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## **SUBJECT: FREE ZONES AND PROPOSALS FOR GUIDELINES ON THEIR FUTURE MODERNIZATION**

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### **Abstract**

This report presents the findings and conclusions of the ‘Study of the impact of free zones and proposals for guidelines in their future modernisation in light of the European Green Deal’.

It is structured as follows:

- ▶ Objectives and research questions, methodology, and context of the study (Section 1);
- ▶ Findings per research question (Section 2);
- ▶ Conclusions (Section 3);
- ▶ Case studies, proposal for guidelines on good practices regarding green free zones to contribute to the objectives of the European Green Deal, and methodological notes (in annexes).

### **Objectives and research questions**

The underlying objective of the report is to provide a study on the performance of the EU free zones in several aspects and to compare them with free zones in third countries in terms of these aspects. This study aims to assess the pros and cons of EU free zones, as well as their prospects for a sustainable future.

This objective can be further narrowed to three specific objectives.

Assess: first of all, the study aims to provide an assessment of the performance of free zones in the European Union (EU) based on key indicators such as jobs created, the volume/value of goods that entered or exited free zones or were



traded therein, but also relevance-related issues like objectives (current and future) and key activities. Furthermore, the study aims to identify risks related to the free zones within the customs territory of the Union.

Compare: the performance and risks are also compared with free zones outside the EU on concrete aspects (e.g. anti-money laundering, environmental and State aid aspects).

Provide a proposal for guidance: finally, the study provides a compilation of best practices on how EU free zones best contribute or can best contribute to the European Green Deal's (EGD) objectives (see Annex VII), as well as the added value that free zones can contribute towards achieving such objectives.

The assessment criteria covered by the study are the following five key assessment criteria:

- ▶ effectiveness: in terms, e.g. of the extent that free zones have created wealth, trade or employment in line with their objectives;
- ▶ efficiency: extent to which the costs/risks (economic, social and environmental) related to the free zones (including forfeit tax income) are commensurate with the benefits;
- ▶ relevance: extent to which free zones' activities and objectives match the identified needs;
- ▶ EU added value: extent to which there is a need for the EU to coordinate certain aspects of free zones, apart from the fact that the customs union is an exclusive competence of the EU.

The assessment criteria are reflected in the research questions (RQs) presented briefly below with the exception of EU added value. The assessment of EU added value is provided in the study's final conclusions, based on the answers to all research questions. The scope of the RQs is described in the following table.



**Table 1: Scope of the research questions**

No.	Question	Criterion	Scope of the research question
1	What is (are) the core activity(ies)/purpose(s) of the free zones established in the Union in the short and in the long run? What are the objectives of the Union free zones in the short and in the long run and what needs were meant to be met? Are they still valid?	State of play / Relevance	These questions aim to map the need for setting up free zones, their objectives and the activities/incentives they provide. This analysis leads to identifying the rationale for free zone establishment and operation, and objectives, leading to an overall assessment of their relevance.
2	Regarding the customs provisions regulating free zones in the EU, are the current rules fit for purpose? Do these rules ensure proper functioning of the free zones or are there any weaknesses or gaps in the legal framework (UCC)?	Effectiveness	This question focuses on whether EU customs and other related legislation regarding free zones helps to ensure the proper functioning of the free zones. This does not only cover the appropriateness of the rules themselves, but also an analysis of how they are implemented and enforced in EU Member States, and if current systems (incl. IT) help to facilitate this.
3	To what extent have the free zones contributed to the economic growth of the country/region/where they are located?	Effectiveness	The scope of the research question focuses on economic indicators such as the annual contribution of the free zone in the country's/region's economy; the value of all the goods / services traded; and investments in the free zones.
4	Have the benefits obtained from the free zones outweighed such costs or not (and to what extent)?	Efficiency	This is a classical Efficiency question, but what is specific is that within this study, it focuses on a combination of risks and benefits, because most risks cannot be quantified.
5	Does the fact that goods can be stored in free zones with no time limit entail risks (mainly in terms of taxation)? Do free zones disclose the value of goods stored on their premises or are there privacy and confidentiality clauses (akin to bank secrecy) in place?	Effectiveness/ Efficiency	This question is, to a large extent, aiming to assess if the free zones are used for tax avoidance issues and other illicit activities. Thus, the study explores to what extent free zones are subject to national ML/TF requirements; access to information requirements; registering; controls; high-value goods and processes.
6	To what extent have the EU free zones contributed to fostering decent employment in the country/region of their location?	Effectiveness/Coherence	This question looks into effects of free zones on job creation, but also the four pillars of the decent work agenda: standards and rights at work, employment creation / enterprise development, social protection and social dialogue, including the practice of freedom of association and collective bargaining.



