

# Smuggling and cross-border shopping of tobacco products in the European Union

a report for the Health Education Authority, London

“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 foregoing 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.

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## SUMMARY

- The global increase in smuggling is now the main argument the international tobacco industry uses to persuade governments not to raise the tax on tobacco products or even to lower tobacco excise duties.
- The most serious smuggling problem facing European countries, including the United Kingdom, is not bootlegging – legally buying tobacco in a low-tax country and illegally reselling it in a high-tax country – but large-scale organised smuggling of tobacco on which no duty has been paid.
- Paying any taxes, even low ones, diminishes the smuggler's profit. A container of 10 million cigarettes can be bought for £150,000 to £250,000 tax-free, but has a current fiscal value in countries of the European Union of £700,000 to £1,500,000.
- In the UK, HM Customs estimated in 1998 that seven per cent (7%) of the total cigarette market was smuggled in freight consignments and three per cent (3%) by bootlegging.<sup>1</sup>
- In 1999 £1,390 million in revenue is expected to be lost through illegally imported cigarettes hidden in freight containers. In the UK, container cigarette smuggling is now the real concern as large scale cigarette fraud is four times as important as bootlegging (estimated at £340 million in 1999).
- Despite a duty freeze on hand rolling tobacco in the UK, bootlegging from Belgium has continued to rise. The revenue lost from smuggled hand rolling tobacco in 1998 is expected to be £730 million.
- The level of tobacco taxation alone cannot explain smuggling. There is little evidence of smuggling in most of the countries with the highest taxes in Europe, while in Spain, Italy and many central and eastern European countries, where taxes are much lower, the illegal sale of international brands of cigarettes is widespread.
- Large-scale smuggling involves criminal organisations with a sophisticated system for distributing smuggled cigarettes at a local level. Criminals are hugely aided by the lack of control of the international movement of tax-free cigarettes.
- Reducing taxes is not a solution to smuggling, as the experience of Canada shows. In 1994, tobacco tax cuts resulted in a loss to the federal government of CAN\$656 million in Fiscal 1994/95, more than twice government predictions. At the same time, teenage smoking prevalence, which had been falling steadily, rose from 16% to 20%.
- There is no doubt that the tobacco industry benefits from smuggling both directly (through the sale of cheap cigarettes, which stimulates consumption,) and indirectly (through the pressure it uses on governments to keep down or lower taxes). There is debate, however, about the evidence of direct or indirect tobacco industry involvement in investigations in different parts of the world that have accused the industry of participation in, or awareness of, smuggling. Some of these court cases have resulted in conviction of tobacco company employees.
- Tobacco smuggling can be reduced, but the action must be taken at national, European and world levels. Important steps will be to: raise public awareness of smuggling; increase the penalties for those convicted of smuggling; require special package markings that will indicate if tax has been paid and will allow officials to trace shipments from the place of manufacture to their final destination; tobacco specific licences for manufacturers, retailers and all the different actors in the distribution network.

## **INTRODUCTION**

Increasing taxation is often considered as one of the most effective measures for reducing tobacco consumption. The tobacco companies oppose such increases and increasingly rely on the argument that higher taxes are an incentive for smuggling.

This threat has been used by the industry in order to convince Ministers of Finance not to raise the tax on tobacco products. In Canada (1994) and in Sweden (1998) the industry was even more successful and convinced those governments to lower taxes on tobacco products in an attempt to resolve the smuggling problem. According to the industry, an increase in cigarette taxes will only reduce legal sales, but not total sales (legal and illegal sales combined). Smuggling will create less revenue for governments, they argue, and even undermine health efforts to keep the number of smokers down. A 'black market' also cuts the income of honest tobacconists and creates more opportunities for organised crime. The smuggling issue has become now the argument most used by the industry to counter the policy of those governments who want to reduce the consumption of tobacco through taxation. In its May 1998 report on tobacco products taxes, the European Commission stressed that the smuggling factor must be taken into account when a tax increase is being considered, as the public-health objective of reducing consumption through high taxation will fall short of its target if tobacco products evade this taxation.<sup>2</sup>

In this paper I will examine the impact of smuggling and cross border shopping on consumption. I will clarify the concepts of cross border sales and smuggling, explain their causes, describe and classify the smuggling situation in some countries, quantify the effects of cross border trade, evaluate the effect of smuggling on sales and tax revenue, define the role of multinational tobacco firms and make recommendations to tackle the smuggling problem.

