

Doctors and Tobacco

Tobacco Control Resource Centre

Tobacco smuggling

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'The trade in contraband sales world wide grew by more than 110% between 1990 and 1997. Smuggling remains an important feature of the cigarette market and is likely to depress legitimate sales for the foreseeable future.' World Tobacco File 1998, p.1322 'Smuggling is a serious problem, but the report concludes that, even where it occurs at high rates, tax increases bring greater revenues and reduce consumption. Therefore, rather than forgoing tax increases, the appropriate response to smuggling is to crack down on criminal activity.' World Bank Report, Curbing the epidemic. Economics of tobacco control. Washington DC, June 1999.

Introduction

Taxation is one of the most effective measures for reducing tobacco consumption. The tobacco companies oppose tax increases. More and more, they rely on the argument that higher taxes are an incentive for smuggling.

According to the industry, increased cigarette taxes will reduce legal sales, but not total sales (legal and illegal sales combined). They argue that increased taxes will lead to increased smuggling, resulting in less revenue for governments and undermining taxation as an effective health policy to curb tobacco consumption.

Two types of smuggling

Different tax incentives, price differentials, geographical characteristics and socioeconomical conditions may lead to different kinds of illegal activities. It is difficult to precisely define smuggling, because smugglers constantly adapt their activities to get around new regulations and customs controls. We distinguish between two kinds of illegal circumvention of taxation: bootlegging and largescale organised smuggling.

Bootlegging

Bootlegging is encouraged by substantial differentials in the price of tobacco products between neighbouring countries or between neighbouring states or provinces. Where there are large differences in retail prices (often more than 300%), dutypaid products may be purchased in a low tax area and transported to a high tax area to be sold illegally. Bootleggers often use especially made vehicles that have been altered to conceal the goods.

An example of bootlegging is the illegal traffic of hand-rolling tobacco between Belgium and the United Kingdom. In 1998, a 50g pack of hand-rolling tobacco cost UK£1.80 in Belgium but UK£7.80

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in the UK. Gangs buy 50 kg of dutypaid handrolling tobacco in Belgium and transport it in small cars to the UK, thus making a daily profit of UK£2000 ([1]).

In 1998, some 5000 tons of handrolling tobacco were smuggled from Belgium to the UK.

Bootlegging is in one sense 'oldfashioned' smuggling. It is often organised by gangs, but does not require huge investments. Large price differences are essential in sustaining this illegal business.

While bootlegging is a problem in some parts of the world, substantial price differences between countries are relatively uncommon and the amount of bootlegged tobacco is much smaller than that from largescale smuggling.

Largescale organised smuggling

Largescale smuggling is characterised by the involvement of criminal organisations, a relatively sophisticated system for distributing smuggled cigarettes locally, and a few controls on the international movement of taxfree cigarettes.

Largescale organised smuggling has increased in different regions of the world.

Worldwide in 1996, an estimated 355 billion cigarettes were smuggled: some 6.5 % of all cigarettes sold ([2]).

While avoidance of taxes is the motivation for smuggling, smuggling cannot be explained by tax levels alone. In many European countries with high taxes, there is little evidence of smuggling; while in Spain, Italy and many Central and Eastern European countries, which have much lower tobacco taxes and prices, illegal sale of international cigarette brands is widespread. Public tolerance, the culture of street selling, the presence of organised crime and the complicity of the tobacco industry also play a role in determining the level of largescale smuggling.

Although the level of sales of contraband cigarettes varies between markets, largescale smuggling of cigarettes has some common features throughout the world.

1. Transport of taxfree cigarettes

Largescale smugglers transport containers of 10 million cigarettes, on which they prefer to pay no tax. Paying taxes would diminish profits and increase the risk of loss by confiscation of the goods. A container of 10 million cigarettes can be bought for some US\$200,000, but has a fiscal value (import taxes, excise duties and VAT) in the European Union of at least \$1 million ([3]). Largescale smugglers operate in all parts of the world, as container transport costs are small compared to the market value of the goods.

