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## **GRADUATED SOVEREIGNTY AND GLOBAL GOVERNANCE GAPS:**

### **SPECIAL ECONOMIC ZONES AND THE ILLICIT TRADE IN TOBACCO PRODUCTS**

**Chris Holden**

#### **ABSTRACT**

Illicit trade in tobacco products has been a significant problem globally for many years. It allows cigarettes to be sold far below their legal price and thus contributes to higher consumption, morbidity and mortality, and deprives state treasuries of a substantial amount of revenue. This article identifies special economic zones (SEZs), particularly free trade zones, as a key conduit for this illicit trade. The development of SEZs as weak points in the global governance architecture is explained with reference to the concept of 'graduated sovereignty', whereby the uniform management of territory by modern states has given way to a more spatially selective form of territorial governance, in which some slices of territory are more fully integrated into the world economy than others via various forms of differential regulation. Attempts to comprehensively (re)regulate SEZs, in the face of growing evidence of the dysfunctionalities that they can engender, have so far been unsuccessful. It is concluded that the neo-liberal global economy has facilitated a regulatory 'race to the bottom', a problem that can only ultimately be overcome by international negotiation and agreement.

#### **KEY WORDS**

Graduated sovereignty; illicit trade; tobacco; special economic zones; free trade zones; transnational crime.

## INTRODUCTION

Illicit trade in tobacco products, usually cigarettes, has been a significant problem globally for many years, both in terms of its impacts on public health and state revenues. One of the most effective means of reducing tobacco consumption, and therefore the disease burden caused by it, is by raising the sale price through taxation (Chaloupka et al, 2000). Nearly all countries impose excise tax and sales or value added tax (VAT) on tobacco products and many apply high import tariffs, so the difference between the tax free price and the tax inclusive price can be substantial (Yurekli and Sayginsoy, 2010, p. 549). Smuggling allows cigarettes to be sold far below their legal price and thus contributes to higher consumption, morbidity and mortality (Chaloupka et al, 2000). It also deprives state treasuries of a substantial amount of revenue.

The extent of cigarette smuggling is difficult to calculate because smuggling routes are extremely complex and data is limited (Yurekli and Sayginsoy, 2010, p. 546), yet all estimates agree that it is a sizeable problem. The best and most recent estimate puts the extent of the illicit trade globally at 11.6% of total consumption, although this can vary between countries from just 1% at its lowest to 40-50% at its highest (Joossens et al, 2010, p. 1645-1646). This equates to a total revenue loss globally of about \$40.5 billion a year (Joossens et al, 2010, p. 1645). If this illicit trade were eliminated, because average prices would rise as a result and consumption would therefore decline, governments would gain at least \$31.3 billion a year and 164,000 premature deaths a year would be avoided (Joossens et al, 2010, p. 1645). So serious is the problem of cigarette smuggling that in 2012 the States Parties to the World Health Organisation's (WHO) Framework Convention on Tobacco Control (FCTC) adopted a Protocol to Eliminate Illicit Trade in Tobacco Products (hereafter 'the WHO Protocol') (WHO, 2013).

Smuggling usually involves hub or transit locations where huge volumes of cigarettes are imported solely to be re-exported (Joossens and Raw, 1998; Yurekli and Sayginsoy, 2010). While economic theory suggests that smuggling and other forms of illicit trade result from price (and therefore tax) differentials between different jurisdictions, empirical studies demonstrate the importance of governance arrangements. For example, higher levels of corruption are associated with weaker law enforcement and higher smuggling (Yurekli and Sayginsoy, 2010, p. 553). Merriman et al (2000) find that the perceived level of corruption in a country statistically explains more of the variance in estimates of cigarette smuggling than do price differentials. In fact, research shows that it is not usually cheap cigarettes that are smuggled into high price markets, but the opposite, with opportunities to evade duties the explanatory factor (Joossens and Raw, 1998, p. 67-8; Joossens et al, 2010, p. 1646). In addition to the differences between duty free and duty paid prices, therefore, the magnitude of the illicit trade in tobacco products can be explained by factors relating to the governance arrangements within and at the borders of jurisdictions and the legal regime that governs how products are traded between those jurisdictions.

The legal regime governing trade between jurisdictions has been exploited by the use of complex smuggling routes designed to confuse authorities and hide the true destination of the product. Products destined for export from one jurisdiction to another are exempt from taxes, including customs duties, excise tax and VAT, while they are in 'transit'. Tax is only required to be paid within the jurisdiction where final sale is intended to occur, so products passing through a third jurisdiction remain legally untaxed. Cigarettes are thus sold by manufacturers to suppliers and then shipped from one destination to another, often changing hands on many occasions (Joossens et al, 2000). Smuggling takes place when all or a portion of the product is diverted into the illegal market and sold without taxes having been paid. The final locus of the illicit sale can be anywhere in the world, including within the country of origin.

Illicit trade thus takes place where there are 'weak points' in local, national or global structures of governance, particularly where borders are compromised for one reason or another. Once large scale illicit trade takes hold, the potential profits associated with it provide incentives for organised crime networks to develop, and can lead to increases in corruption and higher-risk criminal activity supported by these profits (Joosens et al, 2000). Weak governance may exist as a result of state failures and lack of capacity, but may also arise where governments have chosen to govern parts of their territory in a differentiated or graduated manner, as in the case of special economic zones (SEZs), potentially resulting in the (de jure or de facto) loosening of border controls or other regulations.

This article analyses the role of SEZs in the illicit tobacco trade and theorises it with reference to literature concerning the growing political and spatial complexity of governance arrangements under contemporary forms of globalisation. It draws particularly on Ong's concept of 'graduated sovereignty' (Ong, 2000; 2006) and Agnew's (2009) development of Mann's (1984) concept of 'infrastructural power'. It is argued that spatially selective forms of territorial governance such as SEZs can create 'gaps' in governance that facilitate illicit trade. The next section presents an extended discussion of these concepts. Subsequently, I discuss examples of how various SEZs have facilitated the illicit trade in tobacco products. Finally, I analyse the difficulties of effective regulation, or re-regulation, of SEZs, and the trade-offs that governments face when balancing effective regulation with the economic imperative of increasing competitiveness within a globalised world market.

