Trade in Counterfeit Goods and Free Trade Zones

Evidence from recent trends

EXECUTIVE SUMMARY

Preface

Many countries have set up free trade zones (FTZs) to boost business activity and reap the benefits from free trade. These zones have been instrumental in the evolution of trade routes for the integrated supply chains of the global economy. However, FTZs may also facilitate illegal and criminal activities such as trade in counterfeit and pirated products, by providing a relatively safe environment, good infrastructure and light oversight.

To fully grasp the challenge of counterfeit and pirated trade and identify the best ways to address them, policy makers need evidence to document the links between FTZs and illicit trade, including trade in counterfeit and pirated goods. This is precisely the purpose of this study undertaken jointly by the OECD and the EUIPO, which sheds new light on the misuse of free trade zones for trade in counterfeit and pirated goods. We are also grateful to the World Customs Organization, the European Commission's Directorate-General for Taxation and Customs Union, and the United States Department of Homeland Security for providing the data, without which such a study could not have been conducted.

We are very pleased that our two institutions were able to co-operate to develop this solid and unique evidence based research. We are confident that the results of this work will facilitate the development of innovative policy options to respond to the challenges of trade in fake goods and other illicit commerce.

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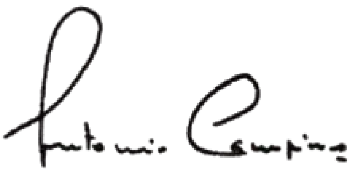

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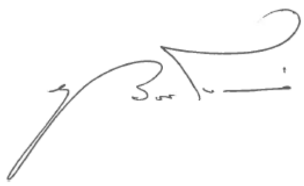

Foreword

Many countries around the world have set up free trade zones (FTZs) as a way to spur economic development. FTZs provide tax advantages and other regulatory exemptions that have been a boost to trade facilitation, business formation and foreign investment. Research indicates that the number of FTZ is growing and that flows moving through them are expanding.

Even though FTZs bring clear economic benefits to their host economies, there is the possibility that they can be misused by criminal organisations to traffic and smuggle counterfeit and pirated goods. This raises the double concern of the impact of crime and illicit trade activities on good governance, public safety and the rule of law, as well as the negative effect that counterfeit trade has on legitimate competitive advantage of rights holders, and consequently on innovation, employment and long-term economic growth. The recent OECD-EU IPO report, *Mapping the Real Route of Trade in Fake Goods,* identified the risks posed by illicit trade in counterfeits transiting through FTZs, and the underlying challenges in terms of enforcement gaps. The findings led to the hypothesis that a significant portion of total illicit trade in fakes seem to transit through, or rely upon, FTZs, and that this needed further examination.

This joint OECD-EUIPO report investigates the empirical links between trade in counterfeit and pirated goods and free trade zones. The report provides robust empirical evidence that documents these links, building on previous studies carried out by the OECD and the EUIPO on trade in counterfeit and pirated goods. At the OECD, this study was supervised by the Task Force on Countering Illicit Trade (TF-CIT), which focuses on evidence-based research and advanced analytics to assist policy makers in mapping and understanding the market vulnerabilities exploited and created by illicit trade.

This report was prepared by Piotr Stryszowski, Senior Economist at the OECD Directorate for Public Governance jointly with Michał Kazimierczak, Economist at the European Observatory on Infringements of Intellectual Property Rights of the EUIPO, under the supervision of Stéphane Jacobzone, Deputy Head of Division, OECD and Nathan Wajsman, Chief Economist, EUIPO. The authors are grateful to Peter Avery and Florence Mouradian (OECD) and to Claire Castel (EUIPO) for their contributions.

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The quantitative research in this study relied on a global database on customs seizures, provided by the World Customs Organization (WCO) and supplemented with regional data submitted by the European Commission's Directorate-General for Taxation and Customs Union, the US Customs and Border Protection Agency and the US Immigration and Customs Enforcement. The authors express their gratitude for the data and for the valuable support of these institutions.

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Executive Summary

Free trade zones (FTZs) have a long and cherished role in world trade, dating back to at least the early 1700s. They can provide numerous, unequivocal benefits to business and host countries. However, lightly regulated FTZs are also attractive to parties engaged in illegal and criminal activities, such as trade in counterfeit and pirated products or smuggling and money laundering, as these zones offer a relatively safe environment with both good infrastructure and limited oversight.

This study confirms the links between FTZs and trade in counterfeit products. The existence, number and size of FTZs in a country correlate with increases in the value of counterfeit and pirated products exported by that country's economy. An additional FTZ within an economy is associated with a 5.9% increase in the value of these problematic exports on average. The study also led to clear findings with respect to the connections between the value of fake goods exported from an economy on the one hand, and the number of firms operating in FTZs and the total value of exports from these zones on the other.

While FTZs were originally established as means to facilitate goods in transit by relieving traders of the need to complete many of the customs formalities that would otherwise apply to goods entering a country for consumption, these zones have evolved over time. They have developed into an important tool for attracting foreign investment and promoting economic development and growth, particularly in developing countries which can use them to leapfrog economic development. However, developed economies have also reaped the benefits of these zones, as evidenced by the several hundred zones operating in the United States alone.

Zones come in many forms, and they are subject to the specific laws and regulations of individual countries. The costs and benefits to businesses and host countries thus vary considerably from one economy to another. For businesses, zones provide numerous benefits, including savings in taxes and customs duties, greater flexibility in terms of labour and immigration rules than in the customs territory of host countries, lighter regulation and oversight of corporate activities, fewer restrictions on corporate activities, and additional opportunities to distribute goods to diverse markets. Furthermore, while there can be costs associated with choosing to locate in a zone, possibly including a range of special zone fees, this burden is often quite light, perhaps with even lower costs than would otherwise be incurred if the business were established in the customs territory of the host country.

For host countries, zones can be beneficial to economies to the extent that they attract foreign investment, create jobs and enhance export performance. The benefits to host countries, however, come at a cost, to the extent that governments are forced to forgo revenue, with any gains stemming from zone activities often failing to offset losses. Moreover, potential benefits to economies only apply to those zone activities that would otherwise not have been established in the customs territory of the given host country.

Beyond the economic costs and benefits to states and businesses, these lightly regulated zones are also attractive to parties engaged in illegal and criminal activities. Some zones may have indivertibly facilitated trade in counterfeit and pirated products, smuggling and money laundering. The problem is aggravated when 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. When zones are operated by private entities, these entities' 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 in and/or capacity for conducting law enforcement activities. They may also lack the capacity or authority to effectively monitor 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 private operators, can be weak, providing further scope for bad actors to exploit zones for their illicit activities.

More effective actions and co-ordination at the national and international levels are urgently needed to ensure that zones are not undermined by illicit activities. This has come to the attention of the OECD, EUIPO, European Anti-Fraud Office, Europol, the World Customs Organization, the World Trade Organization, Interpol, the United Nations Office on Drugs and Crime and the World Health Organization. The following organisations have made proposals to address the situation: the Caribbean Financial Action Task Force, the Black Market Peso Exchange System Multilateral Experts Working Group, the International Chamber of Commerce and the International Trademark Association.

By working together the international community can ensure that FTZs continue to develop as important institutions that promote international trade without facilitating illicit activities. The two goals are not incompatible.