## DEFINITIONS

Some discussions of cross border shopping and smuggling have been hindered by ambiguity about the definitions of some important concepts.<sup>3</sup> The definitions below emphasise the following distinctions: personal use versus commercial purposes, legal versus illegal and small versus large amounts. In this paper, these terms will be defined in the following way:

- a) Legal circumvention
  - i) Legal cross border shopping: buying duty paid tobacco products in a neighbouring country for buyers' own consumption in amounts allowable under the customs regulations.
  - ii) Legal tourist shopping: buying duty paid tobacco products in a NON- neighbouring country for buyers' own consumption in amounts allowable under the customs regulations.
  - iii) Legal duty-free sales: buying tax free tobacco products in amounts that are applicable for travellers' allowances (200 cigarettes or 100 cigarillos or 50 cigars or 250g of smoking tobacco).
- b) Illegal circumvention
  - i) Bootlegging: buying tobacco products from other countries in amounts that exceed customs regulations. The tobacco products are not intended for personal consumption, but are sold to other people.
  - ii) Large-scale organised smuggling: the illegal transport, distribution and selling of large consignments of tobacco products (mostly duty-free cigarettes).

## THE CAUSES AND THE SIZE OF LEGAL AND ILLEGAL CIRCUMVENTION

- a) Legal circumvention
  - i) Legal cross border shopping:

The potential benefits of cross border shopping increase with greater differentials in the price of tobacco products among neighbouring countries or states. However, the travel and time costs of purchasing tobacco products in this way must also be considered.

For example: Belgians, French, and Germans have traditionally stocked up on cigarettes when passing through Luxembourg because of the low price of cigarettes there. In Luxembourg (population: 418 000) 5,165 million cigarettes were sold in 1997. (*Ministry of Finance, Brussels, personal communication*). It is estimated that 85% of these sales were due to cross border sales.<sup>4</sup>

A 1994 study by the Centre for Health Economics at York University found that there is little incentive for cigarette cross border shopping between France and Britain: the savings on 800 cigarettes bought in France and taken back in Britain would be outweighed by the cost of the trip.<sup>5</sup> In practice, it is unlikely that smokers would be willing to travel long distances to obtain relatively small discounts. Cross border shopping occurs when smokers are already across the border for other reasons.

Estimates of HM Customs & Excise confirm that legitimate cross border shopping remains a minor problem. Their estimates are based on the International Passenger Survey, which samples about 48,000 UK residents each year during and shortly after their journey. In 1997, UK Customs & Excise estimated the loss of revenue through legitimate personal imports of tobacco products at less than 0.5% of total cigarette sales and 4.5% of hand rolling tobacco sales.<sup>6</sup> The revenue lost through legal tobacco cross-border shopping in 1998 has been estimated at £85 million.<sup>7</sup>

- ii) Legal tourist purchases:

Tourist shopping is encouraged by price differentials in tobacco products and by the growth in the number of tourists. International travellers sometimes buy small amounts of cigarettes at a lower price than they would pay in their home country.

For most countries legal tourist shopping is a minor problem. One exception is the Nordic countries, where both tobacco prices and the number of travellers are high. For instance, in 1996 Finns made 6.8 million outbound trips where they bought about 700 million cigarettes, which represents 12% of total national sales.<sup>8</sup> Both in Finland<sup>9</sup> and Norway<sup>10</sup> legal imports by travellers are far more important than smuggling.

iii) Legal duty-free purchases:

duty-free sales have grown because of the increase in international travel. Around 45 billion cigarettes were sold through duty-free outlets world wide in 1996. This represents 0.8% of all cigarettes sold in the world. Thirty-nine percent of duty-free tobacco sales occur in airports, followed by ferries at 20%, airlines 12% and other types of outlet 29%. The highest concentration of sales of tobacco goods has been through duty-free outlets in Europe with 69% of sales, followed by Asia-Pacific 18%, the Americas 12% and Africa 1%.<sup>11</sup> Within Europe, the Nordic tax-free market has been important and represented 21% of duty-free sales for the whole of Europe.

Around 22 million people travel by sea between Sweden and Finland each year.<sup>12</sup> In 1998 in Sweden alone, tourist imports of duty-free cigarettes were estimated at 2 billion pieces. Duty-free sales in the European Union will now be greatly restricted. Directive 92/12/EEC and Directive 77/388/EEC put an end to duty-free status between European Union countries on 30 June 1999: tax free cigarettes for personal use are no longer allowed for those travelling inside the European Union, but will only be permitted for those leaving or arriving in the EU. This European decision is important as the EU alone accounts for some 47% of world duty-free tobacco sales. World wide duty-free sales of tobacco products in the year 2000 are expected to be halved with turnover decreasing from US\$ 2.9 billion in 1999 to US\$ 1.5 billion in 2000.<sup>13</sup>

b) Illegal circumvention

Different tax incentives, price differentials, geographical characteristics and socio-economic habits lead to different kinds of illegal circumvention. A description of smuggling remains difficult as smugglers adapt their rules according to new techniques, regulations or Customs and Finance controls. A new phenomenon is the illegal sale of cigarettes by Internet, where cigarettes are distributed via the Internet using mail orders from clients in high price countries. Internet cigarette smuggling will not be discussed here as its scale is still unknown.