#### GRADUATED SOVEREIGNTY AND GLOBAL GOVERNANCE GAPS

As Walker (1998, p. 356) observes, the concept of sovereignty 'was introduced into legal and political thought as a way of comprehending a one-dimensional pattern of state-centred authority',

or as Hirst and Thompson (1999, p. 256) put it, “‘sovereignty’ in its modern form is a highly distinctive political claim – to exclusive control of a definite territory.’ Sovereignty implies control over both specific areas of territory and particular functions and so ‘tends to be restricted by boundaries of space and subject matter’ (Walker, 1998, p. 356). This identification of sovereignty with control of a specific territory implies that sovereignty has been exercised ‘uniformly within a given territory’ (Pauly and Grande, 2005, p. 8).

Yet, as Pauly and Grande note (2005, p. 8), empirical investigation indicates that the ‘practices, expression, and even theoretical conceptualisation’ of sovereignty have been subject to change historically. Indeed, they argue that ‘the idea that sovereignty can be divided and reconfigured is... one of the most important innovations in modern political philosophy’ (Pauly and Grande, 2005, p. 11). While issues concerning the locus of sovereignty have always been inherent in federal polities, the distribution of powers between levels of government is usually specified by a constitution and related to particular territorial states (Watts, 1998). Contemporary discussions of the divisibility of sovereignty go beyond this, noting, as Ruggie (1993) does, that state territory can be ‘unbundled’. Agnew (1994; 2009), for example, has been one of the foremost critics of ‘sovereignty myths’, particularly the assumptions that state sovereignty is congruent with both a specific ‘nation’ and with a defined territory. Drawing on the work of Michael Mann (1984), Agnew (2009, p. 117) highlights the distinction between what Mann calls ‘despotic’ and ‘infrastructural’ power, linked respectively to ‘the two different functions that states perform...: (1) the struggle for power among elites and interest groups in one state and between those and elites and interest groups in other states and (2) the provision of public goods that are usually provided publicly (by states).’ Until recently, argues Agnew (2009, p. 118), the provision of infrastructural goods had a largely territorial basis, since the populations benefiting from them were concentrated territorially and the technologies for providing them ‘had a built-in territorial bias, not least relating to the capture of positive externalities.’ However, it is increasingly the case that ‘infrastructural power can be deployed across networks that, though located in discrete places, are not necessarily territorial in

the externality fields that they produce... New deployments of infrastructural power both de-territorialise existing states and re-territorialise membership around cities and hinterlands, regions, and continental-level political entities such as the European Union' (Agnew, 2009, p. 118).

Pauly and Grande (2005, p. 15) argue that as a result of such processes sovereignty arrangements have become increasingly complex, leading to 'multiple and overlapping hierarchies' in a system of 'complex sovereignty'. In this new situation, 'territoriality still matters', but political authority has been reconfigured across various functional dimensions and spatial scales (Pauly and Grande, 2005, p.15). These developments have been associated particularly with processes of globalisation. Cerny (1998, p. 36), for example, argues that globalisation is 'leading to an unbundling of basic state functions and the growth of uneven, cross-cutting and overlapping levels of governance and quasi-governance, the fragmentation of cultural identities and the reconfiguration of social, economic and political spaces' (see also Cerny, 2010a). According to Grande and Pauly (2005, p. 286), we are beginning to see a transcendence of 'the traditional separations of domestic and international politics, inside-outside and public-private'.

Hirst and Thompson (1999, p. 268-269) too note that 'Politics is becoming more polycentric, with states as merely one level in a complex system of overlapping and often competing agencies of governance'. In many cases, power has been ceded 'upwards' to supranational organisations or 'downwards' to sub-national units (Hirst and Thompson, 1999, p. 270). In relation to the latter, Keating (2001, p. 53) observes how various strategies for 'territorial management', used by states in the past to integrate disparate groups and ensure the integrity of their territories, 'have been undermined by the decreased capacity of national states to deliver the goods.' In a globalised economy, states find it difficult to manage the various interests within their borders to the same extent as previously, leading to them decentralising some functions or decision making powers, but also 'favour[ing] their most competitive regions and sectors' (Keating, 2001, p. 53). Sidaway (2007a, p. 350) makes clear that these processes affect less-developed states as much as advanced ones,

with a partial decoupling of 'nation' and 'development', 'embodied in subtly reworked articulations between territory, accumulation/development and sovereignty.'

There is not simply a uniform ceding upwards or downwards of powers by the state, but rather these powers may be applied differentially to different places and population groups, including within the territory of the state. Sidaway (2007b, p. 332), for example, notes how a variety of 'enclave spaces' are 'governed by a range of legal norms and bounded in an array of formal and informal means that frequently cut-across established state boundaries.' Jones (1997, p. 849) argues that states have a tendency to 'privilege certain places' through accumulation strategies and hegemonic projects, a process he calls 'spatial selectivity'. Such selectivity may involve 'high degrees of institutional and policy experimentation', the particular forms of such experimentation varying depending on the mobilisation of interest groups and social forces (Jones, 1997, p.832). Various forms of SEZ have been the sites for such experimentation (Doucette and Lee, 2015).

Ong (2000) calls this differential treatment of populations and places by states 'graduated sovereignty', a concept she articulates as 'a product of state-globalisation interactions' (Ong, 2000, p. 57). The term 'graduated sovereignty' is used to refer to 'the effects of a flexible management of sovereignty, as governments adjust political space to the dictates of global capital... "graduated sovereignty" is an effect of states moving from being administrators of a watertight national entity to regulators of diverse spaces and populations that link with global markets.' (Ong, 2006, p. 78) This 'flexible management of sovereignty' is typified by the creation of SEZs, which can 'vary in their mix of legal protections, controls and repressive regimes' (2000, p. 66). Such flexibilities include the provision of on-site infrastructure for transnational corporations (TNCs), tax breaks and special import-export allowances, as well as informal understandings with corporations, whereby union activities are suppressed or forms of corporate disciplining are permitted. Different types of SEZ offer different types and degrees of flexibility, and comprise a 'galaxy of differentiated zones' which are 'unevenly integrated into the structures of state power and global capital', resulting in the



'proliferation of differentiated sovereignty within and across borders' (Ong, 2000, p. 68-69). Rather than being uniform then, state sovereignty is graduated into a 'flexible set of state strategies that are not congruent with the national space itself, but are attuned to the workings of global markets' (Ong, 2000, p. 72).

