

A Risk-Based Customs Control System in Free Zones

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Abstract. To support business and promote global trade, the country creates special territories and free zones. Free zones provide entrepreneurs with benefits such as fiscal reliefs, easier access to various resources, and simplified movement of goods, but at the same time create an environment where there are risks of unscrupulous activities. Several studies have concluded that the simplified control of free zone companies and goods implemented by customs authorities poses a high risk of smuggling, violations of intellectual property rights, as well as money laundering. In their research, the authors propose a free zone control model, in which customs risk mitigation measures can be implemented by providing targeted customs control solutions and at the same time without creating additional burdens for entrepreneurs, ensuring fast cargo throughput and increasing the security of international supply chains.

Keywords: Control model, customs control, free zones, risks.

I. INTRODUCTION

Both in the European Union and in other parts of the world, ways to support business and to make global trade faster, more convenient, and more economically profitable are constantly being sought. One of the ways is free zones, which have become especially popular in recent decades, as evidenced by the data on almost 5400 free zones, of which more than a thousand have been created in the last ten years, and this number is expected to increase in the future [1].

Free zones provide entrepreneurs with various tax and customs tariff reliefs, favorable terms for access to land, permits, licenses, employment, administrative facilitation,

and infrastructure support. By taking advantage of these benefits, entrepreneurs are expected to create new jobs, boost exports, diversify the economy, and increase production volumes [1].

However, the benefits and reliefs provided by free zones are also attractive to entrepreneurs who want to carry out illegal circulation of goods and funds. The 47th Research Paper of the World Customs Organization (WCO) expresses the opinion that the control of free zone companies and the goods implemented by customs authorities have been eased, creating a high risk of smuggling, violations of intellectual property rights, as well as money laundering [2].

Free zones can be characterized as "growth poles", which attract foreign direct investment (FDI), thus promoting the economic development of countries and regions. The main advantage of attracting investment is a lower level of bureaucracy [3]. Free zones are one of the production models and to increase production efficiency, it needs an efficient transportation and customs clearance system, which is the reason why free zones located in ports have become the main choice for foreign investment. The characteristic features of free zones are high trade liberalization and internationality, which especially attract foreign investments [4].

On the other hand, other authors take a critical look at free zones and the opportunities and benefits they offer in their research. The offshore space in which free zones operate helps to obscure beneficial owners and illicit trade practices, which hamper authorities' efforts to track money flows and collect taxes [5]. There is also an opinion that the

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model in which free ports operate discourages capital mobility – goods (assets) can be in transit and stored in the free zone for an unlimited time, and they can be sold and moved without being exported or taxed [6]. The purpose of the study is to identify the main security and customs risks of supply chains in free zones, to identify the regulatory framework that ensures customs to manage the possible identified risks, and to provide a solution for monitoring and controlling the operation of free zones. .

II. MATERIALS AND METHODS

A. Literature review

The customs and tax reliefs available in free zones attract not only honest entrepreneurs but also players that want to use free zones for illegal activities and profit from them. According to the regulatory regulations of the European Union, it is not necessary to submit a customs declaration for goods in the free zone, so unlike other procedures for storing goods, entrepreneurs do not need to provide a guarantee for goods stored in the free zone [7]. According to the authors, this is one of the most important reliefs, because the financial resources available to the entrepreneurs are not reduced in case of long storage of goods. However, in case of illegal release of goods into free circulation, there is no guarantee for covering the tax debt, and as a result of insufficient information about the goods, there are limited opportunities to determine the value of the goods to calculate the customs debt.

Illicit trade is mainly carried out where there is a weak monitoring system, resulting either from a lack of capacity or overly eased monitoring conditions. In free zones, customs control is mainly carried out based on the information available in the accompanying documents of the goods [8]. The greatest risk occurs when goods are transited or transhipped through free zones, as it is easier to hide the origin or destination of the goods, creating both fiscal risks and threats to public safety and security [3].