In this section I distinguish between two kinds of illegal circumvention: bootlegging and large-scale organised smuggling.

Their main differences can be summarised in the following way:

<i>Characteristics:</i>	Bootlegging	Large-scale smuggling
<i>Quantities:</i>	Thousands of cigarettes	Millions of cigarettes
<i>Tax status:</i>	Duty-paid	Tax free
<i>Investments:</i>	Small	Large
<i>Organisation:</i>	Individuals and gangs	Criminal networks
<i>Caused by:</i>	Price differentials	Tax avoidance
<i>Location:</i>	Neighbouring countries or within a short distance	Short and long distance smuggling

i) Bootlegging:

Bootlegging is encouraged by important price differentials (often more than 300%) in tobacco products among neighbouring countries or between neighbouring states or provinces. Large differences between retail prices encourage the purchase of duty-paid products in a low tax area, which are then transported into a high tax area. Bootleggers often use specially made delivery vans and trucks whose structures have been altered with extra walls, roofs and other hiding places. In Poland a pack of Marlboro cost \$1 in 1997, while it cost \$3 in Germany. Along Germany's long eastern border with Poland the clandestine transport of cigarettes in a vast number of small consignments, carried in private cars and small vans is very common.<sup>14</sup> There are similar problems between Greece and Bulgaria, and between Austria and Hungary.

Another 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 £7.80 in Britain, compared to £1.80 in Belgium. Gangs buy 50 kg duty-paid hand-rolling tobacco in Belgium, transport them in small cars (which are

difficult to detect by customs officials) and make a profit of £2000 a day.<sup>15</sup> Despite the duty freeze on hand rolling tobacco in the UK, smuggling of these goods has continued to rise. The revenue lost from smuggling of hand rolling tobacco in 1998 is expected to be £730 million. The estimated market share of smuggled hand rolling tobacco in the UK was 75% in 1998.<sup>16</sup> Some five thousand tons of hand-rolling tobacco were smuggled from Belgium into the UK in 1998.

**Sales of hand rolling tobacco in the UK and Belgium in the period 1990-1998 in tons:**

year	UK	Belgium
1990	4 170	4 579
1992	3 840	4 780
1994	3 050	4 940
1996	2 220	7 719
1998	1 790	9 287

Source: UK industry and Belgian Ministry of Finance

While the UK lost some £730 million in revenue in 1998 because of bootlegging hand-rolling tobacco, Belgium gained some £100 million.

Bootlegging can be described as the old-fashioned, classical way of smuggling. It is often organised by gangs, but it does not require huge investments. Large price differences are essential to justify this illegal business. Bootlegging is a problem in some regions of the world, but huge price differences among neighbouring countries are not common<sup>17</sup> and the market share of bootlegged tobacco products is much smaller than the market share of large-scale smuggled tobacco.

ii) Large-scale organised smuggling:

Large-scale smuggling is encouraged by the presence of criminal organisations and is a relatively sophisticated system for distributing smuggled cigarettes at local level. It is hugely aided by the lack of control of the international movement of tax-free cigarettes.

The level of large-scale organised smuggling has increased in different regions of the world. The number of cigarettes smuggled in the world has been estimated at about 355 billion in 1996. This represents 6.5% of all cigarettes sold in the world.<sup>18</sup>

Large-scale fraud in the UK cigarette market in 1998 is thought to have been over twice as important as cross-channel smuggling. HM Customs and Excise estimate in that year the proportion of the UK cigarette market smuggled in freight consignments was 7 per cent and by bootlegging 3 per cent.<sup>19</sup> In 1999 £1,390 million in revenue is expected to be lost through illegally imported cigarettes hidden in freight containers. In the UK, container cigarette smuggling is now the real concern as large scale cigarette fraud is four times as important as bootlegging (estimated at £340 million in 1999).<sup>20</sup>

While it is true that the incentive for smuggling is the avoidance of taxes, it is not true that only the level of taxes can explain the causes of smuggling. In most of the countries with the highest taxes in Europe there is little evidence of smuggling, while in Spain, Italy and many central and eastern European countries, where taxes and prices are much lower, the illegal sale of international cigarette brands is widespread.<sup>21</sup> Public tolerance, a culture of street selling, the presence of organised crime and the complicity of the industry are also factors which determine the level of large-scale smuggling.

Sales of contraband cigarettes have affected regions and markets to different degrees. But despite these differences, there are some common characteristics of large-scale smuggling of cigarettes around the world.