The concept of graduated sovereignty, then, allows us to understand better those instances where the state chooses to govern a territory in a differentiated manner, while Agnew's (building on Mann's) distinction between despotic and infrastructural power provides a further analytical lens. While Agnew (2009) shows that infrastructural power can be extended beyond the territory of the state, via currency arrangements, for example, examination of SEZs demonstrates that infrastructural power can be selectively implemented in a designated slice of a state's territory and made available (sometimes exclusively) to external actors. Easterling (2014, p. 35), for example, notes how TNCs benefit from various subsidised infrastructure investments at the same time that they are exempt from taxation. Such infrastructural inducements are often presented according to a common formula, as states compete to attract capital (Easterling, 2014, p. 31). Control within SEZs is often exercised by bespoke authorities that are distinct from central or local governments, and increasingly zone governance is handed to private corporations or public-private partnerships, in a further unbundling of sovereignty as functions are contracted out to the private sector (Easterling, 2014, p. 34; World Bank, 2008).

Nevertheless, despite selective deregulation, SEZs may involve various forms of disciplinary supervision, especially for workers (Easterling, 2014, p. 54). While SEZs have market-building goals, their governance may involve authoritarian rather than liberal forms (Zhang, 2012). This is a particular issue in export processing zones, some of which explicitly deny the right to freedom of association, and others of which make an unstated bargain with TNCs not to enforce what labour regulations formally exist (McCallum, 2011, p. 4). Excessive and compulsory overtime, poor health and safety conditions, unjust dismissal, blacklisting, intimidation and physical violence against union

organisers have all been reported in such zones (McCallum, 2011, p.4). The forms of mobility available to workers in and around SEZs often contrast with the globally agile movement of goods and capital, with (often predominantly female) workers facing a stark choice between rural poverty and regimented conditions, such as those in some Chinese zones, for example (Ngai, 2004). In some cases, such as that of India, zone development has depended on forcible land dispossession (Levien, 2011).

Yet such spatial strategies are not the result of states simply imposing their will on society or of them merely responding to the needs of transnational capital in a mechanistic way (Jones, 1997; Park, 2005). Rather, the state can be seen as a site of contestation between various actors and social forces, both 'external' to, or 'above' it and 'internal' to, or 'below' it (Glassman, 1999; Park, 2005; Cerny, 2010b). Thus in Korea, the sites and the forms of 'spatially selective liberalisation' through SEZs was determined by struggle and compromise between conflicting interests and ideas, in this case those that favoured the inherited institutional frameworks of the 'developmental state' and those favouring economic liberalisation (Park, 2005). In Dubai, the construction and development of the Jebel Ali Free Trade Zone was the outcome of negotiated relationships between the Emirate's government, the neighbouring emirates that formed the United Arab Emirates, British imperial interests and local and foreign businesses (Keshavarzian, 2010).

The complexity of these new forms of governance means that both the willingness and the ability of states and the various jurisdictions to cooperate with each other are crucial to ensuring effective governance (Grande and Pauly, 2005, p. 294). In the best case scenario, we would see what Beck (2005) calls 'transnational cooperation states' acting in concert with each other to ensure new modes of collective problem-solving, in which 'different levels of governance are institutionally differentiated and yet integrated' (Grande and Pauly, 2005, p. 288). Yet, the potential problem with such complex and differentiated forms of governance, as Hirst and Thompson (1999, p. 269) identify, is that if the different levels and functions of governance are not effectively tied together in a

coherent manner, 'then the unscrupulous can exploit and the unlucky can fall into the "gaps" between different agencies and dimensions of governance.' If the various governing powers at different levels are not 'sutured' together, 'then these gaps will lead to the corrosion of governance at every level' (Hirst and Thompson, 1999, p. 269-270).

Furthermore, dominant forms of neo-liberal globalisation have been fundamentally associated not with cooperation but with competition. Peck and Tickell (1994), for example, argue that the 'institutional searching' that globalisation processes have given rise to is leading not to a new 'institutional fix', but rather a 'regulatory vacuum' in which policies such as the implementation of SEZs represent the 'selling [of] the local to the global'. The result is 'the jungle law of neoliberalism', in which localities are pitched into a 'beggar-thy-neighbour' competitive race to the bottom. Cerny (1998, p. 49) argues that there is an emerging 'governance gap', as 'multilayered and asymmetric' structures give rise to 'increasingly suboptimal outcomes'. In such a situation, there are likely to be new 'organisational opportunities... for those operating more or less "outside the law"', including drugs traders, mafia and those populations that have been marginalised or excluded (Cerny, 1998, p. 57). The largest problem in this regard, Cerny argues (1998, p. 57-58), 'is where different dimensions of extra-legal activities intersect with legal or quasi-legal ones', potentially leading to a 'transnationalised black economy'. Nordstrom (2000, p. 36), too, notes how extensive networks that 'cross various divides between legal, quasi-legal, gray markets and downright illegal activities' have become internationalized and may themselves challenge the legitimacy and sovereignty of the state. The next section investigates these issues further by examining the governance of SEZs and their vulnerabilities to crime in general, and to the illicit trade in tobacco products in particular.

#### SPECIAL ECONOMIC ZONES AND ILLICIT TRADE

Evidence that some SEZs, particularly free trade zones or 'free zones', have been a conduit for illicit tobacco trade has been mounting for some years, such that Article 12 of the WHO Protocol deals

specifically with free zones. However, the nature of the phenomenon necessarily means that it is difficult to research and that evidence is fragmented and incomplete. Evidence is often based on customs seizures, not always in the SEZ or jurisdiction via which the products have first been smuggled, but often once they have been transported to another jurisdiction. Customs seizure data is collated by the World Customs Organisation (WCO) and discussed in publications by that and other international organisations. As an observer at sessions of the International Negotiating Body for the WHO Protocol in 2008 and 2010, it was clear to the author of this article that the vulnerabilities of zones to the illicit tobacco trade is widely accepted within the customs and public health policy-making communities, yet few attempts have been made either to synthesise existing knowledge of this phenomenon or to theorise it.

