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## In Name Only

Are Free Trade Zones assisting capitalism or criminals  
and crony capitalists?

Roger Bate  
*Adjunct Scholar*

## **Short Abstract**

*Global free trade negotiations have been stalled for nearly two decades, yet bilateral trade deals and free trade zones (FTZs) have compensated for this stagnation by continuing to enhance trade and growth. FTZs have flourished in emerging nations, even within autocracies that rhetorically oppose open trade. FTZs possess many attributes of capitalist economies – free exchange, low taxes, no tariffs or other customs rules, and light regulation. All of these traits can attract foreign companies, foreign investment in domestic companies, industrial production, and overall wealth generation. However, such zones are also troubling; they can produce several negative results including a strong mafia presence, massive counterfeit operations, tax evasion, money laundering, and even terror financing. At best, FTZs are workarounds that are desirable only when the political system is captured by vested interests that limit international trade. At worst, they are deniable locations for odious regimes to gain hard currency and even credibility.*

## **Executive Summary**

While waiting nearly twenty years for a new global free trade agreement, governments have been trying to protect domestic economies and attract foreign trade and investment at the same time. One solution has been the expansion of special zones, often in ports or disadvantaged areas. In principle, these zones are supposed to have a light touch – limited regulation and customs oversight and low or no taxes. In practice, many of these sites have no functioning safeguards at all and attract businesses of all stripes, including the illegal and dangerous. The worst zones are not run by legitimate administrators but by mafia kings – some even finance terror groups like Hezbollah, and many seek to deprive legitimate businesses and authorities of their income and tax revenue. Even ports in more respectable nations often assert that FTZs are separate from them, and therefore, they are only partially responsible for what transpires in them.

The victims of these trade zones are wide and varied, and most never make the press. I've been given examples, but many are hard to properly verify. Fake products that are either made or traded through these zones apparently kill many: The 149 American deaths caused by a fake blood-thinning drug,<sup>1</sup> the bus crash that killed 15 in Canada because of counterfeit brakes,<sup>2</sup> and the 51 deaths in Libya due to alcohol poisoning.<sup>3</sup> The wider harm is just as tragic, with violence and corruption financed by trade in these zones: the illicit cigarette smuggling that acquires millions of dollars for terrorist organizations,<sup>4</sup> or the 16 Italian judges who were found to be

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<sup>1</sup> Roger Bate, "The deadly world of fake medicine," *CNN Health*, last modified July 17, 2012, <http://www.cnn.com/2012/07/17/health/living-well/falsified-medicine-bate/index.html>.

<sup>2</sup> "Counterfeiting Resources," UNICRI, <http://counterfeiting.unicri.it/database.php?sec =C&c =6>.

<sup>3</sup> "Alcohol poisoning kills 51 in Libya," *BBC News*, last modified March 11, 2013, <http://www.bbc.co.uk/news/world-africa-21747409>.

<sup>4</sup> Sari Horwitz, "Cigarette Smuggling Linked to Terrorism," *The Washington Post*, last modified June 8, 2004, <http://www.washingtonpost.com/wp-dyn/articles/A23384-2004Jun7.html>.

partnered with the Camorra.<sup>5</sup> In most cases like this, no one would think to put some of the blame on the zones where the products and funding are generated.

Criminal syndicates are finding that the creation and distribution of counterfeit goods carry lower penalties than narcotics trafficking, are much harder to detect, and tend to be low priorities for authorities. Furthermore, the market for everyday and luxury products they are now infiltrating is far greater than the one for traditional criminal activities. Plus, items like pharmaceuticals are easily adapted into the syndicates' existing networks and areas of expertise. These illegal and dangerous activities are enabled by the lack of oversight at many FTZs in emerging markets.

As is to be expected, citizens of countries with well-developed consumer protection and a fair judiciary (i.e. good governance) enjoy the best protection from illicit goods. It is doubly unfortunate that free trade zones are used by emerging economies that are struggling to participate in external trade *because* of poor governance. Fakers and pirates are able to take advantage of the loosening of controls in trading posts where rules are already poorly enforced due to a lack of will and/or capacity.

Panama's Colón zone is the second largest FTZ in the world, after Hong Kong, where multi-billion dollars of trade and thousands of businesses take advantage of its proximity to the Canal. Colón advertises itself as the trading showcase of the region:

Seaports with modern facilities, container ports, direct access through the Pan-Pacific Highways, air access, and trains transport containers daily from the Pacific to the Atlantic Ocean. Dividends arising from external operations, or operations executed or consumed abroad, are tax free. There are no capital investment taxes. Municipal and local taxes do not apply to firms operating in the free zone, and there are no taxes on shipments to or from the free zone from or to anywhere in the world.

Yet the Colón zone is also home to some very dangerous actors who specialize in money laundering and the narcotics trade.<sup>6</sup>

Despite the fact that Dubai assists the US in the War on Terror, its Jebel Ali zone is rife with businesses including 16 massive cigarette factories, some of which I saw and more I heard about,

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<sup>5</sup> "Camorra Mafia Arrests in Naples, Italy Includes 16 Judges and \$1.3 Billion in Seized Assets," *The Huffington Post*, last modified March 19, 2012, [http://www.huffingtonpost.com/2012/03/19/camorra-mafia-arrests\\_n\\_1364844.html](http://www.huffingtonpost.com/2012/03/19/camorra-mafia-arrests_n_1364844.html).

<sup>6</sup> Daniel Muñoz and Myriam Rivera, "Development of Panama as a Logistics Hub and the Impact on Latin America," Masters Thesis, *Massachusetts Institute of Technology*, June 2010.  
Barney Warf interviewing Nicholas Noyes and Gene Bigler in "Tailored for Panama: Offshore Banking at the Crossroads of the Americas," *Geografiska Annaler. Series B, Human Geography*, Vol. 84, No. 1 (2002), pp. 33-47  
Ropp, Steve C., "Explaining the Long-Term Maintenance of a Military Regime: Panama before the U.S. Invasion," *World Politics*, Vol. 44, No. 2 (Jan., 1992), pp. 224.  
U.S. Department of Justice, "Money Laundering and Financial Crimes," 2012, pg. 150, <http://www.state.gov/documents/organization/184329.pdf>

which make products that will be passed off as branded originals.<sup>7</sup> Hence the production is legal in Dubai, but their final branding is not. These illicit cigarettes are extremely dangerous to consumers because they not only contain carcinogens already present in tobacco, but they may also contain immediately toxic products and far higher tar levels. In addition, these cigarette factories lower legitimate tax revenue of Western nations and funnel money to the same terrorist groups that the Dubai authorities otherwise seek to combat.<sup>8</sup>

The Shenzhen zone in China is one of the greatest producers of fake goods in the world. Some of these goods stay within China, while others make their way to American consumers. As previously mentioned, 149 died from one such incident in 2008. Currently, 80% of the US pharmaceutical supply chain originates or passes through China or India. While both are attempting to police these legitimate trades, neither has achieved anything approaching an acceptable standard.