**CHARACTERISTICS OF LARGE-SCALE CIGARETTE SMUGGLING**

a) Tax-free Cigarettes

Large-scale smugglers are not interested in legally purchasing cigarettes in a low tax country in order to sell them illegally in a high tax country. Large-scale smugglers

transport containers of 10 million cigarettes and do not want to pay taxes (even low taxes) on this quantity of cigarettes. Paying tax diminishes their profits and increases their risk of loss in case of confiscation of their goods. A container of 10 million cigarettes can be bought for £150,000<sup>22</sup> to £250,000 but has a current fiscal value (import taxes, excise duties and VAT) in countries of the European Union of £700 to £1,500 thousand. Large-scale smugglers operate in all parts of the world, as the container transport costs are small compared to the market value of their goods.

b) International Brands

Marlboro is the world's most valuable brand and it remains one of the most in demand in the contraband sector. Smuggling has focused mainly on well-known international brands, since instant recognition and confidence in the merchandise are essential to these quick, furtive transactions. Smugglers are uninterested in little-known brands. They prefer international brands, as they can sell them almost anywhere.<sup>23</sup>

c) Transported 'In Transit'

The most common way to buy tax-free cigarettes, is to buy cigarettes under the 'in transit' regime. Transit is a concession system aimed at facilitating trade. Its essence is to allow the temporary suspension of customs duties, excise and VAT payable on goods originating from and/or destined for a third country while under transport across a defined customs area.

An example will illustrate this. Cigarettes from the United States enter Belgium for onward transport to North Africa. In this case, the goods would be placed under a transit regime for transport by road from Belgium to Spain, from where they would be shipped to North Africa. Provided the re-export of goods is confirmed, no taxes would be due in the European Union.

In 1996, about 100,000 million cigarettes passed through the port of Antwerp in Belgium. Thus anyone wishing to purchase American duty-free cigarettes for European black markets is likely to buy products warehoused in Antwerp, simply because that is where the cigarettes are. Fraud occurs when the transit cigarettes do not arrive at their declared destination and are sold on the black market without being taxed.<sup>24</sup>

d) Passed through a Wide Range 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 employed to render investigation as difficult as possible is to arrange for a consignment to pass through a bewildering range of owners in a short space of time. The object is to make the final owner untraceable, and to make the links between the successive owners as obscure as possible.<sup>25</sup>

e) The Presence of Criminal Networks

The 1997 annual report of the European Commission, *Fight against Fraud*, notes that more than 50 criminal networks have been identified in the course of large-scale investigations of different kinds. Organised crime has its sights trained on high-risk products in which trafficking brings huge profits. The report describes how fast former torpedo boats and even an Ilyushin IL-76 transport plane have been used to ferry illegal consignments of cigarettes across Spanish borders. The crime syndicates adapt extremely well to the measures adopted to combat their activities and are very flexible, both geographically and operationally, when it comes to using different methods of transport and different distribution and money-laundering networks.<sup>26</sup>

Criminal networks specialising in cigarette smuggling operate more easily in countries where corruption is high, the control of the authorities is lax and commodities other than tobacco are also being smuggled. The countries around the world with a high level of cigarette smuggling (more than 30% of total sales) are not the countries with the highest prices or taxes, but mostly countries which score high on the corruption index,<sup>27</sup> such as Yugoslavia, Ukraine, Columbia, Pakistan or Nigeria.

f) Distributed in Non-Official Outlets

Large-scale smuggling also requires a willing market and a good local distribution network to supply to it. The Nordic countries have the highest cigarette prices in the

world (between US \$4 and \$6 a pack), but a low level of smuggling, as street selling is not acceptable in northern Europe. In countries such as Spain and Italy prices are low, but the level of smuggling is high, as street selling is culturally acceptable.<sup>28</sup> In Spain 40% of contraband cigarettes are sold on the streets and 23% in the bars.<sup>29</sup> According to a 1997 survey conducted by the London firm Albemarle Marketing Research, most of the illegal tobacco in the UK is sold in pubs.<sup>30</sup> Unregulated distribution networks, such as street vendors or unlicensed retailers, provide more opportunities to sell contraband cigarettes. It is mainly street selling, which is very common in developing countries, which facilitates the distribution of illicit cigarettes.

While the incentive for smuggling is to make profits by avoiding taxes, the causes of smuggling are far more complex than the level of taxes. Attributes of the cigarette market that make smuggling more likely include: street selling, sales in pubs and bars, lack of tax stamps, relatively high and increasing prices, prohibitions and restrictions on the sale and manufacture of international brands. Countries with large black markets and high levels of corruption are especially vulnerable to smuggling.

