacity to target and interdict illicit trade on a granular scale without interfering with the legitimate flow of products is limited, as is capacity to carry out effective risk assessment analysis and product inspections. Criminal networks that are engaged in the sale of illicit goods are increasingly exploiting the institutional gaps and vulnerabilities present in postal and courier operations. The seriousness of the situation is supported by the OECD survey of member countries, where most respondents indicated that the growing volume of small parcels posed a major threat to their ability to combat illicit trade (Box 1.1).

### Box 1.1. OECD 2016 Survey on institutional capacities to counter illicit trade

The OECD illicit trade survey was distributed to OECD member countries. It consisted of three parts: one on penalty schemes, one on the issue of misuse of small shipments and one on problems related to Free Trade Zones (FTZs). The survey was sent to the 35 OECD member countries. Three responses were received to the first part of the survey on penalties, 15 responses to the small shipments-specific part and 10 responses to the part on FTZs.

The survey consisted of 45 closed questions: nine concerned penalties; 15, small shipments; and 21, FTZs. Sample questions included: "Please indicate the three most common seizures in illicit goods via small shipments", "Does your government have a national strategy to address the growing risks from illicit trade in small packages via postal and courier services?", "What are the identified forms of illicit trade or illegal activity in "high-risk" foreign FTZs?" and "What, if any, challenges do your administration face in recording 100% of shipments into and out of the FTZ?".

The sale of products online has further complicated the situation, providing bad actors with a means to boost trade in small shipments as consumers are able to purchase items directly from suppliers, in small, individualised quantities. In effect, the importance of large firms and retailers as importing agents has declined, with consumers becoming far more active in this regard. This shift has affected the regulatory and policy framework for law enforcement, and the ability of customs, police and other relevant government agencies to stop illicit trade.



### *1.2.1. Adequacy of information and the role of intermediaries and vendors*

The provision of advance commercial information on small shipments is uneven or contains gaps. There are important data quality issues that remain due to omissions or mistakes in data (either accidental or intentional) that affect the risk-assessment process. Low information quality and lack of information or description on small packages are important in this regard. The consequences are significant as the capacity of authorities to diminish risks to health, safety and the security of citizens is mitigated. In some instances, governments are working with courier and postal bodies to obtain advance commercial information. The postal stream poses the most significant challenge in nearly all countries surveyed, due to structural gaps in obtaining data before arrival, and a lack of recourse for data inaccuracies.

Data quality remains a cause for concern in both courier and postal streams. When data quality issues arise, customs often have no recourse or redress when dealing with non-commercial actors.

There are important capacity-based differences between the courier and postal intermediaries that must be taken into account. Survey results and discussions with experts indicate that the postal stream represents a more important risk for illicit trade due to the frequent absence of proper risk assessment, reflecting the fact that accurate and advance data is less frequently available for postal modes. In the courier mode, advance information is likely to be more readily available, but effective (two-way) cooperation between express companies and customs administrations remains challenging.

### *1.2.2. Postal intermediaries*

Postal intermediaries often lack the appropriate infrastructure to fully digitize shipments. The current international legal framework under the Universal Postal Union (UPU) does not require advance transmission of information that would be useful for risk assessing products. Updates to IT infrastructure are being affected by concerns over their affordability.

Several pilot projects are underway to tackle key information challenges in OECD and non-OECD economies; they are aimed at addressing ways to deal with the information gaps continue to affect abilities to stop illicit goods.

### *1.2.3. Courier intermediaries*

“Data rich” courier intermediaries (i.e. express companies) pose a different set of challenges. Whereas postal companies are generally single national entities, express firms are a more disparate group and are not represented by a single international body. They are instead associated with industry groups, such as the Global Express Association and regional bodies, but these groups do not have the ability to dictate or enforce international standards. Couriers are, however, subject to national regulations and laws in the jurisdictions in which they operate. Customs authorities have expressed concerns over difficulties in obtaining adequate information on shipments from courier companies; the limited ability to process data and information from various disparate sources has been flagged as an issue in this regard.