Evidence relating to the vulnerabilities of various kinds of zones to illicit activity in general, to illicit trade in tobacco products in particular, and to the role of specific zones in the latter was therefore collated from a number of published sources. Much of this evidence is published by international organisations, including both intergovernmental and business organisations. The websites of these organisations were therefore searched using the following terms: 'special economic zones', 'free zones', 'illicit trade' and 'tobacco'. A snowballing strategy was used whereby relevant references to additional organisations or specific publications in retrieved documents were followed up. Relevant documents are cited below and include those of the following organisations: the Central Intelligence Agency (CIA), Euromonitor, the European Commission, the Financial Action Task Force (FATF), the International Chamber of Commerce (ICO), the International Monetary Fund (IMF), the US Library of Congress, the Organisation for Economic Cooperation and Development (OECD), the United Nations Office on Drugs and Crime (UNODC), The World Bank, the WCO, the World Economic Forum (WEF), the WHO, and the World Trade Organisation (WTO).

Reports by these organisations were supplemented by relevant academic articles. Press reports retrieved from a simple web search using the above search terms were also utilised where relevant.

However, given the difficulty of substantiating such reports, where journalistic sources were used, precedence was given to the work of the International Consortium of Investigative Journalists (ICIJ), which has a reliable track record of investigative reporting of the illicit trade in tobacco products. Much of the work of the ICIJ and of cited academic articles is based on analysis of internal tobacco industry documents available online from the Truth Tobacco Industry Documents (<https://www.industrydocumentslibrary.ucsf.edu/tobacco/>). These documents, currently encompassing approximately 88 million pages in 14.6 million documents relating to all aspects of tobacco industry activity, were made available to the public as a result of legal settlements reached in 1998 between US states and tobacco companies, which compelled the companies to release documents filed in discovery in contemporary and future US lawsuits. A discussion of the provenance, scope and limitations of these internal industry documents can be found in MacKenzie and Holden (2016).

International organisations will have their own agendas and it is appropriate to identify these. Relevant reports may not be concerned solely with the illicit trade in tobacco products. The FATF, for example, which was a creation of the G7, has primarily been concerned to understand and combat money laundering processes and, since 2001, terrorist financing. Similarly, organisations such as the WCO and the UNODC are concerned with all illicit trade rather than simply that in tobacco products. The evidence reviewed below indicates that illicit trade in tobacco products is often part of wider patterns of criminal activity also involving narcotics and money laundering. A discussion of the limitations of business sources is given when discussing these in the next section.

The World Bank (2008, p. 2) defines SEZs as 'geographically delimited areas administered by a single body, offering certain incentives... to businesses which physically locate within the zone.' SEZs are often described as 'deterritorialised', that is, they are not treated as part of the territory of the state within which they are located. Domestic regulations relating to any type and combination of customs procedures, import and export duties, taxes and labour regulations may not apply. States

may actively choose to establish such zones as part of a strategy to attract foreign direct investment (FDI) and gain competitive advantage, or they may do so at the behest of international organisations such as the World Bank and IMF. The number of new zones increased rapidly from the 1980s, with 176 zones in 47 countries in 1986 growing to 3,500 zones in 130 countries in 2006 (Farole, 2011, p. 1). The World Bank (2008, p. 3) identifies a number of different types of zone, as follows:

- Free trade zones (also known as commercial free zones) are fenced-in, duty-free areas, offering warehousing, storage, and distribution facilities for trade, trans-shipment, and re-export operations.
- Export processing zones are industrial estates aimed primarily at foreign markets. Hybrid EPZs are typically sub-divided into a general zone open to all industries and a separate EPZ area reserved for export-oriented, EPZ-registered enterprises.
- Enterprise zones are intended to revitalize distressed urban or rural areas through the provision of tax incentives and financial grants.
- Freeports typically encompass much larger areas. They accommodate all types of activities, including tourism and retail sales, permit on-site residence, and provide a broader set of incentives and benefits.
- Single factory EPZ schemes provide incentives to individual enterprises regardless of location; factories do not have to locate within a designated zone to receive incentives and privileges.
- Specialized zones include science/technology parks, petrochemical zones, logistics parks, airport-based zones, and so on.

Various of these different types of zone may be utilised by those engaged in illicit trade, depending on the specific form of illicit activity and the specific incentives offered by the zone, but free trade zones (FTZs) or simply 'free zones' have been identified as particularly susceptible to illicit activity.[1]

For example, various free zones have been accused of acting as centres for money laundering. A report by the FATF (2010, p.4) notes that ‘the same characteristics that make FTZs attractive to legitimate business also attract abuse by illicit actors’. The report identifies a number of ‘systemic weaknesses’ that make zones vulnerable to such abuse, including inadequate anti-money laundering safeguards; relaxed oversight by competent domestic authorities; weak procedures to inspect goods and register legal entities; and lack of adequate coordination between zone and customs authorities (FATF, 2010, p. 4).

In general, it is possible to identify two distinct types of illicit trade in tobacco products via SEZs, which may overlap and which are discussed in more detail below: smuggling via SEZs, most often free zones, and illicit manufacture within zones themselves. Trans-shipment, whereby goods are transferred from an importing means of transport to an exporting means of transport and perhaps thereby to a third party, has been identified as a particular problem in relation to smuggling via free zones (WCO, 2013, p. 9). As Friman and Andreas (1999, p. 11) point out, the global expansion of licit trade has expanded ‘the pipelines within which illicit flows can hide’, so that trans-shipment of illicit goods ‘has surged with globalisation’. Chalfin (2006, p. 253) has noted how the development of new forms of information technology in customs procedures has moved the form of shipment monitoring from physical checks to documentary data collection and analysis, in the process ‘decoupling... state authority from the usual territorial limits and foundations of its expression.’ While in itself this represents a change in the form rather than the capacity of state monitoring, designed to facilitate the speedy and seamless flow of goods between places, it can be problematic in free zones, which are designed to act as trans-shipment hubs. Documents may be forged, physical checks harder to implement, and zone authorities may not accept the jurisdiction of customs authorities. According to the WCO (2013, p. 9):

Trans-shipments via Free Zones are of particular concern to Customs administrations worldwide as they provide opportunities for fraudulent manipulations... and pose potential

security risks. Consistent with the purposes of Free Zones, goods introduced into these areas are, in many jurisdictions, not subject to Customs controls... Without a seamless traceability of the transport chain... and [in] the absence of appropriate control mechanisms, it is not possible to meet the [standards of the WCO and prevent smuggling].