Europe is not immune from the trade of fake products, and there are major counterfeiting problems particularly with zones in Cyprus and Turkey, which are primarily used for transshipment and re-packaging. Even the US, which has 240 free trade zones, has problems with a few. For example, smuggled tobacco products in the New York State zone bordering Canada deprived both nations of millions in tax income.<sup>9</sup> The smuggler's savings were then likely re-invested into more sophisticated illegal activities or laundered via more legitimate activities, corrupting these as well.<sup>10</sup>

In this paper, I explain the rise of these free trade zones, how the worst are run, who benefits from the sale of counterfeit products, and why we should care. I have spent the past decade analyzing the products made and repackaged in these zones and the thousands of deaths they cause, especially in regards to fake medicine. This spawned my interest in the zones themselves.

This is very much an introductory working paper, and as such it is far from exhaustive in terms of products, geography, or even public policy. While there is a general discussion of wide geographic reach early in the paper, most of the original research and commentary comes from the Middle East (notably Turkey, Lebanon, Dubai, Jordan and Israel), and relies heavily on interviews with security consultants (of both local governments and businesses). Very few of these contacts were willing to be identified publicly.

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<sup>7</sup> "Transnational trafficking and the rule of law in West Africa: A Threat Assessment," *United Nations Office on Drugs and Crime*, (July 2009): accessed September 28, 2013, [https://www.unodc.org/documents/data-and-analysis/Studies/West\\_Africa\\_Report\\_2009.pdf](https://www.unodc.org/documents/data-and-analysis/Studies/West_Africa_Report_2009.pdf).

<sup>8</sup> Jamie Smyth, "Security: Smoking out the smugglers," September 1, 2013, accessed September 28, 2013, <http://www.ft.com/intl/cms/s/0/5d7b8b00-0fe3-11e3-a258-00144feabdc0.html>.

<sup>9</sup> Bree Spencer, "Akwasasne: A Complex Challenge to U.S. Northern Border Security," *The National Strategy Forum Review* 20, no. 3, (Summer 2011): accessed September 28, 2013, <http://www.nationalstrategy.com/Portals/0/documents/Summer%202011%20NSFR/Akwasasne.pdf>.  
<http://www.nationalstrategy.com/Portals/0/documents/Summer%202011%20NSFR/Akwasasne.pdf>

<sup>10</sup> Kelly Phillips Erb, "Up In Flames: Cigarette Taxes Create Opportunity For Revenue And Crime," August 20, 2013, accessed September 28, 2013, <http://www.forbes.com/sites/kellyphillipserb/2013/08/20/up-in-flames-cigarette-taxes-create-opportunity-for-revenue-and-crime/>.

## ***The Benefits of Global Free Trade***

The importance of freedom from tariffs and other impediments to the movement of goods for global trade is one of the few points on which nearly all economists can agree. Unfortunately, since the successful completion of the Uruguay Round on the General Agreement on Tariffs and Trade in the 1990s, there has been no significant political move towards expanding the benefits of freer multilateral trade. New bilateral deals are common, however, and the US and EU have enacted a combined total of 37 trade agreements since the Uruguay Round was completed.<sup>11</sup>

The absence of new multilateral trade agreements is not due to a lack of interest. Since the formation of the World Trade Organization (WTO) in 1995, the spread of these trade agreements has not been very successful worldwide. The Millennium Round at Seattle failed in 1999, and the launching of the Doha Round in 2001 to expand the benefits of earlier agreements foundered at the outset. Emerging nations had the opportunity to exercise their veto power in ways they had never dared to before; they correctly argued that US and EU intentions were often self-serving and occasionally hypocritical, especially with regards to agricultural subsidies. Instead of continuing negotiations, however, India and many African nations ignored the immense potential benefits of freer trade; instead they dogmatically refused to open their agricultural and textile markets, where domestic lobbies are particularly strong.

I saw firsthand how the impasse was exacerbated by the rise of (un)civil society groups that pressured emerging nations to boycott open-trade deals. While debating with protesters, I and hundreds of others were tear-gassed in the streets of Seattle in 1999. Seattle remains the nadir of WTO meetings. The death knell of Doha was the Cancun ministerial meeting a few years later. Although it occurred without violence, there was a subsequent collapse of talks. I recall the Australian Ambassador to the WTO complaining that emerging nations had destroyed the meeting by refusing to open key parts of their markets.

A decade later, there is still little hope of a new global free trade deal. Although there have been no resolutions in favor of global free trade, localized political solutions have evolved and continue to benefit from the global rounds. Tariffs are generally far lower than they were fifty years ago, even in textiles and agriculture. However, some still remain and cause inefficiencies that lead to rent seeking and corruption. With an eye on limiting the damage of some of these tariffs, free trade zones have since flourished.

## ***American FTZs***

‘Foreign’ trade zones were enacted into US law in 1934; during the Great Depression the notion of ‘free trade’ was particularly hard to sell, hence Congress altered the name to “expedite and

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<sup>11</sup> For the US, the largest and most significant of these is the 2004 Dominican Republic-Central America-United States Free Trade Agreement (CAFTA-DR), whose six additional members represent the third largest US export market in Latin America. See: Office of the United States Trade Representative, *CAFTA-DR (Dominican Republic-Central America-FTA)*, 2013, <http://www.ustr.gov/trade-agreements/free-trade-agreements/cafta-dr-dominican-republic-central-america-fta>.

encourage foreign commerce.” As Lewis Leibowitz, chairman of the US National Association of Foreign-Trade Zones, stated in 2012:

Since the end of World War II, the world trading community has negotiated eight rounds of tariff reduction. Each time, however, tariff relationships can be changed in ways that do not help American business. If tariffs are reduced on finished products but not on raw materials and components used to make them, we inadvertently encourage investment and manufacturing outside the United States.

Seventy-nine years after FTZs came into existence, these zones are still primarily defended as job enhancement vehicles for “the creation and maintenance of employment through the encouragement of operations in the US which, for customs reasons, might otherwise have been carried on abroad.”<sup>12</sup>

It is not inaccurate to say that FTZs create employment: about 320,000 Americans work in 240 zones within the US.<sup>13</sup> Politically, it is expedient to focus on US jobs. The true purpose of many FTZs, however, is the elimination of the dead hand of government from trade and commerce whenever governments themselves have failed to make useful trade arrangements.

The International Convention on Simplification and Harmonization of Customs Procedures defines an FTZ as a region where national customs laws regarding import duties and taxes do not apply.<sup>14</sup> Today there are roughly 3,500 free trade zones located in 130 countries, all of which facilitate the production, repackaging, and trade of products around the globe with rapid speed.<sup>15</sup> Some commentators believe that FTZs, “have been established in many countries as testing grounds for the implementation of liberal market economy principles...[and] are viewed as instruments to enhance the acceptability and the credibility of the transformation policies and to attract domestic and foreign investment.”<sup>16</sup> Usually, these zones are established in underdeveloped parts of the host country in order to attract employers to the region, reduce poverty and unemployment, and stimulate the area's economy. These zones are often used by multinational corporations to produce goods (such as cars, clothing or shoes) or to repackage products for different markets, especially where local languages are demanded by public safety law (such as cigarettes and pharmaceuticals).