Discussions with courier companies indicate that efforts have been made to transmit electronic information on shipments to customs that would enable customs authorities to carry out risk assessment and target suspect shipments more effectively. Courier companies in some instances are providing access to facilities, allowing customs

inspection of goods upon arrival, and are working with enforcement to locate and seize accounts of clients known to use this mode for illicit trade.

#### ***1.2.4. Current successes in security and facilitation***

Pilot projects focusing on national security risks for air shipments (i.e. explosives and other harmful products) are focusing on requirements for the provision of advance data, in electronic form, before the loading of goods onto airplanes. The projects, which are being carried out in the European Union, Canada, the United States, as well as other countries, have been successful in finding ways to secure advance data in order to help screen for threats. They have been based on effective inter-agency cooperation and public-private sector coordination.

#### ***1.2.5. E-commerce and illicit trade***

The sale of illicit goods continues on large, web-based retail platforms and on independently hosted sites. New trends, including the use of social media and person-to-person encrypted chats, are also emerging as new transaction platforms to re-direct or finalize transactions; these mechanisms are in addition to known illicit marketplaces on the “dark web”. Continuing to build partnerships among law enforcement, working with Internet service providers (ISPs) for website take downs, and developing agreements with e-commerce platform operators are important tools, but the rapid evolution of e-commerce necessitates a more systematic approach to tackling online illicit trade, focusing on ways to stop it at the source.

As with couriers, major e-commerce platform operators possess large amounts of detailed data and information on the description of goods being traded, their value, the vendors involved, the consumers and the histories of parties using the platforms. This information, alongside other important indicators, can be useful for risk-assessment. There are, however, few agreements between authorities and e-commerce vendors to facilitate information exchange.

#### ***1.2.6. Policies to combat growth in trade in illicit products via small shipments***

The sharp growth in the use of postal and courier streams as a delivery method for smuggling small packages containing prohibited or restricted goods has significantly impacted the institutional capacities of governments to effectively screen and interdict the goods. Criminal networks are exploiting gaps in these institutional capacities to benefit their illicit activities. Governments need to consider taking the following actions to address the situation:

##### ***Engage courier and postal intermediaries in efforts to detect and interdict trade in illicit products.***

Courier and postal intermediaries face different challenges when addressing issues related to illicit trade. Governments and international organisations should address each separately and reforms should be undertaken to strengthen mechanisms for detecting and interdicting illicit trade; cooperation amongst the different parties should be encouraged in this regard.

*Build on best practices identified in pilot projects to improve i) the quality of small shipment data available to customs authorities and ii) risk assessment techniques.*

Pilot projects for enhancing air security involving small packages illustrate ways in which the exchange of important information can be relayed to authorities to enable them to make more informed decisions on transport risks. Customs authorities need to build on the good practices that have been identified; this would include mandating preload advance cargo information and exploring ways in which the measures could be expanded to enhance the risk-assessment of small packages, with minimal impacts on legitimate trade.

*Expand capacity for accessing, integrating and evaluating datasets from stakeholders.*

Customs should explore ways of using technology and innovation, including data analytics and machine-based learning, in more progressive, forward-looking ways. Large amounts of information are likely to be available electronically from parties involved in trade, and customs should work to find ways of integrating this information into their databases in a seamless manner, with a view towards improving risk assessment and the modelling techniques that they are using.

*Engage e-commerce platform operators in efforts to detect online transactions in illicit products.*

E-commerce transactions are “faceless”, in the sense that transactions do not involve physical sellers or buyers (at least in a traditional sense); this complicates customs risk assessment as the supply chains can be highly disaggregated. Customs needs to engage with the industry with a compliance-based approach to develop trusted traders; large online e-commerce vendors that can act as authorised economic operators (AEOs) not only for vendor-based revenue collection, but also for holding firms accountable for the products that are sold on their platforms.

*Strengthen efforts to move against parties engaged in online trade of illicit products.*

Law enforcement would benefit from addressing the risks of cybercrime and illicit trade in e-commerce from a top-down approach. This would include shutting down web-retailers that engage in illicit trade and cooperating with foreign and domestic law enforcement entities to impose injunctions and pursue “take-down” requests of websites. Governments also need to develop new methods for maintaining forward-looking visions on the constantly evolving situation in cybercrime.