## HOW DOES SMUGGLING AFFECT TAX REVENUE?

According to the Confederation of European Community Cigarette Manufacturers, many countries are currently experiencing disappointing returns from increases in cigarette excise rates. They argue that many smokers try to minimise or evade tobacco taxes, which they perceive as excessive and unfair. Initially smokers may trade down to cheaper cigarettes. They may switch to cheaper substitute products such as hand rolling tobacco. Eventually, consumers may maximise opportunities to purchase more cheaply across borders and may turn to contraband. According to the tobacco industry, it is becoming increasingly difficult and costly for governments to realise revenue projections by continually increasing excise rates. Cigarette excise thus fails the effectiveness test, they argue, particularly when the levels become too high.<sup>31</sup>

When countries have considered raising excise duties the consistent response of the tobacco industry has been to overstate the impact of tax increases on illegal sales. The Tobacco Manufacturers' Association in the UK, for instance, claimed to be astounded "at the decision of the British government to put around 20p on a pack of cigarettes from December 1998, "in face of all the evidence". This would, they argued, cause further smuggling and, perversely, could lead to an increase in consumption.<sup>32</sup>

The official reaction of the industry remains that they do not believe in the effectiveness of tax increases to decrease overall sales. According to the industry, the cause of smuggling is taxes and the solution to combat smuggling is to reduce taxes, as Canada did in 1994 and Sweden in 1998.

The UK Government does not take the same view. In *Smoking Kills*, its White Paper on tobacco (December 1998), the government says, p61: "The growth in tobacco smuggling is a major cause for concern, but cutting duty rates is not the answer since it would increase the number of smokers." A description of what has happened in Canada and Sweden may clarify the situation.

Canada:

Reducing taxes, as Canada did in 1994, is not a solution to smuggling concerns. Canadian surveys have shown a subsequent increase of smoking, particularly among young people. During the period 1979-1991 the real price of cigarettes increased by 159% and teenage smoking fell from 42% to 16%. In 1994 the real price fell by one third as result of the tax reduction and teenage smoking increased from 16% to 20%.<sup>33</sup> Total tobacco consumption estimates ceased their downward trajectory and are now headed upwards. From a health point of view this is a clear and significant loss. The revenue losses are equally acute.<sup>34</sup>

The February 1994 tobacco tax cuts resulted in a combined federal and provincial revenue loss of over CAN\$1.2 billion in fiscal 1994-1995. The federal loss was CAN\$656 million, more than twice government predictions. According to the Non-Smokers' Rights Association in Canada, government revenues would be much better off with a return to pre-tax levels, even with increased smuggling. Alternative anti-smuggling policies, in conjunction with tax increases, would result in still higher revenues while minimising smuggling.<sup>35</sup>

**Total tax revenue from tobacco sales in  
Canada (CAN\$ million)**

1991	4,981
1992	6,081
1993	5,632
1994 (pre-rollback)	4,879
1995 (post-rollback)	3,652

*Source: Non-Smokers' Right Association  
(Fiscal years run from April 1-March 31)*

Sweden:

While recent experience in Sweden has shown that tax increases are effective, it also indicates that it was probably politically unwise to introduce large price increases over a too short period.

Like the other Scandinavian countries, Sweden has high cigarette prices and a low level of smuggling. A report of the Swedish National Police made an attempt to quantify the size of the non-taxable market in Sweden, including cigarette smuggling.<sup>36</sup> The authors found that the non-taxable cigarette market in Sweden most probably amounted to two per cent of the total cigarette market in 1996: a low level of smuggling despite the fact that the level of cigarette prices in Sweden in 1996 was higher than the average in the European Union. Two successive price increases between December 1996 and August 1997 raised the price for a pack of cigarettes from 31 SEK (\$4) to 44.5 SEK (\$5.80). From an already high level of prices, the price of a pack of cigarettes was increased by 43% in a period of only eight months.

Several articles in the media reported an increase in smuggling, as confiscation by customs authorities rose from 17 million cigarettes in 1996 to 39 million in 1997.<sup>37</sup> There was no doubt that the huge price increase was unpopular among smokers and undermined support for high tobacco taxes. As result, the parliament decided in 1998 to lower the taxes to the level of July 1997 (36.5 SEK or \$4.80), which is still among the highest rates in Europe.

New research on smuggling, published in 1999, showed that the amount of smuggled cigarettes effectively increased from 200 million cigarettes in 1996 to 500 million in 1998. While the tax increase in Sweden was unpopular, it was still effective. Tobacco tax revenue rose by 9% in 1997. Data from an annual survey among 6000 persons indicated a significant reduction of smoking prevalence during 1997. Some 17% of men were daily smokers (compared to 21% in 1996). Among women, 22% were daily smokers (compared to 23% in 1996). In the youngest age group (16-24), 12% of the men were daily smokers (compared to 16% in 1996), whereas 19% of the young women smoked daily (compared to 23% in 1996).<sup>38</sup>

**Revenue from excise duty on cigarettes  
in Sweden in million SKR and Euro**

Year	SKR	EURO (€)
1995	6300,00	688,81
1996	6126,00	707,83
1997	6496,00	751,19
1998	5842,00	616,92

*Source: Commission of the European Communities*

According to the most recent data on tax revenue, there is no doubt that increased tobacco taxes yield more revenue. For instance, the global tax revenue from tobacco in the 15 EU countries was €50 592 million in 1994 and €60 278 million in 1997. Lowering taxes, as Sweden did in 1998, led to a decrease of 10% of total excise duties in 1998. Freezing the tax rates, as Denmark did, may also lead to less revenue. Denmark is the only country in the EU where the real price of cigarettes has decreased by 1% in the period 1996-1999. In 1998, excise tax revenue from cigarettes was lower than in 1997.