The "GRYPHON II" operation implemented in 2016 also shows the vulnerability of free zones to illegal trade. As part of the operation, shipments of tobacco products were especially monitored and more than 700 million cigarettes, almost 300 thousand cigars, and 250 tons of other tobacco products were seized. This operation confirmed that the free zones are being used for the illegal trade of tobacco products, as there were reports of shipments disappearing during transit between the various free zones [9].

Free zones have been established in Latvian ports and their main risks are smuggling, movement of counterfeit goods, violations of the CITES convention, and tax evasion. The number of cases of cigarette and drugs smuggling tends to increase, as shown in Fig.1 by the number of seizures made by the State Revenue Service (SRS) Customs Board in ports in the period from 2020 to 2023.

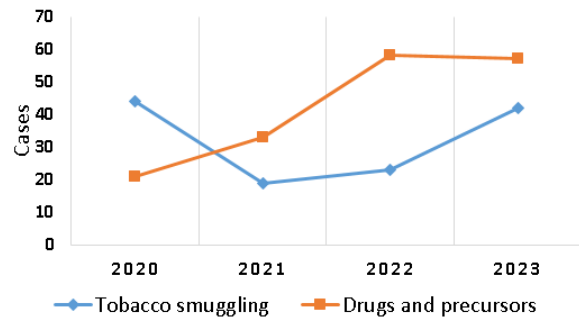


Fig. 1 The number of seizures made by the SRS Customs Board in the period from 2020 to 2023.

There is a risk in the production and distribution of counterfeit goods in free zones. The International Chamber of Commerce (ICC) is critical of free zones, but at the same time points out that most of the free zones act as a tool that promotes international trade and national development. One of the reasons why the illegal trade in counterfeit goods has increased in free zones is that the development of standards, monitoring, and regulations governing the operation of free zones has been slower than the development of these zones [10].

A study conducted in 2018 found that the existence of even one free zone significantly increases the export value of counterfeit and pirated goods from a given economy. There is a direct correlation between the size of free zones, the value of exports, the number of companies and employees existing in them, the volume of investments, and the volume of circulation of goods that violate intellectual property rights. Considering other influencing factors, such as the level of economic development, the fight against corruption, and general trade volumes, it can be argued that free zones are exposed to the risks of moving goods that violate intellectual property rights and are used for the implementation of illegal activities [11]. The share of counterfeit goods from economies with the 20 largest free zones is twice that of economies without any free zones [12].

The risks associated with the use of free zones for money laundering and terrorist financing have also been specially studied. The Financial Action Task Force (FATF) concluded in a 2010 study that trade-based money laundering is one of the most common methods used by organizations to launder proceeds of crime. Using complex schemes, invoices are issued with a reduced or increased value of goods, which is easier to implement in the free zone. Fictitious shipments are made, false value and quantity of goods are applied, one form of fraud is the issuing of multiple invoices for goods to justify an increase in value and the transfer of goods to another jurisdiction. The most common offenses in which free zones can be used to launder proceeds of crime are smuggling, illegal drug trade, membership in organized crime groups, fraud, as well as the distribution of counterfeit goods [13]. The environment of free zones is good for hiding and making it as difficult as possible to identify the real beneficiary of illegal profits and the origin of those profits, for example when dealing in goods stored in free zones such as works of art. The buyer can store the works of art purchased by illegal means in the free zone, naming the cargo agent as responsible and not revealing the true owner of the goods [14].

Between 2011 and 2018, the Customs Enforcement Network (CEN), established by the WCO, received reports from 48 countries of more than 600 seizures related to free zones. The structure of confiscation cases is shown in Fig.2.

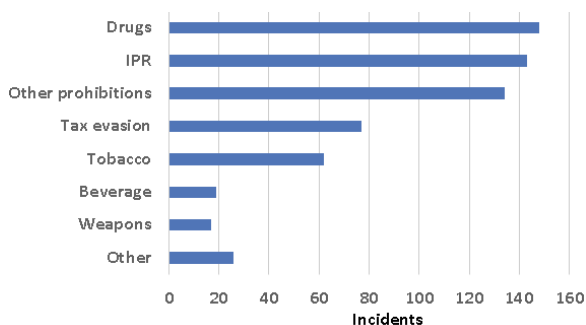


Fig. 2 Structure of seizures in free zones in the period from 2011 to 2018 [12].