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<sup>12</sup> The Foreign-Trade Zones Board, “Rules and Regulations,” in *Federal Register* 77, no. 39 (February, 2012): 12112, <http://www.gpo.gov/fdsys/pkg/FR-2012-02-28/html/2012-4249.htm>.

<sup>13</sup> The Foreign-Trade Zones Board, 72<sup>nd</sup> *Annual Report of the Foreign Trade-Zones Board to the Congress of the United States*, (2011): 2, <http://ia.ita.doc.gov/ftzpage/annualreport/ar-2010.pdf>.

<sup>14</sup> World Economic Forum, *Global Agenda Council on Organized Crime: Organized Crime Enablers* (July, 2012): 2, [http://www3.weforum.org/docs/WEF\\_GAC\\_OrganizedCrimeEnablers\\_Report\\_2012.pdf](http://www3.weforum.org/docs/WEF_GAC_OrganizedCrimeEnablers_Report_2012.pdf).

<sup>15</sup> World Bank. *Special Economic Zones: Progress, Emerging Challenges, and Future Directions*, eds. Thomas Farole and Gokhan Akinci (2011): 5, [http://www-wds.worldbank.org/external/default/WDSPContentServer/WDSP/IB/2011/08/16/000386194\\_20110816014424/Rendered/PDF/638440PUB0Ext00Box0361527B0PUBLIC0.pdf](http://www-wds.worldbank.org/external/default/WDSPContentServer/WDSP/IB/2011/08/16/000386194_20110816014424/Rendered/PDF/638440PUB0Ext00Box0361527B0PUBLIC0.pdf).

<sup>16</sup> “Tax Free and Duty Free Trade Zones in Africa: Import Export Processing Zones,” West Africa Import Export, <http://www.africa-import-export.gm/free-trade-zones-africa.html>.

By 2008, FTZs hosted 68 million jobs and \$500 billion in direct trade-related value.<sup>17</sup> More than 2,000 zones are in 119 developing and transitional economies, mainly within Asia, the Pacific, and the Americas.<sup>18</sup> In addition, more than half of these zones are privately owned and operated and employ 40 million people.<sup>19</sup>

As such, FTZs enhance world trade and development and may also signal the advantages of moving towards free market principles. Of course, FTZs can also allow autocratic regimes to perpetuate illiberal societies by employing pockets of capitalism to generate wealth, possibly even strengthening their undesirable governments. In the case of China, however, authorities deployed zones with this aim, but were ultimately unable to control them once millions of Chinese citizens tasted the benefits of capitalism.<sup>20</sup> The outcome is an apparently successful, but potentially volatile, blend of communism and crony capitalism. Even the most sinister totalitarian governments, like Syria or North Korea, have set up FTZs so that their regimes can acquire hard currency, foreign direct investment, and a patina of openness. Like China, these regimes have tried to control the flow of benefits, but from what I observe, and more importantly what security experts who have spent far more time in such locations, they have probably had greater success in doing so than China.

There are other inherent dangers in poorly managed FTZs. If a host nation's legal, customs, and security apparatus does not pay sufficient attention to their own FTZs, problems ranging from counterfeiting and smuggling to money laundering and terror financing may occur. This can have a demonstration effect and lead some to believe that such a free-for-all can be equated with Western capitalism. The problem with these FTZs has a more immediate impact on neighboring countries, with spillover effects of illegal activity. Unfortunately, the bad behavior goes both ways: the zones of these rogue regimes aren't just affecting their own, but tend to corrupt those around them. As security consultants in the Middle East and Asia informed me, FTZs in places like North Korea and Iran are often used by their neighbors to carry out less savory enterprises and shirk their public duties while being able to maintain plausible deniability.

Every US state has at least one FTZ where the reprocessing of goods, limited manufacturing, and research and development can take place. This lowers the overall tax burden and shrinks the bureaucracy of large and small businesses alike. For example, there are small tariffs on intermediate products that go into the production of pharmaceuticals and cars, whereas their finished products attract low tariffs or are exempt all together. To keep tariff costs as low as

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<sup>17</sup> The World Bank Group, *Special Economic Zones: Performance, lessons learned, and implications for zone development* (April, 2008): 7, <https://www.wbginvestmentclimate.org/uploads/SEZs%20-%20Performance,%20Lessons%20Learned%20and%20Implications%20for%20Zone%20Development.pdf>.

<sup>18</sup> Ibid., 23.

<sup>19</sup> Ibid.

<sup>20</sup> China's movement from a centrally-planned economy to a more market-based one has been assisted by special economic zones. The two-decade long economic transformation started off slowly with these SEZs, which functioned as an experiment in market openness. Their success encouraged further economic reform beyond just these special trade zones. Today, for example, nearly all items are sold at market prices instead of being determined by the state, small firms are privatized, most wages are set by the market, and there has been a growing trend in foreign trade and investment.



possible, companies import the final materials into an FTZ, manufacture the final product, and then import into the US proper. They create employment in the US and lower their tax burden rather than importing the raw materials into the US directly.

FTZs are workarounds. When political lobbies have succeeded in establishing tariffs, which lower consumer welfare, FTZs can limit some of the distortions. But given the nature of FTZs is to bypass laws – often protectionist laws it must be said – these zones are properly seen as an useful fudge at best. In US-based FTZs, laws against fraud, counterfeiting, corruption, and terrorism, as well as laws in favor of protecting labor and the environment, are generally enforced. Dan Griswold, President of the US National Association of Foreign Trade Zones, explained to me that the vast majority of FTZs perform in exemplary fashion. There are a few concerns, however, such as the St Regis-Mohawk Reservation in New York State, which is a major transit point for smuggling high value, high tax, and easily transported products like cigarettes.<sup>21</sup>

### ***Akwesasne and contraband tobacco***

Ottawa's Macdonald-Laurier Institute held a conference on March 26, 2013 to discuss how to combat contraband across Native American reservations, especially those inhabited by the Mohawk peoples.<sup>22</sup> Counterfeit cigarettes tend to find their way to the reservations, originating mainly in China and imported via Vancouver. These fakes are often sold side by side with smuggled tobacco products. Numerous academic and security experts discussed reasons for the generic problems across Canada and the unique problems encountered on the reservations, which possibly account for most of the contraband trade between the US and Canada.<sup>23</sup> It became obvious that a critical reason for the massive contraband smuggling across the reservations was because of different beliefs about whether the trade could be considered legitimate or illegal. Native American opinion is that their trade is legal because historic treaties granted them the right to trade products such as tobacco.

So while tobacco smuggling is a criminal issue for the Canadian police, politicians in Ottawa, and the US, the Mohawk peoples believe it is a political issue to be resolved through negotiations. The discrepancy is further complicated since, according to at least one security expert at the MLI conference, the organized crime operations that benefit from the trade in the reservations pay a tithe (estimated at 10% of their trade) into a community fund. Since this money has been invested into building schools and helping home ownership, all the Mohawk people that I spoke with thought the trade had significant upsides even while acknowledging that the dangers of smoking and the criminal enterprises fall on others outside of their communities. The sovereignty arguments that they put forward in order to allow them to continue trading do break down, however, when this trade leads to violence or moves from tobacco into

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<sup>21</sup> Spencer, "Akwesasne."