### **1.3. Combatting illicit trade and related criminal activities in free trade zones**

Free trade zones have long been a part of world trade, dating back to at least the early 1700’s. Originally established as means to facilitate goods in transit by relieving traders from many customs formalities that would otherwise apply to goods entering into a country for consumption, the purpose of zones has evolved into a tool for attracting foreign investment and promoting economic development and growth, particularly in developing countries. Benefits have, however, also accrued to advanced economies, as evidenced by the several hundred zones operating in the United States alone.

The specific benefits offered by zones differ according to the different laws and regulations of the countries where they are established. The costs and benefits to businesses and host countries thus vary considerably from one economy to another. For businesses, the benefits that zones offer can include: tax and customs duties exemptions, labour and immigration rules that are more flexible than those applicable in the customs territory of host countries, lighter regulation and oversight of corporate activities, fewer restrictions on corporate activities, and opportunities to improve distribution of goods to diverse markets. On the other hand, the costs of establishing a business in a zone, which might include a variety of special zone fees, may be lower than would otherwise be the case if the same business were established outside the zone and within the territory of the host country.

For host countries, zones can be beneficial to economies, to the extent that they attract foreign investment (particularly in high-tech industries), create jobs (particularly higher-skill) and enhance export performance. The benefits for the host countries, however, come at a cost, to the extent that government revenues are foregone and fall short of any revenue gains that might otherwise occur through zone activities. Moreover, potential benefits to economies would only apply to those zone activities which would otherwise not have otherwise been established in the customs territory of host countries.

Lightly regulated zones are, however, also attractive to parties engaged in illegal and criminal activities. Zones have facilitated trade in counterfeit and pirated products, smuggling and money laundering, often providing bad actors a relatively safe environment for carrying out their illicit activities. The problem is aggravated in instances where governments do not police zones adequately; this can occur when zones are deemed to be foreign entities that are outside of the scope of domestic policing activities. It can be further aggravated when zones are operated by private parties. These parties' main interests are likely to be in finding ways to expand zone occupancy and provide profitable services to zone businesses. They may therefore have little direct interest and/or capacity in law enforcement, may not have the capacity or authority for scrutinising zone operations. Even where government authorities are actively involved in overseeing zone activities, there is evidence that co-ordination between these authorities and zone operators, particularly those that are private parties, can be weak, providing further scope for bad actors to exploit zones for their illicit activities.

### *1.3.1. International regulatory framework*

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.

#### *World Customs Organization*

The RKC has historically been the principal instrument aimed at international harmonisation of customs practises for import and export procedures. Annex D, Chapter 2 of the convention provides an extensive framework for the regulation of FTZs and customs warehouses. 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, the convention contains few compliance mechanisms that could be used to enforce provisions (such as binding dispute resolution mechanisms).

### *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 noted that some zone benefits might be considered as export subsidies, which are governed by the WTO Agreement on Subsidies and Countervailing Measures (ASCM); such subsidies are prohibited under that agreement. 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.

#### *1.3.2. Evidence of illicit trade in FTZs*

The existence of illicit trade in FTZs is well-documented. A 2010 study by the OECD's Financial Action Task Force identifies FTZs as posing a high risk for money laundering and a risk to the integrity of global financial regulatory standards. In the report, informed by a member country questionnaire, FATF documents the lack of adequate oversight, inadequate standards for business registration practices, and inadequate (or absent) use of anti-money laundering practices in certain FTZs around the world. The report also notes that inadequate documentary requirements for imports and exports can lead to the exploitation of such zones for the use in fraud and trade-based money laundering operations.