The structure of seizures demonstrates the main groups of risks – cigarette and drug smuggling, intellectual property violations, and tax evasion. Violations detected in free zones are global. The country of dispatch of the confiscated goods and the country where the violation was detected may differ or be from different regions, and there may also be situations where countries belong to the same region. For example, the share of counterfeit goods from economies with the 20 largest free zones is twice that of economies without any free zones [12].

B. General analysis

One of the factors that make free zones more susceptible to illegal activities is the lack of international standards governing the movement of goods through free zones in transit, as the monitoring of goods in transit usually becomes a secondary objective [15]. International regulations that have an impact on global trade do not always clearly formulate requirements for goods in free zones [2]. It should be noted that agreements containing clear requirements for free zones aim to reduce the risks of illegal drug trade, tobacco smuggling, and intellectual property rights in free zones. The authors of the paper believe that it would be particularly important to include specific provisions for free zones in the legislation that regulates the other previously identified groups of existing risks, such as the illegal movement of fauna and flora specimens (CITES) and the use of cultural objects for money laundering, which is one of the frequently described methods used for money laundering in free zones.

One of the most important legal acts in the field of customs is the International Convention on Simplification and Harmonization of Customs Procedures [16]. Chapter Two of Special Annex D of the Revised Kyoto Convention contains 21 standards and recommended practices that define the principles of the zones' operation. There are cases where the concept used in the Revised Kyoto Convention, that free zones are considered to be outside the customs territory, is misinterpreted and leads to the concept of "extraterritorial free zone", which has a reduced involvement of customs services in the monitoring of goods and eased customs control measures are applied [2]. Free zones are established in the geographical territory of countries, but the government has defined them as structures outside the normal customs regime [5].

The revised Kyoto Convention stipulates that customs services can control goods located in free zones at any time [16], but there are also cases where this norm is not implemented in reality, for example, customs officers cannot enter the territory of the free zone without prior approval. The customs cannot stop the operation of the free zone even if the customs have evidence of smuggling activities, the customs authorities of individual countries have the right to check the cargo only at the moment of its import or export, data on the movement of cargo in free zones are not submitted, as a result of which certain important information is not available to customs administrations and customs control is limited [2]. Existing standards, monitoring, and other controls for free zones have expanded, but have not always kept pace with the growth in the number of companies and the volume of illegal trade in goods and services. Competent state authorities do not always have timely physical access to the premises, there are difficulties in obtaining information on the activities of companies registered in the free zone with goods and on the ownership of goods that are moved in transit, manufactured, or assembled in free zones, even in cases where international standards require it [17].

In Latvia, the physical access of the customs service to the free zones is ensured, however, however, access to real-time data on goods imported, exported and stored in free zones, as well as the sender and receiver of the goods, does not provide opportunities for automated risk analysis, as IT systems are not integrated into a single system. Information about the real sender and receiver is not always specified in the cargo manifest, and accompanying documents are not always included in the application for moving or unloading goods. It should be noted that the submission of summary declarations on imported and planned exported goods is an essential source of information for risk analysis, however, it should also be noted that the information included in the summary declarations is aimed at assessing security risks, while the information required for fiscal risk analysis is insufficient. The authors conclude that the Revised Kyoto Convention has an insufficient set of standards and recommended practices that apply to the identified risks of free zones and directly determine the requirements for the effective organization of customs control over goods stored in free zones. The Convention also does not include the recommendations put forward by the WCO on the integration of IT systems, the involvement of customs authorities in the process of creating free zones, or the promotion of the use of Authorized Economic Operator (AEO) status [16].

As a member state of the European Union, Latvia is bound by the regulatory framework of the European Union and the national legislation must be based on the legal acts of this framework. The movement and accounting of goods in Latvia is regulated by Cabinet of Ministers Regulation No. 500 of August 22, 2017 "Regulations of Customs Warehouses, Temporary Storage and Free Zones", as well as regulations incorporated in the Customs Law, which delegate the Cabinet of Ministers to determine the procedure for recording stored, processed, sold or purchased non-EU goods in the free zone.