<sup>22</sup> This meeting was held under the Chatham House rule, so although comments can be reported they cannot be attributed to individual persons

<sup>23</sup> See <http://www.nationalstrategy.com/Portals/0/documents/Summer%202011%20NSFR/Akwesasne.pdf> for details of the amount of lost revenue and "Just say no to contraband cigarettes," *National Post*, May 8, 2008, accessed September 28, 2013, <http://www.nationalpost.com/opinion/columnists/story.html?id=af6a15f5-cb82-42cc-9381-e841c748b001>.



methamphetamines, cocaine, heroin or other narcotics. But it doesn't break down enough to lead to a reversal of opinion.

The long run challenge is to find something else that is profitable for the Mohawk peoples who engage in this trade. Until this is accomplished, their trade will continue. And as police experts at the meeting acknowledged, the discussion also needs to be taken offshore because many of the counterfeit products traded through the reservations come from China and other emerging markets. Engaging with the security services in these countries is also important in order to limit supply.

While the St. Regis zone is arguably a failure for the US and Canada, the area's transgressions are minor when compared with many other locations abroad.

### *A selection of problematic FTZs.*

Panama's Colón Free Trade Zone, the world's second largest FTZ after Hong Kong, generated \$8.6 billion in exports and re-exports in 2008 and is one of the busiest ports in the world (owing to its close proximity to the Canal).<sup>24</sup> Participating companies are exempt from all corporate, federal, and municipal taxes, while products imported, exported, or stored in the FTZ are exempt from otherwise applicable tariffs and duties.<sup>25</sup> While many South American nations are infamous for their cumbersome and bureaucratic structures that deter international trade, Panama's fortified secrecy laws and looser banking regulations rival those of Switzerland.<sup>26</sup> However, just as legitimate corporations benefit from such favorable terms, illegal activities have persisted and even accelerated in the Colón FTZ since the 1970s. Local military elites have colluded with clients by importing products tariff-free and reselling the items to the Panamanian market at full tariff price, while pocketing the difference.<sup>27</sup> Military officials have also financed terrorist activity by working with contraband smugglers to transport weapons and illicit goods to militaries and armed groups across South America.<sup>28</sup>

Some FTZs act as pseudo-mafia states, where an environment of 'no rules' becomes one of 'rule by the most influential' (and often brutal). Such FTZs undermine the notion of what free trade and free markets should be: places where rules are limited but enforced properly, consistently, and systematically. After all, while Europe and the US have problems with fraud, corruption and special interests driving politics, they still exhibit fairly open trade and the rule of law.

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<sup>24</sup> Financial Access Task Force, *FATF Report: Money Laundering Vulnerabilities of Free Trade Zones* (March 2010): 12, <http://www.fatf-gafi.org/media/fatf/documents/reports/ML%20vulnerabilities%20of%20Free%20Trade%20Zones.pdf>.

<sup>25</sup> Daniel Muñoz and Myriam Rivera, "Development of Panama as a Logistics Hub and the Impact on Latin America" (Master's Thesis, Massachusetts Institute of Technology, June 2010).

<sup>26</sup> Barney Warf interviewing Nicholas Noyes and Gene Bigler in "Tailored for Panama: Offshore Banking at the Crossroads of the Americas," *Geografiska Annaler. Series B, Human Geography* 84 no. 1 (2002): 33-47.

<sup>27</sup> Roger Bate, "Do special enterprise zones undermine capitalism and our safety?" American Enterprise Institute. Last modified March 20, 2013. Accessed October 1, 2013. <http://www.aei.org/article/economics/international-economy/trade/do-special-economic-zones-undermine-capitalism-and-our-safety/>.

<sup>28</sup> Steve C. Ropp, "Explaining the Long-Term Maintenance of a Military Regime: Panama before the U.S. Invasion," *World Politics* 44 no. 2 (January, 1992): 224.

This is not the case in many parts of the world. As in Panama, at least two security consultants I spoke with assert that the intersection of military officials and extensive economic enterprises (legitimate and not-so-legitimate) owned in whole or in part by ranking officers is a phenomenon found in places like China, Vietnam, and Iran. While states such as Turkey and South Korea had similar situations, over the last couple decades both have been able to devolve commercial control to genuinely private interests. At the same time a freer media, international pressure, and truly independent judiciaries have evolved to further their transition to market democracies.

However, enterprising military regimes are only one subset of the larger issue. Lax regulations and corporate cronyism allowed Aruba to become a haven for the Italian Mafia in the 1990s; by 1992, the Sicilian-based Caruana-Cuntrera family owned 60% of all property on the island through the arrangement of unsavory, preferential agreements with the local government.<sup>29</sup>

Aruba's ideal location off the coast of South America, along with loose enforcement of domestic legislation within its free trade zone, allowed the country to become a crucial transshipment point in the American-European narcotics trade.<sup>30</sup> By the mid-1990s, Aruba's reputation as a criminal layover had become so entrenched that foreign investors were diverting business away from the island. As a result, multinational corporations were able to appeal to the Aruban government to overhaul its laws.<sup>31</sup> Despite entrenched interests, Aruba illustrates how FTZs can be reformed and provides insights into larger issues on the horizon for places like Dubai and Singapore, which are even more interconnected with the international community. These city states are dependent on a continuation of the positive popular perception of their reputation among the international community. As they become less able to compete on cost both will rely increasingly on the level of service and quality of their products. The safety of goods that transit their borders, along with the legitimacy of the business interests involved, directly affect their access to North American and European markets. The ease of doing business in these locations is crucial to their survival, and a series of scandals, which are entirely possible given what I've seen transit these locations (e.g. fake medicines, illicit tobacco), could reverse in a few months what took decades for them to create in the global imagination.

Aruba implemented more comprehensive background checks on companies and tightened oversight of incoming and outgoing shipments, enabling it to maintain better inventory controls.<sup>32</sup> In fact, as Aruba's FTZ has evolved it has become the preferred venue for foreign and domestic Venezuelan investors who are interested in structuring trade and other transactions in a reliable, legal, and relatively transparent manner. Although Aruba still has problems with inventory management and does not have the oversight of US FTZs, this example shows that foreign FTZs can be improved while increasing safety and economic benefits as a result.

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<sup>29</sup> Tom Blickman, "The Rothschilds of the Mafia on Aruba," *Transnational Institute* (1997): 3.  
<http://www.tni.org/sites/www.tni.org/files/Blickman%20Mafia%20Aruba%20paper.pdf>.

<sup>30</sup> Jim Kouri, "Aruba: A drug trafficker's paradise," *RenewAmerica*, last modified August 10, 2005,  
<http://www.renewamerica.com/columns/kouri/050810>.

<sup>31</sup> Financial Access Task Force, *FATF Report*, 38-42.

<sup>32</sup> *Ibid*, 38-42

Unfortunately, most of the world's worst FTZs are run by groups that have no interest in reform at all.