7	Do the free zones in the Union make the elimination of duties, customs, etc., conditional on compliance with international standards on labour rights in the exporting countries (e.g. interviews with authorities responsible for free zones)?	Coherence	This question aims to assess whether the policy of free zones may have also contributed to the promotion of international labour standards in third countries by making some benefits conditional on complying with these standards.
8	Are the analysed free zones contributing to the objectives established in the European Green Deal (EGD)? If not, how far away are these free zones from fulfilling such objectives and what is the cost this lack of compliance entails?	Coherence	This research question assesses whether the effectiveness stemming from the indicators of free zones is coherent with the EGD aims and priorities established in the Communication Commission on the European Green Deal dated 11/12/2019. It determines how and to what extent the free zones practically contribute (or could contribute) to those priorities.
9	Do free zones have a plan to contribute to the objectives established in the European Green Deal? If yes, which concrete actions are envisaged to be taken in the following ten years? How should the	Coherence/ Relevance	Building on the previous research question, this question assesses the free zones' concrete plans for contributing towards the EGD in the next ten years. The purpose of this RQ is to determine whether

### **Mapping of free zones – EU and worldwide**

Free zones have been in existence for a long time. However, their number has increased significantly in the second half of the last century. There are estimates that free zones account for over 20 per cent of world trade.<sup>10</sup> The use of free zones has thus become quite common, but it is worth noting that there is no commonly accepted definition of free zones, except only in very general terms – areas that provide a regulatory regime for businesses and investors distinct from what applies typically in the broader national or subnational economy where they are established<sup>11</sup> (e.g. in terms of tax breaks, duty exemptions, simplified administrative procedures, and other financial incentives). Next to the lack of a common definition, the term is used interchangeably with other terms, like Special Economic Zones (SEZ), Freeports, Free Trade Zones, industrial



parks, etc. While there have been various attempts to use common definitions or clarify the differences between the terms,<sup>12</sup> as of today, there is still no commonly used definition.

While many free zones are located in developing and emerging economies, as of 2022, there are 62 active free zones in the EU (see the table below). EU Member States have the authority to designate free zones, provided that they comply with EU law (Articles 243 to 249 of the Union Customs Code). Within the EU, free zones imply that goods brought from third countries can enter these zones without being subject to import duty and other charges related to their import (e.g. VAT), unless they are finally consumed or released for free circulation.

Table 2: Presence of free zones in the EU27 (Source: EC13 and own elaboration)

Country	Number of free zones
Austria	None
Belgium	None
Bulgaria	3
Croatia	10 (2 of which are inactive)
Cyprus	1 (inactive)
Czech Republic	2
Denmark	1
Estonia	3
Finland	None
France	2 (of which 1 is inactive)
Germany	2
Greece	4
Hungary	1 (inactive)
Ireland	None
Italy	6
Latvia	4
Lithuania	3
Luxembourg	1
Malta	1
Country	Number of free zones
Poland	7
Portugal	1
Romania	6
Slovakia	None
Slovenia	1
Spain	8
Sweden	None
The Netherlands	None
Total	62 active free zones



As shown in the table, there are currently active free zones in 18 MSs. Seven MSs do not have a free zone, and two have only one free zone, which is inactive (Cyprus and Hungary). The table also shows that there is no direct link between the size of countries and the number of free zones established – e.g. Croatia has eight active free zones, while Germany has two.