Taking into account the peculiarities of the procedure, the Union Customs Code (UCC) [7] provides that it is necessary to record the goods in a manner approved by the

customs services, and the records must also include information that allows the customs services to monitor the relevant procedure by identifying the goods, determining their customs status and implementing the transfer [7], however, the regulatory acts of the European Union do not specify more detailed requirements on how goods must be recorded, as well as certain requirements to provide customs with electronic access to company accounting systems for automated risk assessment.

Commission Delegated Regulation 2015/2446 of July 28, 2015, supplementing Regulation of the European Parliament and Council (EU) no. 952/2013 regarding the detailed regulations that apply to some provisions of the UCC (hereinafter referred to as the Delegated Regulation) provide for several data elements that must be included when accounting for goods, and the national regulation specifies this. However, at the national level, the information circulation system established in the regulatory framework stipulates that the accounting and identification of goods is ensured by the person in whose free zone non-EU goods are stored, processed, sold, or bought, which means that the holder of the free zone permit is responsible [18], and the record is not required from the user of the procedure or other persons who carry out the relevant operations with the goods as defined in the UCC [9], so it could be said that the national regulation contains lighter requirements. The authors believe that the elements of data indicated in the inventory are only slightly different from those that need to be included in the inventory of goods in the customs warehouse, which in turn shows that the existing regulation determines the need to provide a lot of information about goods in free zones. It is not sufficient for customs control, so the condition of providing a customs declaration would not lead to drastic changes in the formalities when applying the special procedure of "storage in a free zone".

The existing regulatory framework allows goods to be processed without changing, or in some cases changing, the eight-digit combined nomenclature code when applying storage in the free zone. A deeper analysis of the permitted actions concludes that, for example, after adding goods accessories, changing packaging, and cutting goods (specifically applicable to general cargo), tracking and controlling goods is practically impossible. The regulation of the UCC stipulates that the customs services have the right to prohibit from carrying out activities in the free zone persons who do not provide the necessary guarantees that the customs regulations will be observed [7], unfortunately, the national regulation only provides for evaluating whether the type of accounting of goods introduced by the free zone companies meets the requirements [18].

In Table 1, the authors of the study have collected data on the compliance of the regulatory framework contained in legal acts with the determined risk mitigation measures.

TABLE 1 REQUIREMENTS FOR RISK MITIGATION MEASURES IN FREE ZONES [16], [7], [18]

| | The Regulatory Act | Revised Kioto Convention | Union Customs Code | National Regulation in Latvia |
|---|---|--------------------------|--------------------|-------------------------------|
| Risk mitigation measures in free zones (FZ) | Definition of FZ as part of the customs territory | - | + | - |
| | Ensuring customs control in free zones | + | + | - |
| | Control of incoming outgoing vehicles | - | + | - |
| | Requirements for AEO status | - | + | - |
| | Providing data about companies | - | - | - |
| | Customs checks on entrepreneurs in FZ | - | + | - |
| | Customs provides company training and information | - | - | - |
| | Involvement of customs in the planning process of FZ | + | / | - |
| | Need to coordinate of any operations with goods in FZ | / | / | / |
| | Submission of a simplified declarations | - | - | - |
| | Integration of IT systems in FZ | - | - | + |

One of the shortcomings is the low level of involvement of customs authorities both in determining the regulation of free zones and in planning operations. It is explained that such a situation has arisen because the creation of free zones is primarily based on economic and industrial importance, and ministries play a key role in the implementation of policies, the creation of free zones, and the approval of entrepreneurs. According to the survey data, approximately 40% of the customs administrations of the member states are not involved in the process of creating free zones and in evaluating the applications of entrepreneurs who want to operate in the free zones [2]. Customs implements limited cooperation with the private sector as well [15]. Controls of free zones are often random rather than based on risk analysis [13].