### ***FTZs and Terror Financing***

Cocaine revenues from a trafficking network based in Colombia had been sent to the Lebanese Shia terrorist group, Hezbollah, in exchange for access to Middle Eastern narcotic consumers. Lax banking laws in one Asian country<sup>33</sup> allowed the traffickers to launder the funds through a "Black Market Peso Exchange." Colombian traffickers would deposit money in the Asian account and then buy the currency back with pesos, using the currency to move the drug shipments in and out of Panama (including the Colón FTZ). The network utilized a peso exchange system in Miami as well. Regional trafficking has troubled security officials for decades, but the global nature of illicit trade and finance that security officials see today is unprecedented.<sup>34</sup>

An FTZ in Ciudad del Este, located near the juncture of the Brazilian, Paraguayan, and Argentine borders, has drawn concerns from security experts. The "Tri-Border Area" (TBA) of these three countries became infamous for the trafficking of illicit goods due to lax border security and the promotion of the tourist industry. After the terrorist attacks of September 11, 2001, Paraguayan police responded to US pressure by arresting a powerful Lebanese immigrant whose electronics store was a front for a massive money-laundering and DVD piracy scheme that funded Hezbollah.<sup>35</sup> Thus, without even a moderate level of oversight by national governments, FTZs can provide havens for actors that pose dangers more violent than economic loss.<sup>36</sup>

Documented evidence of counterfeit goods passing through FTZs around the world has caused business advocacy groups to call for greater regulation of free trade zone customs enforcement.<sup>37</sup> The Jebel Ali FTZ in Dubai is one of Europe's largest sources of counterfeit goods.<sup>38</sup> In 2008, the year I first visited the zone to investigate transit in fake pharmaceuticals, 15% of all the cases of seized counterfeits at EU borders occurred en route from the UAE.<sup>39</sup> As I saw, many pharmaceuticals undergo modification and unlicensed products can be superficially rebranded. This leads to uncertain provenance and concerns about the quality of the medications. A public

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<sup>33</sup> The FATF report does not specify the country.

<sup>34</sup> Ibid., 21.

<sup>35</sup> Matthew Levitt, *Hezbollah: The Global Footprint of Lebanon's Party of God* (Georgetown: Georgetown University Press, 2013), 83.

<sup>36</sup> "Organized Crime is Increasingly Active in Film Piracy; Three Cases Link Terrorists to Piracy Profits," RAND, last modified March 3, 2009, <http://www.rand.org/news/press/2009/03/03.html>.

<sup>37</sup> Walt Bogdanich, "Counterfeit Drugs' Path Eased by Free Trade Zones," *The New York Times*, last modified December 17, 2007, <http://www.nytimes.com/2007/12/17/world/middleeast/17freezone.html?pagewanted=print>; BASCAP, *Free Trade Zones* (2013), <http://www.iccwbo.org/Advocacy-Codes-and-Rules/BASCAP/International-engagement-and-Advocacy/Free-Trade-Zones/>.

<sup>38</sup> United Nations Office on Drugs and Crime, "[The Globalization of crime - A transnational organized crime threat assessment](#)" Last modified June 2010. Accessed October 1, 2013. [http://www.unodc.org/documents/data-and-analysis/tocta/TOCTA\\_Report\\_2010\\_low\\_res.pdf](http://www.unodc.org/documents/data-and-analysis/tocta/TOCTA_Report_2010_low_res.pdf).

<sup>39</sup> UNODC, *The Globalization of Crime*, (2010): 179. [http://www.unodc.org/documents/data-and-analysis/tocta/TOCTA\\_Report\\_2010\\_low\\_res.pdf](http://www.unodc.org/documents/data-and-analysis/tocta/TOCTA_Report_2010_low_res.pdf).

health inspector has uncovered similar label-modification activities in the FTZs of the Netherlands Antilles.<sup>40</sup> Even as Aruba, Panama, and officials who have oversight of the TBA step up efforts to deal with these issues at the local level, criminal syndicates are still quicker at shifting their activities to Belize, Bolivia, and nearby islands. While this doesn't mean that stopping the bad guys is hopeless, it does mean that cross-border and more comprehensive action is a necessary reality once syndicates are put on the defensive.

Through extensive investigations into the counterfeit pharmaceutical trade for my book *Phake: The Deadly World of Falsified and Substandard Medicines*, I discovered how multinational gangs would occasionally use FTZ locations to produce pharmaceuticals.<sup>41</sup> However, FTZs most frequently served as repackaging sites where phony pharmaceuticals passed through for distribution.<sup>42</sup> Zones in China, Panama, and the UAE were the most regularly implicated. When I bought pharmaceuticals from bogus Canadian websites as part of my research for the book, the drugs would often arrive from China (via Dubai) with payment going to accounts held in Panama. Such operations not only rip off consumers and threaten their lives, they also embolden criminals. It is the opaqueness of the FTZ operations that ensure that most fake drug investigations fail before they even start. Transparency should be an integral part of any free trade regime, so that while governments slowly address security concerns, consumers can act and discern for themselves.

### ***Dangers that are not a priority – the case of bulk chemicals***

Other than using FTZs for their own benefit, most interested parties are focused on preventing specific dangers. Western businesses monitor FTZs in their attempt to prevent production, repackaging, and transit of counterfeit versions of its own products. Similarly, Western governments are focused on trade in lethal products (some of which overlap with trademark infringements of Western products) and the money trails of criminal entities, especially terrorist organizations or funders that use FTZs. These are understandable priorities, but far less attention is paid to trade in other products that ironically might be as dangerous to the public and cause even greater financial losses.

Simply spending a few days in and around major FTZ ports will expose one to the vast volumes of container traffic passing through these areas. Because of the contacts I had made investigating for *Phake*, I was naturally paying attention to the trade in bulk chemicals that circulate, seemingly without inspection, around the world. Guy Villax, CEO of the Portuguese pharmaceutical company Hovione, explained to me the provenance of many of the

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<sup>40</sup> "Free Trade Zones and Counterfeit Drugs: An Interview with PSM's Bryan Liang and Netherlands Antilles' Chief of Staff of the Inspectorate of Public Health," The Partnership for Safe Medicines, last modified July 12, 2010, <http://www.safemedicines.org/2010/07/free-trade-zones-and-counterfeit-drugs-an-interview-with-psms-bryan-liang-and-netherlands-antilles-c.html>.

<sup>41</sup> Roger Bate, *Phake: The Deadly World of Falsified and Substandard Medicines*, (Washington, D.C.: AEI Press, 2012).

<sup>42</sup> International Chamber of Commerce, "Controlling the Zone: Balancing facilitation and control to combat illicit trade in the world's Free Trade Zones." Last modified May 2013. Accessed October 1, 2013. <http://www.ip-watch.org/weblog/wp-content/uploads/2013/05/FTZ-report.pdf>.

chemicals that go into the production of medicines and foods are unknown, even by European and US firms.<sup>43</sup>

While groups like Rx360, a US industry group focusing on supply chain assurance, is improving the situation for Western manufacturers, the transit of bulk chemicals is still far from secured. With the help of some private security officers, I saw the manifests of cargo ships coming in and out of FTZ ports in three countries and the unloading of the products in one. In at least one instance, the chemicals in the container did not match the chemicals on the manifest. And in half of the dozen manifests that I saw, the original source of the products was not correctly identified. Nearly all of the chemicals had originated in China, but their production was in several locations identified as Italy or UAE.