2. International brands

Smuggling focuses mainly on wellknown international brands, as instant recognition and confidence in the merchandise are essential to these quick, furtive transactions ([4]). Marlboro is the world's most valuable brand and remains one of the most in demand in the contraband sector.

3. Transported in transit

Taxfree cigarettes are most often bought 'in transit'. Transit is a concession system aimed at facilitating trade which allows the temporary suspension of customs duties, excise and VAT payable on goods originating from and/or destined for a third country while the goods are transported

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through a defined customs area. However, many cigarettes simply fail to arrive at their final destination, having been bought and sold by unofficial traders. Fraud occurs when the transit cigarettes do not arrive at their declared destination, but are sold without taxes on the black market ([5]).

4. Passed through a number of owners

Fraudulent transactions typically involve several separate buyers between the initial purchase of the cigarettes and their disappearance from legitimate circulation. The key point for a fraudster is not to be discovered. One mechanism used to make investigation difficult is to arrange for a consignment to pass through a bewildering number of owners in a short time. The aim is to make it impossible to trace the final owner, and to obscure the links between successive owners ([6]).

5. The presence of criminal networks

A 1997 EC report states that more than 50 criminal networks have been identified in various large-scale investigations ([7]). Criminal networks that specialise in cigarette smuggling operate more easily in countries where there is a high level of corruption, the authorities lack control, and other commodities are also smuggled. A study for the World Bank assessed the extent to which other factors, such as general corruption levels, contribute to smuggling. Using standard indicators of corruption levels based on Transparency International's Index of Countries, it concluded that (with certain notable exceptions) the level of tobacco smuggling tends to rise with the degree of corruption in a country ([8]). Countries with high levels of cigarette smuggling (more than 30% of total sales) are not those with the highest prices or taxes, but rather those with a high corruption score, such as Yugoslavia, Ukraine, Columbia, Pakistan and Nigeria.

6. Distributed in nonofficial outlets

Largescale smuggling also requires a willing market and a local distribution network to supply it. Unregulated distribution networks provide more opportunities to sell contraband cigarettes. The following make smuggling more likely: street selling, sales in pubs and bars, lack of tax stamps, relatively high and increasing prices, and prohibitions and restrictions on the sale and manufacture of international brands. Countries with large black markets are especially vulnerable to smuggling.

Does smuggling lead to less tax revenue?

According to the World Bank, the experience of a large number of high-income countries shows that, even in the face of high levels of smuggling, tax increases bring increased revenues and reduce cigarette consumption ([9]).

Publicly, the tobacco industry maintains that tax increases are not effective. The industry asserts that smuggling is caused by taxes, and that to combat smuggling, taxes must be reduced. Both Canada and Sweden have reduced taxes on tobacco in response to concerns about smuggling. A description of what followed may clarify the situation.

Canada

From 1979-1991 in Canada, the real price of cigarettes increased by 159% and teenage smoking

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fell from 42% to 16%. In 1994, Canada reduced tobacco taxes in response to concerns about smuggling, causing the real price of cigarettes to fall by onethird. Teenage smoking increased from 16% to 20% ([10]). Total tobacco consumption ceased to fall, and is now increasing.

From a health point of view this is a clear and significant loss. The revenue losses are equally acute ([11]). The February 1994 tobacco tax cuts resulted in a combined federal and provincial revenue loss of over CAN\$1.2 billion in the fiscal year 1994-1995. The federal loss was CAN\$656 million, more than twice that the government had predicted ([12]).

Sweden

Like other Scandinavian countries, Sweden has high tobacco prices and low levels of smuggling. Two successive tax increases between December 1996 and August 1997 raised the price per pack of cigarettes from US\$4.00 to US\$5.80, and increase of 43% in only eight months. The media indicated that smuggling had increased ([13]). The huge price increase was unpopular among smokers and undermined support for high tobacco taxes. As result, the Swedish parliament decided in 1998 to lower taxes to the July 1997 level -which is still among the highest in Europe.