The lack of reliable monitoring of the users and administrators of free zones is mentioned as an additional risk factor. Information on the monitoring of the security-related activity of the administrators of free zones, which in some cases is not even there at all, is not made public, so the control is not considered sufficiently effective in cases where the activity of a specific zone could have a bad impact on the country's reputation [15]. Both the reputation and the security of international supply chains depend on the monitoring of free zones [3]. There is no substantive obligation on free zone entrepreneurs to ensure that they do not facilitate illegal trade by acting on behalf of third parties [15]. On the other hand, reduced monitoring can be described as an advantage, as it creates a private business environment for more successful international competition [5].

The operation of free zones is aimed at liberalization or reduction of controls, including simplification of customs procedures. These risks are not always considered in the free zone planning process [15]. In recent years, the awareness of the risks existing in free zones has grown significantly, however, these risks are not considered because they are judged to be insignificant in relation to the potential economic benefits of the countries.

In free zones, there are risks associated with the circulation of certain goods that are particularly vulnerable due to their value, size, high tariff rate, volume of trade, and potential violations of intellectual property rights, such as

cigarettes, alcohol, luxury goods, and electronics [13]. In Latvia, there are special regulations regarding excise goods, for example, for moving such goods from one free zone to another, it is necessary to draw up a transit declaration. The authors believe that a significant risk-increasing factor is the possibility of performing various actions in free zones with any type of goods, repackaging, dividing, and changing the label, thereby significantly reducing or even losing the ability to track them. If the traceability of goods is lost, then entrepreneurs have ample opportunities to carry out crimes, for example, forge documents, exchange goods, make fictitious transactions

A significant disadvantage in free zones is also the lack of coordination of information systems, most often there are separate and different systems for entrepreneurs and customs [13]. Customs risk management is essentially data-driven, and in this case, the lack of information on cargo movement and company's operations in free zones hinders risk analysis [2]. The International Chamber of Commerce, on the other hand, believes that the lack of integration of information systems may not be a significant problem if customs are provided with access to the systems of free zone companies so that reusable data can be exchanged [19].

Based on the previously analyzed information, a total of seven risk-promoting factors in free zones can be distinguished, however, only 4 factors are those that can be directly acted upon by the customs authorities (see Fig.3)

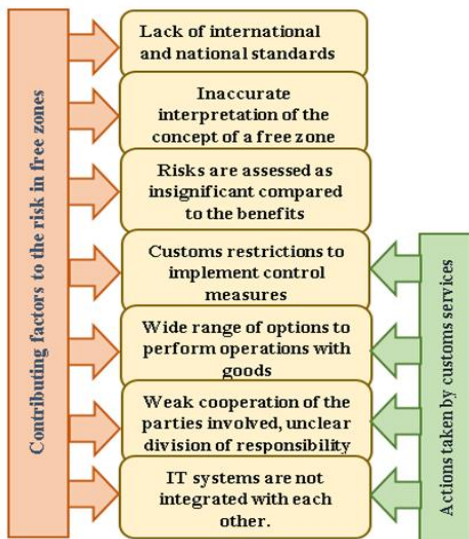


Fig. 3. Contributing factors to the risk in free zones

To develop a safe environment for international trade in free zones, customs authorities need full-fledged legal protection. Although the limited ability of customs services to carry out control measures in free zones is closely related to, for example, the lack of international standards, weak cooperation with other monitoring organizations, opportunities for entrepreneurs to take advantage of the reliefs in free zones through regular document controls and physical inspections, as well as the provision of a free zone the resources necessary for monitoring, customs services can increase their ability to perform adequate monitoring of free zones, as well as reduce the negative impact of the wide range of permitted operations with goods in the free zone. One of the most important risk-promoting factors is

the lack of integration of information systems, so customs services need to show initiative to inform about the existing problem and jointly implement measures with the private sector to ensure the flow of information.

III. RESULTS AND DISCUSSION

Due to the wide distribution of free zones around the world and the regional differences that exist, the practices implemented in the movement and storage of goods in free zones vary. If, for example, in the European Union, thanks to a uniform legal framework, the monitoring of free zones is carried out according to uniform basic principles, then, for example, there may be considerable differences in third countries.