According to Amir Khan, an Indian pharmaceutical consultant based in Delhi who monitors the chemicals trade, none of the chemicals could be easily turned into explosive materials and none were immediately lethal or toxic. Thus, there is little attention paid to this trade by Western authorities.<sup>44</sup> According to Guy Villax, chemicals like these have been sold at major trade events like the CPhI Global Conference, and the next conference in Frankfurt is in late October. The vast majority of the buyers, sellers, distributors, and middle men operating at this massive trade fair are legitimate; but, in the past at least, amongst these players are a few disreputable traders who know the real provenance of these chemicals.

Any organization that does not conduct serious audits will not know that chemicals allegedly made in Italy were actually made in China. These chemicals could be inferior, which could lead to substandard products that endanger lives. It is likely that the purchasers of these chemicals will be at the most cost-conscious end of production, but even major brand name suppliers might procure these by mistake –especially if there are shortages in usual suppliers. Manufacturers do conduct tests on the chemicals that they procure, but some important and dangerous problems (e.g. trace impurities can be carcinogenic and are rarely spotted unless specifically measured, which is expensive and in 99% of cases not required) are not easily seen in routine tests.

The trade in these chemicals occurs outside of FTZs for sure, but their rapid transit through FTZs and the apparent relabeling that can occur without any oversight at all means that these areas enable this vast trade. It is arguable that this keeps the price of medicines low, but it also has a potentially lethal side effect. Moreover, numerous corporate names are used within FTZs that make it difficult to trace the source of products and help to obscure the parties responsible. While a regular port can have just as many corrupt officials, these officials are more vulnerable to authorities backed by the political will to protect domestic consumers. FTZs not only introduce a legal and psychological barrier to the interference of authorities; they also allow blame to be shifted to the more amorphous “international community.”

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<sup>43</sup> Personal Communication; October 15<sup>th</sup> 2011

<sup>44</sup> Personal Communication; June 22<sup>nd</sup> 2013

## *Big Trouble in Little Chinas*

There seems to be one universal when it comes to counterfeit products and their trade through FTZs: Regardless of the product, everyone I spoke to says that between 50% and 90% of all international fakes originate in China. The World Customs Organization claims 75% of seized counterfeit products come from East Asian primarily China.<sup>45</sup> The majority of transshipment points revolve around contacts and facilities that are connected to the Chinatowns that stretch from Panama and Paraguay to Kuala Lumpur and Kenya. A century ago, most Chinese triads and tongs were insular and rarely cooperated outside their own dialect groups (and even then they were limited in scope to specific villages and clans). One side-effect of the Chinese unity cultivated after 1989 has been a pan-Chinese identity that has even infiltrated criminal syndicates, allowing them to scale up and staff their organizations. Meanwhile, China is able to run far-flung operations that are often staffed and even enforced by local ethnic groups under Chinese leadership. As one Malaysian security expert explained to me: “There are about five syndicates in the Klang Valley and they are all managed by the Chinese, even though they involve Indians and Malays at the lower levels.”

With Chinese middleman minorities thoroughly dominating legal and illegal commerce in Southeast Asia, Chinese counterfeiters are able to take full advantage of the geography that rings the South China Sea, which is ideal for moving goods in and out of tens of thousands of islands, inlets, and other shelters. These century-old networks allow illicit distributors to scatter and reform their shipments in any number of locations and configurations, sometimes even with the assistance of local governments and militaries. For shipments heading to Panama or Dubai, Latin and Arab syndicates are often the partners of choice for accessing their own markets or using paths and techniques perfected by narco-traffickers to enter North American and European markets.

But Chinese efforts are often tacitly and unwittingly aided and abetted by policies of entire nations, not just their FTZs. Take the Philippines, for example. The local priorities of the customs agents there are to interdict trade in rice. For reasons of protectionism, which has been rhetorically defended with the canard of food security, the Philippines are a great market for rice smugglers who can make vast amounts of money by illegal importation. The Philippines are made up of hundreds of islands, and as Ranier Ragos, a senior Philippines customs officer explains, it is a “full time job to prevent illegal smuggling of rice.”<sup>46</sup> While Ragos and his colleagues are busy with such efforts, the far smaller but vastly more valuable shipments of more lethal products, like fake pharmaceuticals or poor quality tobacco, are rarely intercepted.

Of course Chinese fake products hurt the Chinese at home too, as demonstrated by the baby milk formula scandal that hit Shenzhen and Hong Kong. In 2008 the worst single incident led to 6 deaths and 300,000 infants affected. The Chinese company Sanlu had illegally added the

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<sup>45</sup> United Nations Office on Drugs and Crime, "Transnational Organized Crime in East Asia and the Pacific: A Threat Assessment." Last modified April 2013. Accessed October 1, 2013. [http://www.unodc.org/documents/data-and-analysis/Studies/TOCTA\\_EAP\\_web.pdf](http://www.unodc.org/documents/data-and-analysis/Studies/TOCTA_EAP_web.pdf).

<sup>46</sup> Personal Communication, May 23<sup>rd</sup>, 2013

chemical melamine to diluted milk products in order to falsely boost protein levels.<sup>47</sup> While the company was sanctioned by the state, consumers had no standing to get redress in court. This led Chinese mothers to risk arrest by illegally bringing bulk quantities of foreign infant milk formula into China from Hong Kong and further afield. Under pressure from Beijing, Hong Kong authorities prevented all customers from purchasing more than two cans of formula per day. Rule breakers faced up to two years in prison and a \$64,500 fine. One drug investigator told me privately that criminals started to take advantage by faking foreign milk formula labels (most of the faking being done in the free zone of Shenzhen and to a lesser extent in Hong Kong). In the past year, three different Chinese companies, Mengniu, Ava Dairy, and Yili Group, have run into problems. The first two recalled baby formula containing high amounts of aflatoxin, a fungal carcinogen probably introduced via the feed for cows. And Yili issued a recall of its formula due to high mercury contamination.<sup>48</sup>

Since the onset of these events, change has begun to take place in China. As one computer professional and mother of two based in Shenzhen reflected to me, “On the one hand, it is scary to hear about all these problems with [milk powder](#). Still, I think it’s good to know about these things so I can make decisions...Just a few years ago, we would never have heard there were any problems. Of course, now we hear about so many problems it makes it difficult to trust anyone. Still, I guess that’s how reform starts, right?”

### ***China’s fakes are aided even by the better FTZs***

When convenience suits them, many countries treat their free trade zones as separate from the responsibilities of their own sovereign territory. Even in Singapore, one of the best run pro-capitalist nations of the world, there is disquiet amongst some US security officials that Singaporean officials will often wait a full week after a ship has left to review the documentation and other information; by this time, any perpetrators of frauds would be long gone and would prove difficult to hunt down after the fact. Dubai levies severe penalties for fakes found inside domestic markets, but there are no similar penalties (let alone actual enforcement) for goods being exported. With small local markets that are easy to protect, massive revenues from their positions as major transshipment hubs, state-of-the-art transportation facilities and lax regulations, both these ports have enabled smugglers and counterfeiters.