Other forms of illicit trade and criminal activity that have been noted are as follows:

- *Tobacco.* Reports by the OECD (2016), INTERPOL (2014) and the International Tax and Investment Center (2013) document the exploitation of FTZs by criminal networks specializing in illicit tobacco trade, particularly for unlicensed and duty-unpaid cigarettes (“illicit whites”).
- *Counterfeit products.* Reports by the OECD and the European Union Intellectual Property Office (2016 and 2017), EUROPOL (2015) and the Business Action to Stop Counterfeiting and Piracy (2013) show that the market for fakes is supported by a series of global export hubs, many of which are identified as FTZs. The reports provide specific examples of the nature and scope of the counterfeiting.
- *Arms and other controlled goods.* A report in the Strategic Trade Review published in 2016 highlights the strategic trade control vulnerabilities of FTZs. This report notes that FTZs represent a threat to undermine anti-proliferation efforts, citing a case where controlled goods that were subject to an embargo were smuggled via FTZs to an embargoed country, using false declarations to avoid scrutiny. The report notes that trade in such goods, which include products such as uranium enrichment machinery, weapons and small arms, and dual use goods, can use zones as transshipment points to avoid sanctions.
- *Illegal gambling.* A 2017 report on FTZs and gambling by the International Centre for Sport and Security notes a broad range of illicit activities that are carried out in FTZs. In addition to illegal gambling, the report notes that the lack

of financial oversight in some zones has resulted in casinos operating in zones becoming prime targets for money laundering operations.

### *1.3.3. Policies to combat illicit trade and related criminal activities in FTZs*

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, 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 the activities that may or may not take place and guidelines for information sharing). 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 for exercising oversight and conduct inspections in FTZs, ii) lack of commercial information on activities conducted 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, including between zone operators, trade and logistics firms.

To address these issues, countries need to work together to develop a common international framework or set of standards that enables greater transparency, and a mechanism to ensure compliance with these standards. The following actions need to be considered.

#### *Formalise definition of FTZs.*

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 them in a formal and codified manner in international agreements.

#### *Expand information requirements for goods moving through zones, penalise misuse of zones and enhance security screening*

A number of good practices have been identified for developing information that can to help enhance efforts to combat criminal activities in zones. The use of restricted (high risk) goods lists, mandatory submission of electronic data, rapid adjudication of violations in zones and severe monetary fines for violations, as well as enhanced security screening, represent good practises that should represent minimum requirements for FTZs.

#### *Strengthen cooperation with stakeholders and encourage development of codes of conduct.*

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 achieve better business practices and promote 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 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 modernizing zone infrastructure.

*Enhance formal responsibilities of zone operators.*

Government-led initiatives such as authorized economic operator (AEO) style certification schemes for FTZs may 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 parties operating beyond customs control, covering, for example, accurate data recording and book-keeping, openness to customs audit and more stringent security standards for employees.

*Streamline customs procedures, and maintain adequate numbers of enforcement officials with ex-officio authority to supervise or control FTZs (or free zones) within their customs territory and according to the applicable provisions.*

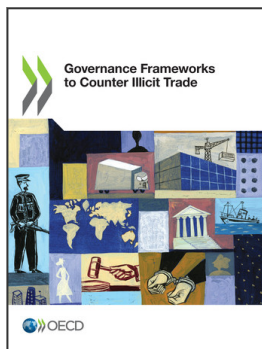
In addition to using zones to boost FDI and exports, some countries rely on zones to provide traders with a means for avoiding inefficient customs practices that add red tape and delays. To reduce reliance on zones for these purposes, countries should explore ways to streamline their general customs procedures. Furthermore, each country should ensure that it has adequate numbers of officials with ex-officio authority to supervise or control all FTZs within their customs territory and according to the applicable provisions. 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.

*Ensure wide participation of countries in FTZ discussions.*

Discussions on ways to improve efforts to combat criminal activities in zones involves a broad range of countries, all of which need to be involved in developing effective solutions, particularly in light of the different interests that they may have.







**From:**  
**Governance Frameworks to Counter Illicit Trade**

**Access the complete publication at:**  
<https://doi.org/10.1787/9789264291652-en>

**Please cite this chapter as:**

OECD (2018), “Key Institutional Capacities to Counter Illicit Trade”, in *Governance Frameworks to Counter Illicit Trade*, OECD Publishing, Paris.

DOI: <https://doi.org/10.1787/9789264291652-3-en>

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