The FATF (2010, p. 17) specifically identifies cigarettes as items that are vulnerable to smuggling via free zones because of the high volume of containers, the ease of repackaging and relabelling and the general lack of oversight.

The second main form of illicit activity – manufacture within zones - reflects an apparent shift more recently towards the smuggling of cigarettes that have been produced for the primary purpose of illegal trade rather than the genuine brands produced by transnational tobacco companies (TTCs) (Holden, 2016). Cigarettes manufactured intentionally for illicit trade include counterfeits of TTCs' brands and 'illicit whites', i.e. cigarettes that may be produced legally within the jurisdiction of manufacture, but which are intended mainly or solely for illicit sale in other jurisdictions (Joossens and Raw, 2012). The OECD, among others, has identified zones as manufacturing and distribution bases for counterfeit products (OECD, 2008, p. 85-86). The rest of this section examines a number of particular cases of SEZs where there is significant evidence of illicit trade in tobacco products, dealing in turn with smuggling via free zones and illicit manufacture within zones. Given the inherently limited nature of the evidence referred to above, these examples are not intended to be exhaustive, but rather to illustrate the nature of the illicit trade that may take place via SEZs.

### Smuggling Via Zones

One of the most widely reported cases of cigarette smuggling via a free zone is that of Aruba during the 1990s. A number of previous analyses have documented the apparent complicity of TTCs in smuggling in Latin America and other regions during this period (Holden et al. 2010; Collin et al,



2004; Lee and Collin, 2006; Le Gresley et al, 2008). The Aruba Free Zone was a central hub in the illicit trade in Latin America during the 1990s, with TTCs routing their products via the zone on their way to various end markets. For example, evidence from internal tobacco industry documents suggests that British American Tobacco (BAT) was complicit in a scheme that saw its cigarettes exported from Venezuela to Aruba, only for them to be illegally shipped back via Colombia to Venezuela for sale on the country's black market (Holden et al, 2010). Similarly, both BAT and Philip Morris have been accused of participating in schemes whereby their cigarettes were shipped via Aruban or Panamanian free zones and then into Colombia's special customs zone Maicao for illegal sale (Ronderos, 2001). Some of this illicit activity appears to have related to the money laundering of illicit drug profits, notably via the 'black market peso exchange'. In this scheme, money earned from drug sales in the United States would be used to purchase cigarettes, alcohol and household goods which were then exported to Colombia and other Latin American countries and sold for pesos (Ronderos, 2001). Cigarette smuggling presents an ideal opportunity for money launderers, given the product's low weight, high relative market value and often low penalties if caught (Marsden et al, 2001). In 2000, a number of Colombian Departments (i.e. states) filed legal action against BAT and Philip Morris in the United States under the Racketeer Influenced and Corrupt Organisations Act (RICO) (Beelman, 2000; Ronderos, 2001; Gillespie, 2003), although the action ultimately failed since the US court ruled that it did not have jurisdiction.

Another free zone in Latin America that evidence suggests has been a major transit route for the illicit tobacco trade is the Colon Free Zone (CFZ) in Panama. The CFZ is the second largest free zone in the world after Hong Kong and is crucial to Panama's economy, handling imports and re-exports equalling 7.5% of national gross domestic product in 2012 (WTO, p. 71). The zone hosts around 3,000 companies and provides direct employment for 30,000 people, with another 5,000 employed indirectly (WTO, p. 72). The zone was a key conduit for cigarette smuggling during the 1990s (Ronderos, 2001) and, evidence suggests, continues to be so for illicit goods of all kinds (Bate, 2013). As with Aruba in the 1990s, cigarette smuggling appears to have been intimately wound up with the

illicit drug trade and money laundering (Ronderos, 2001; Marsden et al, 2001). Panama is also a key 'offshore' financial centre, comprising 'the largest and arguably most important international banking centre in Latin America' (Warf, 2002, p. 36). Trade via the CFZ is a significant source of earnings for these banks, given its credit-driven nature. As one of the key architects of Panama's offshore banking centre has stated, 'the Free Trade Zone and the banking system are totally symbiotic' (quoted in Warf, 2002, p. 38). In April 2016, Panama's role as an offshore financial centre received renewed attention following the leaking of the 'Panama Papers', a set of 11.5 million files from the Panama-based law firm Mossack Fonseca (Harding, 2016). According to the CIA (2015), Panama is a 'major cocaine trans-shipment point and primary money-laundering centre for narcotics revenue; money-laundering activity is especially heavy in the Colon Free Zone'. Although the government has made some attempt to tighten anti-money laundering rules in recent years, the FATF and the IMF identify several remaining problems (IMF, 2014; Lawrence, 2015). While goods and money flow easily through Panama, Sigler (2014, p. 11) notes that the CFZ and the newer Panama Pacifico zone are poorly integrated with the surrounding areas, might exacerbate inequality, and erect 'barriers to entry (both physical and social) to the majority of Panamanian society.'

A number of other SEZs have been accused of acting as hubs for the illicit trade in tobacco products. Among those specifically identified as conduits for cigarette smuggling are the free zone of Ciudad del Este in the Tri-Border Area between Brazil, Paraguay and Argentina (Hudson, 2010, p. 59); Belize's Corozal Free Zone (Cawley, 2013); the Subic Bay Freeport Zone and other zones in the Philippines (Asia Sentinel, 2012); the Xiamen SEZ, which was at the centre of one of the biggest smuggling and corruption cases in China's history (Shieh, 2005); and Dubai's Jebel Ali FTZ, discussed below. However, it is not only zones in low and middle income countries that are vulnerable to smuggling. US 'foreign trade zones' were a key transit point in cigarette smuggling operations in the 1990s, whereby tobacco companies exported cigarettes from Canada to the US zones, from where they were smuggled back into Canada (Beare, 2002, p. 237; Holden, 2016, p. 104). Similarly, illicit penetration of the Spanish cigarette market increased from 'virtually nothing' to over 8% of all

cigarettes smoked between 2007 and 2012, with the main pathway into Spain appearing to be the Canary Islands (Euromonitor, 2013, p. 39). The Canary Islands operates a 'special zone' providing for a series of tax advantages and a free trade zone (ZEC, 2015).