The positive impact of tax increases can also be illustrated with the examples of France and the UK.

France:

Nine successive tax or price increases between September 1991 and December 1996 almost doubled the price of cigarettes (+ 96% or 74% in real terms)<sup>39</sup> in France. As a result, sales dropped from 97 billion cigarettes in 1991 to 83 billion in 1997, smoking prevalence among the adult population decreased from 40% in 1991 to 34% in 1997<sup>40</sup> and smoking prevalence in the 12 to 18 age range was 25%, down from 30% in 1991.<sup>41</sup> During the same period, tobacco tax revenue rose from 32 billion FF to 57 billion FF and smuggling remained at a low level (around 2% of the market). In 1998 there was a slight increase of cigarette sales as prices remained unchanged that year.

The experience of France shows that tax increases are still very effective and do not lead automatically to more smuggling. The low level of smuggling in this country comes as a surprise to many observers, but has been explained by its efficiently controlled retail network. France is one of the few countries in the world where retailers have a licence and are strictly controlled by the General Customs Directorate.

**Cigarette sales and tax revenue from tobacco products in the period 1991-1998 in France:**

Year	Cigarette sales (billion pieces)	Tax revenue (billion FF)
1991	97,1	31,7
1992	96,3	35,3
1993	93,6	41,6
1994	90,1	47,5
1995	88,3	51,0
1996	86,1	54,4
1997	83,0	56,6
1998	83,8	59,6

Source: *revue des tabacs*, nr 451- February 1999

United Kingdom:

Joy Townsend examined data of tax revenue and cigarette prices in the UK during the period 1971-1995. She came to the conclusion that tobacco tax is a relatively efficient vehicle for raising revenue as it has an elasticity of total revenue with respect to tax rates of possibly 0.6-0.9 compared with 0.2 for spirits and 0.6 for wine. This means that a 1% increase in tobacco tax result results in about a 0.6-0.9% increase in tax revenue.<sup>42</sup>

However, despite the positive link between tobacco tax and tax revenue, the threat of smuggling remains and it would be foolish to dismiss the problem. In its 1998 White Paper on tobacco, the UK Government has committed itself to increases in tobacco taxation, but also to clamp down on smuggling by bringing in an extra 100 specially trained staff to combat fraud and smuggling. In the future, it may be necessary that part of the increased tax revenue is used to intensify the fight against smuggling.

**THE ROLE OF THE TOBACCO INDUSTRY**

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 threat of smuggling has also been used to avoid trade barriers or to force open new markets.

The value of smuggling as a market entry strategy is even recognised in trade journals: World Tobacco reported in 1996 that “smuggling has also helped to promote some of the world’s leading brands in markets which had remained closed to foreign imports.”<sup>43</sup>

There is no doubt that the industry benefits from smuggling. The UK tobacco

companies have even admitted it in their annual reports. At page 13 of the 1996 Corporate Report of the Imperial Tobacco Group, one can find:

*“ In the hand rolling sector, Imperial Tobacco’s Golden Virginia brand is exported to many European countries. In particular, sales to Belgium have risen substantially, reflecting the growing legal and illegal cross-border trade in re-imports into the UK. ”*

The 1997 Gallaher annual report says on page 16:

*“Increased tourist demand from the Canary Islands and higher shipments to Andorra contributed to an increase in sales to Iberia of around 37%. Gallaher believes that the gains in Andorra, coupled with a sharp increase of some 13% in handrolling sales to Belgium and Luxembourg, relate to increased bootlegging trade into UK”*

There is debate, however, about whether there is evidence of direct tobacco industry involvement in smuggling. The line of the multinationals is that they sell their cigarettes legally to dealers and that their responsibility ends there. In a BBC programme on smuggling in Andorra, a Gallaher spokesperson defended his company’s policy in the following way:

*“We will sell cigarettes legally to our distributors in various countries. If people, if those distributors subsequently sell those products on to other people who are going to illegally bring them back into this country, that is something outside of our control. . . ”*<sup>44</sup>

Exports from the UK to Andorra increased from 13 million cigarettes in 1993 to 1,520 million in 1997. Taking into account that almost none of these cigarettes were legally re-exported, that Andorra only has a population of 63,000 habitants and that smokers in Andorra on the whole do not smoke British brands, it is hard to believe that the British companies did not know that they were supplying to smugglers. According to the chief EU fraud investigator, Per Knudsen:

*“British tobacco manufacturers must have been aware that the sudden increase of the brands to Andorra could not be explained by the normal market. Neither in Andorra, nor in any of the neighbouring countries. Simply because these brands are not widely sold outside the UK and Ireland. ”*<sup>45</sup>

Since 1997, there have been several court cases and official investigations in different part of the world which accused the industry of supplying smuggled cigarettes and/or at least of being aware of the illegal destination of their products.