The authors, based on the existing risk-promoting factors in the free zones and the gathered existing risk-mitigating measures, have developed an optimal free zone control model (see Fig. 4). This model is based on four levels, the first of which involves the development of a clear regulatory framework in free zones.

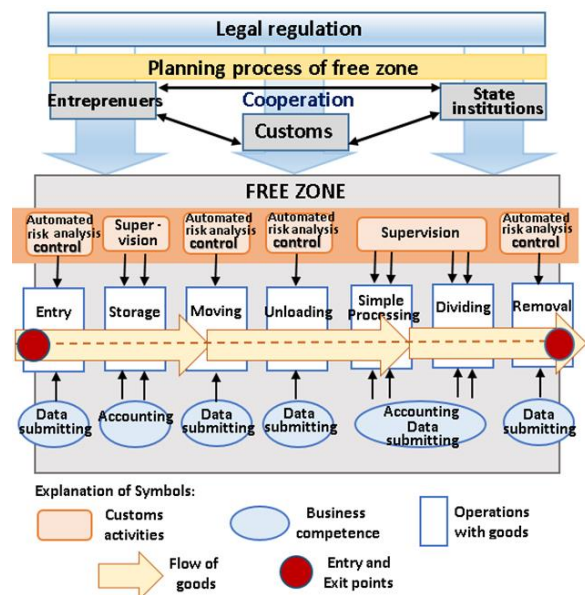


Fig. 4. Free zone control model

It is necessary to develop uniform international requirements that establish that free zones are included in the customs territory of a particular country or union and provide customs authorities with the same powers as in any other part of this territory. Countries should define in their legislation and implement in practice the requirements contained in the standards and recommended practices of Annex D of the Revised Kyoto Convention [16]. State or union-level regulation should provide requirements not only for customs and other state authorities but also for entrepreneurs, clearly defining the rights and obligations of all parties. It is important to establish that the customs authorities have the right to request the data they need to carry out full-fledged control over non-EU goods in the free zone, but the entrepreneurs should provide provisions regarding the possible reliefs and benefits as a result of the systematic fulfillment of these requirements.

The second level determines the involvement of customs services in the planning and development process of free zones as an integral part of the process. It is necessary to assign representatives of the customs service to work in the relevant groups for the planning and development of free zones so that they assess the risks created by the reliefs in relation to the economic benefits created by the free zones. A successful solution for reducing customs risks is to involve in the operation of free zones those entrepreneurs that are recognized by the customs services and have received a certain amount of relief in performing customs clearance activities. For example, in Estonia, the normative regulation stipulates that holders of permits for customs warehouses, temporary storage places, and free zones need a recognized consignee's permit to receive transit cargo transported by road transport, a similar practice is also implemented in the Netherland port of Rotterdam [20]. This practice is recommended in other countries, when planning the attraction of entrepreneurs and the creation of a support program, in cooperation with customs services, creating a favorable environment for successful business.

The Recognized Economic Operator model defined in the SAFE standards [21] has been widely used in many countries around the world. In general, this model of cooperation between entrepreneurs and customs services has been implemented in 98 WCO member states and it increases the security of supply chains and reduces customs risks. Therefore, it is useful to evaluate the possibilities of the certification of Safe Free Zones, based on the AEO concept, the Trade Promotion Agreement, and the Code of Clean Free Trade Zones, which, as recognized by the Klaipeda Free Economic Zone, emphasizes better cooperation obligations between the parties involved and improves the image policy of free zones [22]. Before issuing a permit to operate in a free zone, it is necessary to ensure that customs have the opportunity to conduct a risk analysis of companies, avoiding situations where high-risk companies operate in the free zone. The free zone planning process should provide not only the creation of free zones, but also the creation and management of unified infrastructure elements, thus preventing situations where each controlling and monitoring institution creates different infrastructure elements that perform the same functions, and reducing resource consumption.