### Manufacture Within Zones

Increasingly, illicitly traded cigarettes are manufactured within SEZs, rather than simply being routed through them for the purpose of trans-shipment and tax evasion. This reflects the apparent shift in the overall nature of the illicit trade in tobacco products towards the manufacture of counterfeits of TTCs' brands and the sale of 'illicit whites' (Joossens and Raw, 2012). A key example of the latter is the Jin Ling brand, which is produced in the Russian exclave and SEZ of Kaliningrad and sold widely throughout Europe, but which appears to have no legal market in any European country (Candea et al, 2009a). There has been a sustained growth of the smuggling of Jin Ling cigarettes into the EU since 2005, estimated to cause revenue losses of €700 million per annum (European Commission, 2011, p. 16). Wedged between Poland and Lithuania, Kaliningrad was given SEZ status in 1991 with the break-up of the Soviet Union (Vinokurov, 2004; 2007). At the beginning of the 2000s, Kaliningrad's 'grey' or 'shadow' economy (consisting of 'informal' activities where there may be lack of adherence to legislation; 'hidden' activities where taxes and other payments are avoided; and 'illegal' activities that are specifically prohibited by law) was estimated to constitute approximately one third of its total gross regional product (GRP), although one estimate put it at almost half of total GRP (Vinokurov, 2007, p. 45). The share of outright illegal activities, such as the production and distribution of drugs and weapons, smuggling and prostitution, was estimated at 28% of the total grey economy. Between 20,000 and 40,000 families were estimated to make a living from illegal 'shuttle' trading of cigarettes and other goods across the Polish and Lithuanian borders (Vinokurov, 2004, p. 15). According to Candea et al (2009b, p. 25), the territory has 'gained a reputation as a haven for smugglers and money launderers, and for a police force accommodating to smugglers'

interests.’ Kaliningrad represents an example whereby the costs of the illicit trade, which is not actually illegal when conducted within the territory, can be passed onto other jurisdictions in the form of the lost revenue and greater cigarette consumption that result from the sale of untaxed cigarettes within their borders.

The Jebel Ali Free Trade Zone in Dubai presents another example of cigarette production within a zone. Instituted in 1985, the zone now hosts 5,000 companies from around the world and operates primarily as a re-export hub (Keshavarzian, 2010, p. 272). Evidence suggests that Jebel Ali has been a major transit point for illicitly traded cigarettes in various regions. For example, UNODC (2009, p. 27-30) reports that most of the illicit cigarettes entering West Africa are sourced from FTZs, particularly Jebel Ali. It also identifies zones in the United Arab Emirates, and Jebel Ali in particular, as the second biggest source of counterfeit goods seized at the borders of the EU (UNODC, 2010, p. 179). While the product itself travels via Jebel Ali and/or other zones, the UNODC (2009, p. 29) notes that the companies organising the trade ‘are often headquartered in offshore investment centres in another part of the world entirely.’ However, in addition to acting as a trans-shipment hub for illicit whites produced in Europe, Asia and Paraguay, Jebel Ali itself has become an important manufacturing centre (Euromonitor, 2014). More than 80 companies are licensed to trade in and manufacture tobacco products in the zone itself (Allen, 2013, p. 12), which contains at least ten cigarette factories and a capacity of about 60 billion cigarette sticks a year (Euromonitor, 2014). Cheap white brands produced in Jebel Ali are apparently sold illegally worldwide, including in the Middle East, Europe and Africa (Euromonitor, 2014; Allen, 2013, p. 12).

### The Political Geography of Illicit Trade

The very nature of illicit trade makes it difficult to conduct accurate, detailed and comprehensive research on the phenomenon. While not all SEZs are likely to be conduits or production centres for

illicit trade, some appear to be particularly problematic. The weight of evidence uncovered by various agencies, researchers and journalists points to a systemic, rather than coincidental, problem with trans-shipment of smuggled goods via free zones. A number of international agencies have identified the vulnerability of such zones, not just to tobacco smuggling, but to other forms of organised crime. Indeed, the illicit trade in tobacco products is often entwined with other forms of crime, including narcotics trafficking, and may play a key role in money laundering schemes. Both free zones and other kinds of SEZs may offer opportunities for manufacturing of illicit products.

The problems of zones may also be exacerbated by the connections that those engaged in illicit trade also have with other similar, and sometimes overlapping, types of selectively deregulated locality, notably 'offshore' financial centres. According to the UNODC (2009, p. 29), for example, the ownership of firms engaged in the production and/or smuggling of illicit tobacco products may be 'concealed by a complex network of shell companies, often based in offshore financial centres'. We see here the confluence of two varieties of 'de-territorialised' processes – that of the production and movement of physical goods through selectively deregulated places, separated in their governance from the rest of the state to which they belong, and the movement of money via a series of other (and sometimes the same) places. While the physical movement of goods via zones is difficult to track because of multiple transactions and movements between places and modes of transport, ownership may be equally difficult to track as a result of multiple holding companies and the secrecy offered by 'offshore' financial centres.

The evidence suggests that some zones serve regional or relatively localised smuggling routes, with foreign trade zones in the USA in the 1990s a staging point for smuggling Canadian cigarettes back into Canada, and Aruba in the same decade serving as a conduit for smuggling Venezuelan cigarettes back into Venezuela. Similarly, cigarettes produced in Kaliningrad appear to be mostly smuggled into European countries. Yet this pattern is not universal, with Jebel Ali FTZ appearing to serve as a global hub. Furthermore, illicit trade tends to move from one area of weak governance to another when

the first is 'closed off'. Without a comprehensive global approach to these weaknesses, any attempt to deal with them in one zone while ignoring others is likely to prove ineffective. It is to these questions of selective deregulation, and the problems of re-regulation within a global economy, that the article now turns.