Although the tax increase in Sweden was unpopular, it was effective. Tobacco tax revenue rose by 9% in 1997, but decreased in 1998 after the tax cut. An annual survey indicated a significant reduction in the prevalence of smoking during 1997. Among men, prevalence dropped from 21% in 1996 to 17% in 1997, while among women, it fell from 23% to 22% ([14]). Sweden now has the lowest smoking prevalence in Europe. However, after the tax decrease of August 1998, smoking may now be on the increase again.

The Swedish experience shows that tax increases are effective, but also suggests that it may be politically unwise to introduce large tax increases over a very short period.

The role of the tobacco industry

According to the World Bank, economy theory suggests that the industry itself will benefit from the existence of smuggling. Studies of the impact of smuggling show that when smuggled cigarettes account for a high percentage of the total sold, the average price for all cigarettes, taxed and untaxed, will fall, increasing sales of cigarettes overall. (9)

Despite its professed opposition to criminal activity, the tobacco industry benefits from smuggling in several ways:

- ? smuggling stimulates consumption both directly (through the street sale of cheap cigarettes) and indirectly (through pressure to lower or keep down taxes);
- ? the treat of smuggling has also been used to avoid trade barriers or to force open new markets.

Since 1997, there have been several court cases and official investigations in different part of the world which accused the industry of supplying the smuggled cigarettes or at least of being aware of the illegal destination of their products. For in stance, a former BAT executive was found guilty by

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the Hong Kong' s High Court for his role in his role in an operation that smuggled cigarettes into China. In 1998, a major tobacco company was convicted for actively breaking the law to assist in a smuggling operation. An affiliate of RJ Reynolds International pled guilty to charges of helping smugglers illegally reroute export cigarettes into Canada. It is clear that more and more governments now feel that the tobacco industry has a case to answer in relation to smuggling. BAT is under investigation by the UK Government Department of Trade and Industry over tobacco smuggling. In recent years Canada, Colombian Governors, Ecuador, the European Commission and nine EU Member States (Italy, Germany, Spain, France, Finland, Belgium, Netherlands, Portugal and Greece) and Honduras and Belize have filed lawsuits against international tobacco companies for smuggling. Other investigations continue, spurred on, in part, by internal industry documents released in various lawsuits brought against tobacco companies. (15)

Recommendations

Cigarette smuggling can be reduced, but action is needed at the national, regional and global level. Effective international action should be facilitated by the inclusion of a specific protocol on smuggling in the proposed WHO Framework Convention on Tobacco Control.

Recommendations for national action

- ? Raise public awareness of the negative aspects of smuggling
- ? Increase penalties: cigarette smugglers continue because the benefits outweigh the risks
- ? Place 'taxpaid' markings on tobacco products: these clearly distinguish between legal and illegal goods, making contraband products easier to detect and trace, and the law easier to enforce
- ? Eliminate dutyfree sales, which often serve as a major source of smuggled cigarettes
- ? Require tobaccospecific licences for manufacturers, exporters, importers, wholesalers, transporters, warehouses and retailers. Licences help identify and monitor those involved in the tobacco sector. Conditions can be attached: licences can be suspended for breach of these conditions and of the law. Loss of licence contact as a real deterrent to potential traders in smuggled cigarettes.

Recommendations for international action

- ? Monitoring at national, regional and international level is needed to provide high quality data on smuggling, taxfree imports and crossborder trade of tobacco
- ? Require a legible unique identifying code on all packages of tobacco products to enable the authorities to identify the location, date and company. Each package should also carry a chain of custody mark, indicating the manufacturer and the final destination of the product, as well as

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the distributor, wholesaler and exporter.

- ? Demand recordkeeping and tracking systems that place the onus on manufacturers to prove that cigarettes arrive legally in their intended markets. Hold up the major cigarette companies strictly reliable for any of the cigarette they export ending up as smuggled contraband.
- ? Require exported cigarettes to be labelled with the country of final destination and with appropriate and countryspecific health warnings. Specific labels can also be requested for cigarettes which are not exported.

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