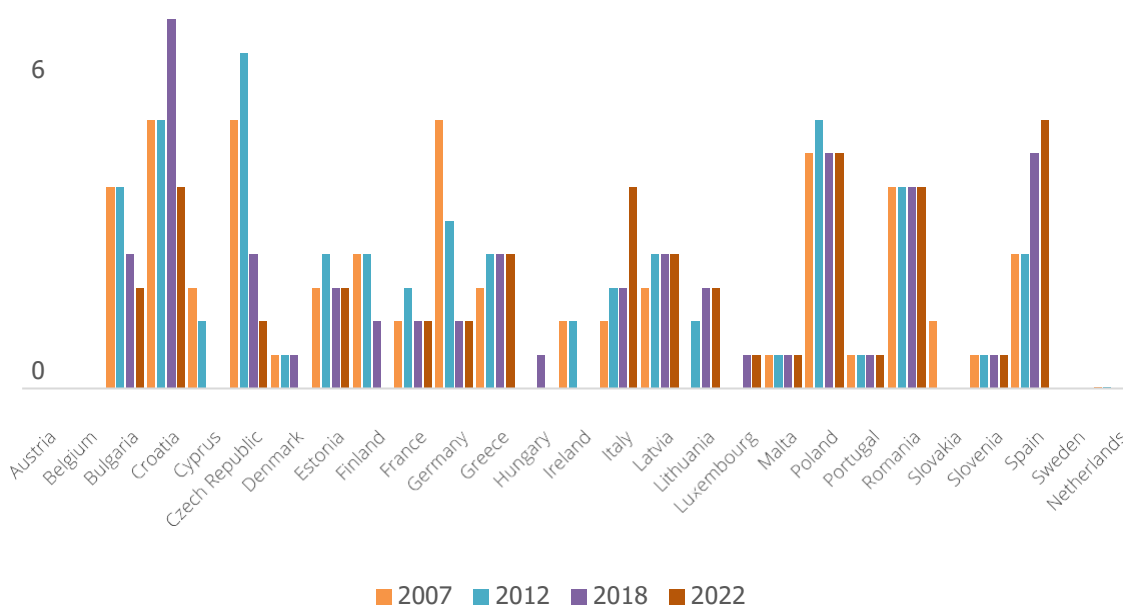
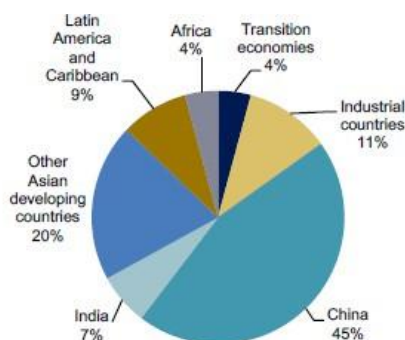


Figure 1: Number of free zones over time by EU country

Source: current and past lists of the EC14

There is a decreasing trend of free zones in the EU, which counted 78 free zones in 2007, 80 free zones in 2012 and 62 active free zones at present. There is a negative EU trend in the number of free zones in total, for example, in countries such as the Czech Republic and Germany which have significantly reduced their number of free zones. Additionally, Finland, France, Slovakia, Hungary, Cyprus, the Netherlands, and Ireland no longer have active free zones with customs procedures in their territories (see Figure 1). Instead, we find the opposite trend in Italy, and Spain, which shows an increasing number of free zones over the years.



Note: Industrial countries: Europe, North America, Australia, Israel, Japan, New Zealand. Transition economies: Countries in Eastern Europe, Central Asia as well as Russia.