#### A REGULATORY RACE TO THE BOTTOM?

The susceptibility of SEZs to illicit trade is the result of an incessant search for competitiveness within the global economy and the dominance of a neo-liberal political-economic paradigm. Graduated sovereignty, as seen in the development of SEZs, is based on selective *exceptions* to governance mechanisms that apply in the rest of the country, thus creating spaces for TNCs to pursue their economic goals unhindered by the normal regulations (Ong, 2006). In implementing such exceptions, SEZs may also create spaces for the operation of criminal enterprises. The barriers to effective regulation in SEZs may be both 'internal' and/or 'external' to the country. The creation of the SEZ may itself have been the result of political struggles between different national and transnational actors (Park, 2005; Keshavarzian, 2010), and once differential regulation has taken place, new interests may be created or allowed to become entrenched which make re-regulation more difficult. Zones in each country will be subject to the specific, idiosyncratic, political struggles that characterise the particular country. Yet what all will have in common is a search for competitiveness within the global market and the incentives and disincentives which that engenders. It is the resulting 'race to the bottom' that represents the biggest obstacle to the effective (re)regulation of SEZs.

The dysfunctionalities created by free zones in particular are severe enough for corporations and business associations themselves to have become aware of them. The WEF, for example, acknowledges that despite the benefits of such zones for businesses, they are also 'at the same time weaker, less transparent and more vulnerable to organised crime' (WEF, 2012, p. 5). The WEF (2012,

p. 5) offers a succinct summary of the process whereby global competition creates a damaging ‘race to the bottom’:

In what is sometimes termed as a “race to the bottom”, FTZs generate reduced trade in competitor jurisdictions, which encourages them, in turn, to create FTZs, reducing the overall level of transparency and “bureaucracy”, while facilitating crime and tax avoidance in those jurisdictions. One result: organised crime groups and counterfeiters use FTZs to move illegal products around the world without detection.

A report by the ICC similarly recognises that free zones are ‘exploited and misused by organised crime groups to produce, distribute, and sell counterfeit goods’ (BASCAP, 2013, p. 1). TTCs have also acknowledged the role of FTZs in the illicit trade, with BAT, for example, describing them as ‘black holes where goods move in with one set of paperwork and out with another, fuelling illicit trade’ (BAT, 2009).

However, the specific interests of business organisations must be recognised when assessing their views. Business Action to Stop Counterfeiting and Piracy (BASCAP), for example, was set up by the ICC for the specific purpose of articulating business interests on counterfeiting to governments and the media. The WEF’s Global Agenda Council on Organized Crime is concerned to understand the effects of organised crime on businesses. These organisations focus on counterfeiting because this is the activity most likely to damage businesses, although it is only one aspect of the illicit trade. In the specific case of illicit trade in tobacco products, where the smuggling of TTCs’ genuine (untaxed) products takes place, the TTCs themselves are likely to gain, since they make their ‘normal’ profit from the original sale to distributors, while overall consumption is likely to increase as the result of the availability of cheap cigarettes (Joossens and Raw, 1998). Indeed, there is evidence that some TTCs were complicit in the smuggling of their own products during the 1990s (Holden, 2016). While there is no evidence of direct TTC input into cited ICC or WEF reports, and there is evidence of a shift in the nature of the illicit trade away from the smuggling of TTCs’ genuine products towards the

production of counterfeit products and 'illicit whites', TTCs may have an incentive to disproportionately emphasise this aspect of the illicit trade, since it competes directly with sales of their genuine products.

The growing recognition of the problems of illicit trade via free zones has led to a number of recommendations for more effective governance and best practice (FATF, 2010; WEF, 2012; BASCAP, 2013). Central to most of these is a challenge to a conception of 'deterritorialisation' that regards the zone as wholly outside the customs territory, so that customs authorities have no control there. The WCO's International Convention on the Simplification and Harmonisation of Customs Procedures (the 'Revised Kyoto Convention' or RKC) (WCO, 1999) regards goods as outside the customs territory only in relation to import duties and taxes. Customs authorities should therefore be regarded as empowered to exercise their normal non-tariff functions, such as the unrestricted right to enter and observe operations, to audit the books and records of companies in the zone, and to undertake border inspections and seizures (BASCAP, 2013). Furthermore, the WCO's SAFE Framework of Standards (WCO, 2015a), by which accredited 'authorised economic operators' receive beneficial customs treatment such as fewer or no inspections on imported or exported goods, can only operate where customs is empowered to operate fully within a zone.

However, whether by design or misunderstanding, many governments interpret customs authorities' lack of control over tariffs in zones as lack of control per se, so that there is no effective control over goods entering and leaving the zone. As the ICC puts it: 'These countries operate under the premise that goods in FTZs are not clearing through Customs and are not being imported' (BASCAP, 2013, p. 3). Furthermore, some countries have regulations empowering customs to control goods entering zones, but do not apply these (BASCAP, 2013, p. 3). The current form of the RKC is inadequate to deal with this, since the specific provisions on free zones<sup>[2]</sup>, which provide for customs authorities to control and check goods entering zones, are contained within a Specific Annex (WCO, 1999: Specific Annex D2), which is not mandatory. Furthermore, even where a country has acceded to



Specific Annex D2, its effectiveness will be determined by the extent to which countries have adopted its provisions into national law, since the RKC contains no dispute resolution or enforcement measures for non-compliance (BASCAP, 2013, p. 15).