According to Middle Eastern regulatory experts that I spoke with, over 70% of seized fake products in the EU can be traced back to Dubai’s Jebel Ali FTZ, where many of the products are re-packaged and re-labeled. Many of these practices are perfectly legal and are carried out in other free trade zones along the way. Mersin is one such FTZ, and is Turkey’s largest port where officials and operators are well aware of EU regulations, which demand that drugs are packaged to service the 24 official languages of the EU’s common market. In Turkey, domestic terror groups like the PKK and Turkish Hezbollah have diversified from narcotics trafficking to the

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<sup>48</sup> Roger Bate, “Chinese Mothers Risk Arrest For Buying Safe Baby Formula,” *Forbes*, April 16, 2013, accessed September 28, 2013, <http://www.forbes.com/sites/realspin/2013/04/16/chinese-mothers-risk-arrest-for-buying-safe-baby-formula/>.



smuggling and counterfeiting of consumer goods.<sup>49</sup> According to a local source, they even fake Fanta bottle tops and cash them in for contest prizes on a massive scale.

As Anatolia becomes an ever expanding workshop for Europe, officials in Ankara, pressured by Istanbul's increasingly competitive multinationals, have been keen to crack down on illicit activities by updating their legal codes, using advanced equipment, and incentivizing enforcement personnel. But as Turkish political will, aggressive policing, and international cooperation have been able to suppress much illicit activity in and outside Turkey's free trade zones,<sup>50</sup> much of the activity has relocated to the Turkish Republic of Northern Cyprus – which is not only a state recognized solely by Turkey, but has its own free trade zones, notably Famagusta.

It is important to understand that Turkey has little control over Cyprus, which as one expert put it, "is its own planet," and both Greek and Turkish Cypriot leaders tend to cause more headaches for their own backers in Athens and Ankara than any tangible political or economic benefit. Famagusta continues to be a hub for all sorts of rogues, and not just Turks; local commentators mentioned Russians, Greeks, Arabs, Israelis, Corsicans, and of course the Chinese and Lebanese. Practically speaking, Ankara has less control over Famagusta than the Israelis do over the West Bank. But, perhaps as one local expert explained, if Ankara doesn't want more control, "it can deny responsibility for any problems."

### *Organized crime and disorganized government criminals*

Latin cartels have found that the organizations they have created to serve the 5% of the world that wants expensive narcotics (often at high risk and high penalties) can easily be adapted to serve the 95% of the world that wants cheap pharmaceuticals (often for low risk and low penalties). Even some governments are getting in on the action and exporting medicines of dubious quality to other countries. The most obvious participants in this are Cuba and Venezuela, with Ecuador, Bolivia, and Paraguay also playing a part, as transit of products is connected to their "medical diplomacy" efforts<sup>51</sup>. However, no one really wants to talk about the details. Private security folks are skittish because there are numerous rumors of paid thugs staking out their children's schools (although such problems are not confined to Paraguay; even relatively respectable Malaysia has this identical problem, according to local security consultants I spoke with).

Along the way, free trade zones not only act as shells to re-arrange goods and confuse monitors, but in many cases they are used as low-cost warehouses for when market and enforcement conditions are favorable for local or regional distribution. According to security officials in Israel

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<sup>49</sup> John Rollins and Liana Sun Wyler. Congressional Research Service, "Terrorism and Transnational Crime: Foreign Policy Issues for Congress." Last modified June 11, 2013. Accessed October 1, 2013. <http://www.fas.org/sgp/crs/terror/R41004.pdf>.

<sup>50</sup> Although, I suspect that the sheer volume of Turkish trade which has been growing exponentially for years just serves to make illicit activity a smaller portion of the whole.

<sup>51</sup> Among leftist regimes medical products and medical staff are transferred as barter for financial or other considerations. For example, Cuba has provided doctors and medicines (sometimes of dubious quality) to numerous fellow travelling socialist regimes.

and Jordan, prior to Syria's civil war, operators would regularly make last minute changes and divert to Syria's port of Latakia if the nearby Libyan free trade zone of Tripoli had temporarily unfavorable conditions for transshipment (authorities raiding, special monitoring, etc.) Things have now changed; with the chaos in Libya, Tripoli is a regularly cited destination for ships that either never make it or arrive empty as they drop their cargo off surreptitiously on one of the hundreds of Greek islands along the way (and inside the EU customs zone).

Transit by ship is important, but as Lebanon and its famous traders illustrate, fakery has taken to the skies in increasing volumes. Middle Eastern Airlines connects the 4 million in Lebanon to the other 15 million Lebanese residing around the world. While the global Lebanese diaspora includes well-known names that have come out of the older, Christian communities like Mexico's Carlos Slim (richest man in the world) and Brazil's Carlos Ghosn (CEO of Nissan), the newer Lebanese migrants tend to be poor Muslims in search of work. These Shi'ites from the Bekaa Valley were implicated in trying to broker uranium purchases in Paraguay for terror groups, and whom often serve as mules in places like Australia and Africa.

However, if recent trends continue, like the indictment of a highly-respected Hezbollah minister's brother for knowingly importing and distributing bad medicines, it may likely derail leaders in Hezbollah's drive for legitimacy.<sup>52</sup> As a Jordanian security expert told me: it is one thing to have the popular club drug named after their spiritual leader (as apparently is the case), and it is another for the name to become a by-word for low quality and dangerous children's vitamins.

### *A Conspiracy of Opportunities*

While there is certainly no monolithic cabal orchestrating the current explosion in counterfeiting through FTZs, there is every indication that the scaling up, merging, and diversification of criminal organizations has created global players that find numerous opportunities to collaborate when their own vertically-integrated criminal enterprises find it necessary.

Still, there is no question that the combined firepower of global crime is nothing compared with even a fraction of the resources at the disposal of world governments. Yet, as one Jordanian government official points out:

Bad guys have good communication skills between each other, not like the good guys. Often good guys are playing each other for their country – French government for their politics, Americans for their products, Chinese for who knows, and private investigators for their money. Not always is a bad guy a bad guy. Bad guys have their motivations and complications too, but sometimes because of their reasons and motivations, they are easier to persuade into cooperating. You can get useful news from the bad guy. To complete the network of information you need to dig down into social networks like Google, Facebook, or hi5 [which is popular in Latin America – and is the third largest

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<sup>52</sup> Fox News, "Brother of Hezbollah Cabinet minister charged with importing counterfeit drugs." Last modified February 15, 2013. Accessed October 1, 2013. <http://www.foxnews.com/world/2013/02/15/brother-hezbollah-cabinet-minister-charged-with-importing-counterfeit-drugs/>.

social network in the world] and other social networks popular in East Asia. Further than that, you need to communicate with China-based Arabs. There are some restaurants in China that are popular for Arabs...in Guangzhou where Arabs gather. New Arabic merchants travel to China and meet the old merchants and trade. That kind of information you can't get from Internet or from governments. We need to know where things are coming from and when so we can be on the lookout<sup>53</sup>.