Figure 2: Free zones geography

Source: World Free Zones Organisation<sup>15</sup>

Unlike the EU trend, in 2021 the UK government, following Brexit, announced the opening of eight new freeports across the country, which will include tax reliefs, customs, business rates retention, innovation and trade. The plan has the objective of creating freeports as hubs for trade and investments, for driving innovation and for promoting regeneration with high-skilled jobs<sup>16</sup>. Beyond Europe, against the background of Intellectual Property Rights infringements<sup>17</sup>, the Kingdom of Saudi Arabia has also recently expressed intentions to launch four new free zones, which will offer incentives to companies that are fiscal and non-fiscal, including competitive corporate tax rates, duty-free imports of machinery and raw materials, and flexibility in employing foreign labour<sup>18</sup>.

Worldwide, there are more than 5 000 free zones, of which more than 1 000 were established in the last decade<sup>19</sup>. As shown in Figure 2, most free zones are located in Asia – above 4 000 (with China having more than 2 500). For comparison, in North America, there were 262 in 2019, while in the same year, Europe had only 105 free zones, with just more than 70 based in the EU.

In addition to geography, free zones can also be mapped by their different characteristics.

► The objectives they aim to achieve. Often this entails promoting trade (e.g. focusing on re-exports). Attracting investment, creating employment, economic





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diversification (regional spread or development of new sectors) are also among the most common objectives.

► The incentives they provide. The incentives for companies to operate in a free zone are often based on customs and tax exemptions, but the package of incentives can also be broader, including strong infrastructure support (roads, electricity, internet, etc.), simplified administrative procedures, and technical assistance (e.g. by providing training).

► The type of activities in the zone. These can range from only re-export-related activities, with limited value-added (e.g. warehousing, packaging, logistics), to manufacturing and processing activities. The latter can focus on a specific industry or cover a variety of industries/sectors.

► The ownership structure of the free zone, which can be public, private or a mix thereof.

These different characteristics of free zones also reflect the different purposes of setting up free zones. The purpose of setting up free zones also differs depending on the specific context, which is related to the geographic location of the free zone (which part of the world), the stage

The report is referring to Special Economic Zones as an umbrella term that comprises all types of free zones, including special economic zones, free trade zones, export processing zones, free economic zones, and freeports. of economic development of the country in which the free zone was set up, and the time period within which it was set up.<sup>20</sup> In the EU, some are focused on regional development (e.g. targeting underprivileged or high-unemployment areas).

The Union Custom Code (UCC)<sup>21</sup> is an important element in the governance of free zones in the EU, and this study focuses on the aspects that are relevant to free zones. The UCC provides a framework for EU Customs legislation and aims, among others, to provide more clarity, legal certainty and uniformity across the EU, and also aims at a paperless and fully automated customs union. It has specific provisions regarding free zones in Articles 243 to 249, in particular:

- designation of free zones (Art. 243);
- buildings and activities in free zones (Art. 244);





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► conditions for customs checks, entry, storage, movement, use, and processing in free zones (Art. 245-249).

The focus on the UCC is particularly relevant when answering research question 2, which explores whether the rules ensure the proper functioning of the free zones or if there are any weaknesses or gaps in the legal framework, including on IT aspects. Further to the UCC, work of the World Customs Organisation (WCO) regarding free zones also provides further practical guidelines on customs involvement in free zones, among others, to prevent illegal activities.<sup>22</sup> The WCO document provides practical guidance on customs procedures/control, including on IT systems.

In that context, it is also relevant to note that there are rules and regulations that affect free zones more indirectly. For example, the EC's 5th Anti-money Laundering Directive makes freeports that are involved in storing, trading or acting as intermediaries in the trade of works of art, i.e. 'obliged non-financial entities'. This makes them subject to stronger customer due diligence (CDD) obligations. In addition, they are considered anti-money laundering (AML) 'gatekeepers' and have to report suspicious transactions to the Financial Intelligence Units (FIUs). Such issues and the AML Directive are particularly relevant to the efficiency questions (RQ4 and RQ5).