The account of Aruba's experiences in the FATF (2010) report is illustrative of the problem. While it indicates that Aruba has attempted to improve governance of its zone since the 1990s, via introduction of better screening of companies and more transparency in transactions, the new FTZ regime has had difficulty understanding company ownership structures, which may be opaque, and has seen 'a substantial shift of trade from Aruba to other countries' (FATF, 2010, p. 41). Aruba's experience indicates a continuing problem in relation to eliminating the 'race to the bottom'. While on the one hand the exploitation of zones by criminal elements potentially impacts every jurisdiction in the world, regardless of whether a country has a zone or not (FATF, 2010, p 28), on the other hand, and similar to the case of 'offshore' financial services regulation, there are clear competitive advantages to non-compliance with best practice (FATF, 2010, p. 44). As Aruba's experience indicates, unless all parties regulate effectively, 'the FTZ which is regulated will lose clients and volume of the business in favour of other FTZs which are not regulated... Integrity has a price and generates a cost which can have consequences on volume of business in zones in terms of competitiveness... The competitive advantage of non-compliance needs to be dealt with, a level playing field needs to be guaranteed.' (FATF, 2010, p. 44). A global approach encompassing all zones is therefore required. Yet it is a measure of the extent of the problem that, as of 9<sup>th</sup> November 2015, only 21 of 103 Contracting Parties to the RKC had acceded to Specific Annex D2 (and five of those with reservations) (WCO, 2015b).

Aside from the RKC, the international treaty most relevant to the illicit trade in tobacco products is the WHO Protocol. Article 12 of the Protocol (WHO, 2013) requires States Parties to implement, within three years of the entry into force of the Protocol for that Party, 'effective controls on all manufacturing of, and transactions in, tobacco and tobacco products, in free zones, by use of all

relevant measures'. It prohibits 'the intermingling' of tobacco products with non-tobacco products in a single container at the time of removal from a zone. Other than the specific provisions applying to free zones, the Protocol's most important provisions, which Article 12 indicates should apply also to free zones, are those dealing with supply chain control, including the implementation of a tracking and tracing regime. As Sou and Preece (2013) argue, to be effective these provisions will require standardised regional and global systems, and effective collaboration between various agencies, particularly the WHO and the WCO at the global level. If any jurisdiction does not implement the tracking and tracing regime to a consistent standard, there will be a 'break' in the system 'leaving all other countries linked to a global system without vital information' (Sou and Preece, 2013, p. 80). At the time of writing, however, only 13 States Parties had ratified or acceded to the Protocol, which will only come into force 90 days after ratification by the 40<sup>th</sup> Party.

## CONCLUSIONS

The uniform management of territory by modern states has given way to a more spatially selective form of territorial governance – 'graduated sovereignty' - in which some slices of territory are more fully integrated into the world economy than others via various forms of differential regulation. Illicit trade in tobacco products via SEZs takes two main forms, which may overlap: smuggling, primarily taking advantage of inadequately supervised trans-shipment in free zones, and manufacturing within zones themselves. While some zones have been identified as particularly problematic, the diversity of SEZs and the mutability of smuggling routes make it difficult to identify which zones are utilised, since the exploitation of such zones may not be stable over time. It is also this flexibility that makes it difficult to combat the illicit trade, except through a generalised re-regulation of customs procedures. Smuggling routes are complex and open to adaptation in response to changes in regulation, customs or police activity in any particular jurisdiction. A crackdown in one or a few places only is likely to lead to the illicit trade being shifted to others.

Furthermore, one form of selective deterritorialisation – the differential customs procedures applied to the movement of material goods – may be allied with another – the use of ‘offshore’ financial centres to move money and obscure the true nature of transactions and their beneficiaries.

The discussion presented here confirms Ong’s (2000; 2006) theorisation of graduated sovereignty and draws attention to the multiplicity of forms that this can give rise to, evident in both the many kinds of SEZ that exist, in the proliferation of ‘offshore’ financial centres, and in the links between these. Greater research is needed into such forms and their interpenetration. The allying of Ong’s concept of graduated sovereignty with Agnew’s (2009) use of the concept of infrastructural power may be fruitful in this regard. These forms of graduated sovereignty have been engendered in large part as a result of neoliberal forms of global competition, demonstrating the link between globalisation processes and current adaptations in the forms of state sovereignty. In this respect, Agnew (2009, p. 207) has argued that ‘Infrastructural power in particular can be extended over space at a distance’, giving currency regimes as an example. However, SEZs demonstrate that states can also provide infrastructure selectively within a particular slice of their territory, but make it available only to external actors, in this case TNCs but also, unwittingly, transnational criminal networks. So while, as Agnew further argues (2009, p. 111), sovereignty ‘is divisible across different areas’ such as the economy and security, we find that in SEZs the selective loosening of economic regulation has unintended negative consequences for security. As Chalfin (2006, p. 253) notes, the ‘state’s role in the spatialization of power is not reduced or replaced by globalization but thoroughly tied to and in many ways productive of the ordering of the global market... an example of the generation of the transnational through the tactics of the state.’ Yet in SEZs, states’ attempts to build markets and attract capital can become dysfunctional, as they permit the access of criminal organisations to the infrastructure of global trade.

The search for competitive advantage within a liberalised world economy has thus resulted in ‘governance gaps’, which produce dysfunctions in the form of illicit trade. The criminogenic

environments that zones can facilitate may have negative effects for other countries and for the world economy as a whole, not just for the country where they happen to be situated. While in principle governments retain the ability to effectively regulate their own territories, different states and jurisdictions may have different capacities or incentives to respond to the problem. In Kaliningrad, for example, where cigarettes appear to be legally produced for the sole purpose of illicit trade in other jurisdictions, we see how the costs arising from governance gaps may be treated as problems which can be passed onto others. Once in train, the process of selective deregulation creates a competitive 'race to the bottom' in terms of the capacity to cope with organised crime, just as it may do in terms of social standards, a problem that can only ultimately be overcome by international negotiation and agreement. SEZs and 'offshore' finance, both of which are implicated in the illicit trade in tobacco products, are forms of selective deterritorialisation that may need to be at least partially reversed – 'reterritorialised' - if the gaps in global governance are to be closed.

#### ENDNOTES

1. Some authors may use a different typology or nomenclature when discussing zones. This article follows the World Bank's typology, referring to SEZs when discussing zones in general and to FTZs or 'free zones' when referring specifically to that type of zone, or when a cited source refers specifically to FTZs.
2. 'Free zones' in the RKC are defined as 'a part of the territory of a Contracting Party where any goods introduced are generally regarded, insofar as import duties and taxes are concerned, as being outside the Customs territory'.

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