The third level in the created free zone control model is based on cooperation, where one of the elements is a qualitative exchange of information between entrepreneurs and customs. When creating the flow of information, it is necessary to provide opportunities not only for customs services to perform risk analysis but also for entrepreneurs, because a large part of free zone companies are members of supply chains, for whom it is important to know the risks of their cooperation partners. It is also essential to cooperate in the implementation of various innovations, allowing entrepreneurs to express their opinions on the planned changes. Cooperation between customs and other supervisory authorities should be based on the division of responsibilities and sharing of resources, which, according to the author, is one of the factors promoting development. According to the author,

if one of the recommendations for improving the control of free zones is to provide customs with opportunities to control entry and exit points in free zones, then it is necessary to closely cooperate with organizations responsible for monitoring the territory and persons.

The fourth and most important level is the process of control of goods in free zones, which is based on the provision of information, based on which it is possible to perform a qualitative risk analysis. The main prerequisite is the submission of data necessary for risk analysis before operations with goods: application of the procedure, movement, unloading, and removal from the free zone. The submission of this data must be done electronically, by submitting, for example, the simplified declaration or by entering the relevant information in any other way into the system, so that an automatic risk analysis can be performed. Along with the submission of data, the problem of product traceability would also be addressed, as an identification number is assigned to each shipment. The World Customs Organization proposes a Unique Consignment Reference (UCR) number, which aims to define a general mechanism flexible enough to deal with the most common scenarios occurring in international trade, making the most of existing references of supplier, customer, and transport. Such a reference number allows the information systems of customs and trading parties to cooperate most efficiently and, when properly applied, it also ensures the exchange of data between declarations and manifests [23]. An important element of the control options is the submission of summary declarations when entering and leaving the free zone or moving goods within the free zone. It is also necessary to ensure the monitoring of incoming and outgoing cargo, consumed goods and losses, the traceability of the weight of goods stocks, and the possibility to control the basic data of customs and global trade compiled by the classification, value, and origin of goods, and it is also necessary to define clear requirements and procedures for third-party service providers [24].

One way to ensure automatic data submission and availability to customs is the integration of entrepreneurs and customs information systems, providing the opportunity to submit data to the customs information system, while simultaneously performing an inventory of goods. The monitoring of the inventory of goods should be based on a risk analysis, which can be ensured if the customs have continuous access to the data on the goods registered in the free zones and the operations carried out with them. The implementation of such conditions can be ensured by the condition that companies operating in free zones must comply with the AEO standards, which require the entrepreneur to provide electronic access to accounting data.

IV. CONCLUSIONS

Summarizing all the analysis carried out, it can be argued that free zones are unique due to the wide range of advantages they offer, providing the opportunity to attract foreign investment, reducing the tax burden on companies existing in free zones, which contributes to the expansion of companies, the creation of new jobs and the

development of a given country or region. At the same time, reducing the administrative burden in free zones increases the level of risks of illegal goods circulation, which in turn negatively affects the security of supply chains, causes losses to the state budget, creates a negative impact on public health, the surrounding environment, and also threatens the preservation of cultural heritage.

The main factors that hinder the operation of customs control and surveillance system include the lack of resources allocated to customs control, shortcomings in the legal framework and ineffective integration of information systems. These factors limit the establishment of an automated customs risk management system in free zones and restrict the customs authority's capacity to take effective and targeted customs control measures.

Countries should create free zones and use their advantages, but at the same time, they should continuously monitor existing trends and recommendations that would reduce the economic, safety, and security risks associated with the creation of free zones and provide opportunities to implement sufficient customs control and at the same time not create additional burdens for entrepreneurs, maintaining fast cargo throughput and security of international supply chains.

An optimal free zone control model covers the continuous improvement of the regulatory framework at the international, regional, and national levels, ensuring the involvement of customs services in the free zone planning process, using the cooperation of parties operating in free zones, promoting the exchange of information, the distribution of duties and responsibilities, and ensuring that customs service's implement a risk analysis-based monitoring and control of imported, exported, moved and stored goods in free zones.

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