B&W and Canada:

a former Brown & Williamson executive has pleaded guilty to trafficking in contraband cigarettes between the US and Canada. The cigarettes were sent from a warehouse in Alabama to a private warehouse in Louisiana, were marked for offshore vessels and thus tax free, and were then sold to a Vietnamese organisation that smuggled them into Canada.<sup>46</sup>

#### Combined action against smuggling in Andorra leads to positive results

The results of the anti-fraud law approved by the Andorran Parliament on 11 March 1998 and implemented on 5 May 1998, combined with the tighter controls exercised by Spanish and French customs, have led to a sharp fall in smuggling of cigarettes in the region. The anti-fraud law strengthens penalties against non-compliance with customs requests, breaking customs seals, false declaration of imports and exports, attempting to bribe a customs official as well as falsification of official documents. Traditional cigarette smuggling has enacted a heavy price on the Spanish ministry of finance, with Spain bearing the brunt of illegal smuggling out of Andorra. The Spanish authorities implemented tight border control in October 1997 to stem the flow of illegal tobacco, which led to a sharp drop in smuggling activity.

According to estimates of the anti-fraud division of the European Commission (UCLAF), in May 1997 contraband cigarettes accounted for 12.5% of the total Spanish cigarettes market, but by May 1998 this had fallen to 6.7%. In terms of Community own resources, UCLAF estimates that this improved fraud prevention policy will save EURO 75 million in customs duties in 1998. It should prevent losses of an estimated EURO 300 million in VAT and excise from the exchequers of the various Member States

*Source: Committee on Budgetary Control, European Parliament, Mission report on delegation visit to the Principality of Andorra 27-29 July 1998, Brussels, European Parliament, September 1998.*

*Protecting the Communities’ Financial Interests and the Fight against Fraud, Annual Report UCLAF 1998, Brussels, 1999.*

BAT and China:

a former BAT executive was found guilty by Hong Kong's High Court of taking US\$2.24 million in bribes in return for ensuring that distributors Giant Island received large quantities of duty-free cigarettes earmarked for the mainland.<sup>47</sup> The Judge, Mr Justice Yeung, said the companies had failed to explain evidence that suggested they knew vast quantities of their cigarettes were being sold to smugglers:

*"A leading international tobacco company sold large quantities of duty-not-paid cigarettes, worth billions and billions of HK dollars, with the knowledge those cigarettes would be smuggled into China and other parts of the world; it is also an open secret known to everyone in Hong Kong that some of these cigarettes would find their way back on the local black market".*<sup>48</sup>

RJ Reynolds and Canada:

In 1998, for the first time, a major tobacco company was convicted of actively breaking the law to assist in a smuggling operation. An affiliate of RJ Reynolds International pled guilty to charges of helping smugglers illegally re-route export cigarettes into Canada. The affiliate, Northern Brands, Inc., has agreed to pay CAN\$15 million in criminal fines and forfeitures for its involvement in these illegal activities.<sup>49</sup>

RJ Reynolds and Europe:

Spanish authorities seized a ship in October 1997, carrying more than 120 million Winston cigarettes bound for the contraband market. The mastermind of this operation, was Michael Hänggl, who says he has been a Reynolds customer for 15 years and has frequently been a supplier to smugglers who bring Reynolds cigarettes into Spain. According to the *New York Times* of 8 May 1998, the Reynolds spokesperson denied that the company knowingly sold to smugglers, but also admitted that Reynolds decided to keep Mr Hänggl as a customer even after he had told the *New York Times* in 1997 that he sold to clients he knew to be smugglers. European authorities say that they believe that the manufacturers routinely sell American cigarettes to traders who immediately resell them onto black markets set up to evade taxes and offering leading brands at a discount.<sup>50</sup>

Philip Morris, BAT and Columbia:

In 1999, Colombia's provincial governors sued tobacco companies Philip Morris and BAT for \$1 billion, alleging they avoided import duty on cigarette imports.<sup>51</sup> According to a study by the Colombian Ministry of Foreign Trade, 64% of the 30 billion cigarettes sold each year in Colombia is contraband, while 26% is made domestically and 10% is imported legally. The study said that of the 5.5 billion Marlboro cigarettes that entered Colombia in the first nine months of 1997, 4.4 billion came from the free trade zones in Aruba and Panama, meaning that they entered tax-free as contraband. Philip Morris denies any wrongdoing. In a statement the company said that it would "discontinue our business relationship" with any customer found to be involved in smuggling, but said the company had "limits to our ability, alone, to affect the cigarette contraband problem."<sup>52</sup> Confidential 1994 documents from BAT showed that the company was well aware that the duty-unpaid cigarette market in 1993 was already more important than the duty-paid market and that the company had a different marketing strategy to launch and support their cigarette brands on the legal and illegal market.<sup>53</sup>

## RECOMMENDATIONS

Cigarette smuggling can be reduced, but action must be taken at national, European and world levels. At the international level, the WHO Framework Convention on Tobacco Control should contain a specific protocol on smuggling. In May 1999 the World Health Assembly passed a resolution calling for work to begin on the Framework Convention on Tobacco Control – a new legal instrument that may address issues as diverse as tobacco advertising and promotion, agricultural diversification, smuggling, taxes and subsidies. WHO and Member States plan to have the Convention process completed by 2003.

Recommendations at national level:

*Raise public awareness on the negative aspects of smuggling:*

In the UK there is concern about the increasing public acceptability of excise smuggling which is considered a victimless crime, if it is seen as a crime at all. A public information campaign (which stressed the involvement of organised crime in cigarette smuggling) was co-ordinated in Germany in 1994-95 and was particularly effective in combating the view that cigarette smuggling and the purchase of smuggled cigarettes was relatively harmless.<sup>54</sup>

*Increase penalties:*

Smugglers get involved in cigarette smuggling, because the benefits are greater than the risks. A revision of penalties is necessary to ensure that the fines, when combined with the probability of getting caught, render smuggling financially unappealing.<sup>55</sup>

*The placement of "tax-paid" markings on tobacco products:*

The purpose of this measure is to distinguish clearly between legal and illegal goods, making contraband products easier to detect and trace and the laws easier to enforce. These markings should be prominent and placed on each package, under the cellophane tear-strip. The tax-markings should be designed in such a manner that they are hard to counterfeit.

*Require special package and product markings to indicate duty-exempt status:*

Combating smuggling requires a strict control of the transport of tax-free cigarettes. To the extent that tax-exempt sales are permitted in duty-free stores or elsewhere, these packages should be clearly marked as such. It should be easy for retailers, consumers and law enforcement personnel to identify what is tax-exempt and what is not.<sup>56</sup>

*Require that manufacturers, exporters, importers, wholesalers, transporters, warehouses and retailers have tobacco-specific licences:*

Licences help to identify and monitor the different actors in the tobacco sector and to facilitate anti-smuggling enforcement. Conditions can be attached to licences and licences can be suspended for breach of the conditions or tobacco laws.<sup>57</sup> The loss of licence could be a real threat to potential traders in smuggled cigarettes that will deter them.

Recommendations at European level and international level

*Gradually increase excise on handrolling tobacco:*

In order to combat bootlegging of hand rolling tobacco, taxation for rolling-tobacco in the European Union should be increased gradually to the present minimum level of taxation for cigarettes. This means that the UK and Ireland should maintain their tax levels for hand-rolled cigarettes and other countries should gradually increase it.

*Collect data:*

Monitoring at national, European and international level is needed in order to produce high quality data on the smuggling, tax free importation and cross-border trade of tobacco products.

*Require serial numbers and chain of custody marks on packs:*

Each manufacturer of tobacco products should be required to print a unique, legible serial number on all packages of tobacco products. This will enable the authorities to identify the manufacturer of the product, the location and date of manufacture. Each tobacco product should also contain a chain of custody mark, which would not only tell officials the identity of the manufacturer, but would also indicate the distributor, wholesaler and exporter.

*Require strict record-keeping:*

Record-keeping and tracking systems are needed which place the onus on the manufacturers to prove that cigarettes arrive legally in their end-user markets.<sup>58</sup> Cigarettes should only be transported if all the intermediate traders, the route and the final destination are known. A computerised control system should enable countries to carry out real-time checks and risk analysis prior to the dispatch of each consignment of tobacco products. In this way, countries will also be informed of each individual consignment and will be able to carry out targeted on-the-spot inspections as and when they choose.<sup>59</sup>

*Require country-specific health warnings:*

Manufacturers all exported cigarettes must be required to indicate on the packet label the country of final destination and to have appropriate and country-specific health warnings. Most countries in the world have regulations which oblige companies to print health warnings on the packages of tobacco products. The style, the wording, the attribution and the language of these warnings differ from country to country. Exporters should label the country of final destination and show that the products for this specific country have the appropriate health warnings. Specific labels can also be requested for cigarettes which are not exported.

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