This study (for example, via the case study on freeports) explores if tax authorities have access at national level to free zones. In terms of tax cooperation, Member States can avail of EU legislation like Directive 2011/16/EU for administrative cooperation in direct taxation, Council Regulation (EU) No 904/2010 on administrative cooperation and combating fraud in the field of value added tax, and Directive 2010/24/EU for mutual assistance in the recovery of taxes, duties and other measures. However, the exchange of information with the requesting MS can only be effective if the requested MS also has access at national level to information on assets held in free zones, including beneficial ownership information. Therefore, if such access is not available at national level, then cross-border cooperation will be impeded. The lack of availability of such access will be an indicator of an inherent risk of tax abuse.



***Modern American Journal of Business,  
Economics, and Entrepreneurship***

**ISSN (E):** 3067-7203

**Volume** 01, **Issue** 09, **December**, 2025

**Website:** [usajournals.org](http://usajournals.org)

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Due to the high risk of money laundering and financing of terrorism, it is important that tax authorities have direct access to free zone information and data, and that cooperation between customs and tax authorities is facilitated. Coordination between authorities is needed on the ultimate beneficial owner's identity - UBO23, and consequently, to detect and identify suspicious transactions. As underlined by the EC24, centralised IT tools for enabling cooperation at EU- level customs and tax authorities are helpful for standardising tax legal procedures in free zones at national level and across borders.

In the EU, free zones have to comply with EU State aid rules<sup>25</sup>. State aid is normally prohibited if it threatens to distort trade and competition between firms, to ensure a level playing field in the EU. However, under certain conditions, they are allowed, for example, to support regional economic development. MSs do not need to notify the European Commission of measures that fulfil the conditions laid down under the General Block Exemption Regulation (GBER)<sup>26</sup>. This, nevertheless, does not prevent the European Commission from investigating the proportionality of such State aid. In the case of free zones, the potential losses of revenue/cost for the competent authorities (customs duties, indirect taxes, possibly others), therefore, need to be outweighed by the benefits of free zones, such as increased employment or attraction of foreign investment. This is also an issue that is relevant to the efficiency questions.

Under the Code of Conduct for Business Taxation, a special geographic area where business (corporate) tax privileges are available qualifies as "special economic zone" (SEZ). Free zones can thus be covered by the SEZ definition only if business tax privileges are applicable. Such SEZs are the object of particular scrutiny by the Code of Conduct Group<sup>27</sup>, e.g. that free zones where business tax privileges apply do not lead to harmful tax practices. The Code applies to business tax measures that provide for a lower tax rate than that which generally applies in the Member State. Such measures are then assessed on a case-by-case basis against five agreed criteria. Under the commitments taken in the Code of Conduct on Business Taxation, Member States are obliged to notify each other—on an annual basis—of any preferential business tax measure they adopted in the previous year that comes within the scope of the Code. One of



the Code criteria is that the SEZ requires real economic activity carried out within the zone (such as distribution and manufacturing activities and activities that generate employment, assets and investments). As such Special economic zones should not provide advantages to companies involved in mobile activities, for example, treasury or the development of intangibles. Equivalent rules apply at international level, i.e. OECD rules.

Finally, through the last two research questions (RQ8 and RQ9), this study aims to identify to what extent the free zones contribute or aim to contribute to the objectives of the European Green Deal (EGD). The overarching objective of the EGD is to transform the EU into a fair and prosperous society with a modern, resource-efficient, and competitive economy where there are no net emissions of greenhouse gases in 2050 and where economic growth is decoupled from resource use. The more specific EGD objectives include the supply of clean, renewable energy, mobilisation of the industry for a clean and circular economy, shifting to sustainable and smart mobility, implementing zero pollution, fair, healthy and environmentally friendly food systems, and resource-efficient building and renovating, and preservation and restoration of ecosystems and biodiversity. The EGD further covers green finance and investment, fair transition, research and innovation, and education and training. The activities of the free zones are analysed against this comprehensive list of objectives to identify both aspirations and existing best practices.

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***Modern American Journal of Business,  
Economics, and Entrepreneurship***

**ISSN (E):** 3067-7203

**Volume** 01, **Issue** 09, **December**, 2025

**Website:** [usajournals.org](http://usajournals.org)

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