Cengiz Gumustus, a former Turkish Interpol officer, runs a private security consultancy and crime laboratory. He echoes the Jordanian official's sentiments by trying to make connections between criminal networks running through FTZs. Unlike most people with a background in law enforcement, Gumustus has predicated his business less on numbers tallied from busts and more on tracking the relationships between various products and their counterfeiters.<sup>54</sup>

Gumustus explains that, "data only becomes information when we start discovering the what's and when's. When "how" is answered it becomes knowledge. By building the system we are developing we can start seeing what happens when we take action." If there is a known counterfeiting route that comes from China into Dubai, then to Port Said over to Famagusta and into Mersin, then he can often predict what would happen if entry to Mersin was blocked and how the networks would re-arrange themselves and react based on precedent and existing links. Gumustus' system is able to start seeing patterns, networks, and relationships that he and other security experts are following up on in an effort to limit the trade of lethal fakes through FTZs. Unlike major multinationals that also maintain extensive databases of counterfeits, Gumustus is one of the first to start organizing across products and sectors. There is no question that counterfeiters readily shift between textiles, pharmaceuticals, and other products since, as Gumustus jokes, "they have no brand loyalty."

Of course, achieving such aims requires the management of FTZs, along with the major companies operating within them, to want to enforce such changes. With that in mind, I offer a few policy suggestions for those who want to make changes.

#### *A few policy suggestions for FTZ authorities that want to change*

Seeing that FTZs work well in the US, there are some basic policy changes that senior managers of foreign FTZs should contemplate.

**First, FTZ managers should be trained on regulatory requirements, anti-money laundering protocols, and customs enforcement.** This should help agencies to navigate the public-private coordination that is expected of FTZ leaders, without which misunderstandings and loopholes occur. Notably, when a government liberalizes trade policy in a given area without revamping customs procedures, the increased queue of international shipments brought about by business-friendly laws does not necessarily lead to increased growth. As I've seen in India and East

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<sup>53</sup> Personal Communication July 31<sup>st</sup> 2013

<sup>54</sup> Personal Communication July 25<sup>th</sup> 2013

Africa, customs officers can take advantage of the increased transit of goods to extract bribes while perishable goods turn into financial losses.<sup>55</sup>

**Second, administrators should actively and regularly inform FTZ participants of the requirements of doing business in the zone, as well as the legal consequences of abusing the reduced trade barriers.** Many businesses would observe anti-trafficking or anti-money laundering measures if FTZ administrators demonstrated the initiative to demand compliance. Administrative incompetence and inertia prevent most otherwise law-abiding firms from bothering to comply with the written law in many zones, across Asia in particular. Criminals then take advantage of slack enforcement of the law. It should be expected that conducting trade in an FTZ necessitates familiarity with the zone's legal framework.

**Third, FTZ administrators should require all businesses to establish an internal compliance officer, who is charged with overseeing company compliance with anti-fraud measures.** Small businesses may oppose such a suggestion, but the risks of not having at least one staff member who is familiar with zone laws is a greater impediment to a functioning zone than the relatively small cost to each company. These officers should also act as a liaison between FTZ authorities and the company leadership. This compliance officer should remain in regular correspondence with the FTZ administrative office.

**Fourth, the background information of all companies must be registered in a well-maintained database overseen by FTZ controllers.** Companies must be willing to detail their organizational structure, the ultimate beneficiaries of business profits, the goods or services provided and exchanged, as well as the clientele connected with the company. If a business is not willing to submit this information to the relevant FTZ controllers, their operations within the zone should be prohibited.<sup>56</sup>

**Fifth, companies must have a physical presence in the locale where they operate.** The so-called "PO BOX" companies are sometimes set up as a front for illegitimate business transactions. If an FTZ authority wants to speak with an official from a particular company, that official should be physically available to meet.

**Sixth, the construction of an international shipping inventory management information system should help monitor the contents of the millions of goods entering and exiting FTZs every day.** Working to integrate data on exit and entry times, container information, and shipping trends should help officials note trends of illicit shipments. This will be a long term project that will require collaboration by both FTZ and government officials from countries all over the world. However, it is becoming more and more apparent that the effectiveness of one FTZ in curbing fraudulent and illegal activity can be undone by a neighboring FTZ that exhibits

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<sup>55</sup> Edgar Cudmore and John Walley, "Border Delays and Trade Liberalization," in *International Trade in East Asia, NBER-East Asia Seminar on Economics* 14, eds. Takatoshi Ito and Andrew K. Rose (University of Chicago, 2005).

<sup>56</sup> In one case, when administrators in Aruba required companies to reapply for FTZ registration with greater detail on company background, several businesses chose not to reapply. See "Money Laundering Vulnerabilities of Free Trade Zones." *FATF Report* (March, 2010): 41.

less thoroughness in regulatory enforcement. Interconnectedness in trade will require interconnectedness in anti-fraud oversight.

## *Conclusion*

Some economists have argued that the kinds of corruption we find across many FTZs can, “grease the wheels of growth” by diverting investors away from costly government bureaucracies.<sup>57</sup> However, evidence to the contrary is overwhelming.<sup>58</sup> Corrupt FTZs increase business costs, deter the entrance of new entrepreneurs into the marketplace, exploit workers, decrease the quality of products bought and sold, and put all of us at greater risk through money laundering and financing of lethal actions. It is not something to be welcomed or encouraged.

The corruption present in so many FTZs is particularly ironic, as corruption kills economic freedom in the very area designated to protect and nurture it. When public officials demand informal payments, the unwritten costs create barriers to trade in the areas designed to facilitate legal transactions. When private actors participate in illicit trafficking and money-laundering, the transparent and efficient market finds itself compromised by clandestine operations that generate only uncertainty in the marketplace.

It is not as if Western lawmakers have failed to attempt to create systems to address these problems. The Financial Action Task Force, an OECD initiative, and the UNODC, have been advising nations for decades on some of the regulations required to promote transparency and limit the dangers from organized crime. But in many places, the concentrated benefits gained by the politically connected from acting illegally in FTZs still easily outweigh the much larger societal costs from these actions. While the better FTZs provide millions with employment and trade benefits, the worst FTZs make and trade in lethal fake products that probably kill thousands and risk millions of lives through terror financing.

Reform is possible using proven methods, but since the failings of FTZs are really reflections of political problems in each location, reform will only occur if political will exists. In many instances, the concerns raised in this paper are shared by many FTZ managers and the recommendations made here are also their desired outcomes. But the outlook is not entirely bleak. Some FTZs have successfully legitimized and now attract more reliable traders, as well as new business in retail tourism. These examples could show the way to others. That said, reform is least likely in the places where it is most needed: poorly governed trade zones are a wider symptom of poor governance in general.

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<sup>57</sup> Pierre-Guillaume Méon and Khalid Sekkat. “Does corruption grease or sand the wheels of growth?” *Public Choice* 122, no. 1 (2005): 69-97.

<sup>58</sup> Pranab Bardhan, “Corruption and development: a review of issues,” *Journal of Economic Literature* 35 no. 3 (1997): 1320-1346; Rohini Pande, “Understanding Political Corruption in Low Income Countries,” *Handbook of Development Economics*, eds. Paul T. Schultz and John Strauss (2008): 3155-3184.