



TOBACCO SMUGGLING

Every year tens of billions of cigarettes disappear into the lucrative black market for tobacco products.¹ Tobacco smuggling seriously harms public health by undermining tobacco tax policies, reducing average prices for cigarettes and making tax-free cigarettes available to young people and price-sensitive smokers who might otherwise quit. Cigarette smuggling also helps finance criminal and terrorist groups, as well as reduces government revenue that is an increasingly important funding source for tobacco control and other public health programs.

How Smuggling Works

Organized tobacco smuggling generally involves the diversion of large consignments of cigarettes onto the black market while the product is in transit. By diverting cigarettes while they are in the wholesale distribution chain (where they are carried untaxed), large-scale smugglers generally avoid all taxes. Smuggling is widely misunderstood to arise from exploitation of tax differentials between countries, but this is a relatively small part of the problem and much less profitable to the smugglers. In fact even if all countries had exactly the same price and tax structure, smuggling would continue on a similar scale.

Winners and Losers in Smuggling: The Problem of ‘Perverse Incentives’

The root of the problem is that losses arising from smuggling fall on national finance ministries, not on tobacco manufacturers or wholesalers that control the distribution system. On the other hand, tobacco manufacturers and wholesalers gain from smuggling in several ways: they make their profit when the product is first sold; smuggling creates a supply of cheap cigarettes and lowers average prices, boosting demand; and smuggling enables tobacco company lobbyists to press for lower rates of tobacco tax in the legal market, again with the aim of boosting demand. The profits derived from cigarette smuggling are enormous. It is estimated that this trade is as lucrative as the trade in illicit drugs, but the criminal penalties for cigarette smuggling are much lighter.

These ‘perverse incentives’ mean that a freight container of cigarettes worth up to US\$2 million at legal retail prices can somehow be ‘lost’ to the black market in transit. Most of that lost revenue is ultimately due to finance ministries in countries in which the product will eventually be sold, but tobacco companies and wholesalers still take their share even if the product enters the black market. Smuggling would be unlikely to occur if the tobacco companies and wholesalers had an incentive to protect the full US\$2 million retail value of the consignment. Instead they have the opposite incentive – to facilitate smuggling.

Why Smuggling Occurs

The tobacco industry argues that high tobacco taxes are the primary cause of tobacco smuggling

and that reducing taxes is the only cure. However, smuggling occurs in all parts of the world, even in regions where taxes are low.^{2, 3} The reality is that price is only one of many factors that influence smuggling rates. Others include:

Tobacco Industry Complicity: As recent court cases and internal industry documents make clear, cigarette companies have been heavily involved in smuggling operations. Senior tobacco industry executives have been convicted of smuggling-related offences in Hong Kong and Canada, and a wholly-owned subsidiary of R.J. Reynolds Tobacco Company pled guilty to charges related to its involvement in smuggling cigarettes from the United States into Canada. In 2003, the Canadian federal government launched a \$1.5 billion-dollar lawsuit against R.J. Reynolds and Japan Tobacco alleging a conspiracy to flood the Canadian market with smuggled cigarettes.⁴ Meanwhile, Colombia's provincial governments have filed suit against Philip Morris alleging that the tobacco company defrauded the governments of billions of dollars in revenues through a complex smuggling and money-laundering scheme.^{5, 6} In January 2005, British American Tobacco faced new allegations that it had taken part in a multi-million dollar smuggling operation scheme in Canada.⁷

Weaknesses in the Transit System: The lack of more secure systems for transporting cigarettes in international trade fuels the black market by giving smugglers access to a large supply of cigarettes free of all taxes and duties.

Cross-Border Price Differentials: Price differentials are a significant factor in the case of informal bootlegging. It is much less a factor in large-scale organized smuggling of "in transit" cigarettes. Contrary to popular belief, for example, smuggling is not common in those Nordic countries with high cigarette taxes.^{8, 9}

Duty-Free Sales: The existence of a large volume of duty-free tobacco products in international commerce creates opportunities for smuggling.

Lack of Resources: Most countries do not devote the necessary resources to tobacco tax enforcement until after a smuggling problem has developed. It is much more difficult to eradicate smuggling networks once they are established than to take measures to prevent the networks from taking root in the first place.

Lax Enforcement and Insufficient Penalties: Smugglers tend to thrive in countries that tolerate smuggling, where enforcement is lax and corruption is widespread. In addition, many countries fail to treat tobacco smuggling as a serious crime, imposing penalties that are a fraction of those for smuggling other products such as pharmaceuticals or firearms. This makes tobacco more attractive to smugglers, who weigh the huge potential for profit against the small chance of getting caught, convicted, jailed and/or fined. In March 2000, the UK government announced a series of measures designed to curtail tobacco smuggling, such as the requirement of a duty paid mark and deployment of additional Customs officers. However, there are no sanctions for non-compliance. In contrast, a July 2004 agreement between Phillip Morris, the European Community and 10 EU Member States has specified severe ramifications in the event of non-compliance. The agreement, which will last for 12 years, was a result of a lawsuit filed against Phillip Morris for smuggling cigarettes into the EU. The key feature of this agreement is that

Philip Morris International (PMI) will be heavily penalized if it does not control smuggling of its cigarettes. PMI agreed to make payments in the event of seizures of their genuine products above certain quantities (for any seizure of genuine PMI cigarettes in the 10 EU countries, the company agreed to pay back all taxes due - if more than 90 million genuine cigarettes are seized in those 10 EU countries, PMI agrees to pay 5 times the amount of taxes due). Furthermore, the Agreement contains provisions on tracking and tracing, record-keeping, approval and termination of contractors, money laundering and compliance protocols to control future smuggling.¹⁰

Lack of Effective International Cooperation: While international treaties and other mechanisms have been developed to reduce trafficking in pharmaceutical drugs, illegal drugs, firearms and other products, no similar systems have been implemented to reduce tobacco smuggling. Although the World Health Organization Framework Convention on Tobacco Control (FCTC) contains some useful measures to combat smuggling, these still need to be elaborated in a protocol (see below).

How Cigarette Smuggling Harms Public Health

Restraining Tobacco Taxes Worldwide: Raising tobacco taxes is one of the most effective measures available to prevent children from smoking and encourage adults to quit.¹¹ Smuggling – and the fear of it – has become the greatest impediment to raising tobacco taxes worldwide. The tobacco industry has successfully exploited this fear, convincing policymakers around the world that virtually any tobacco tax increase will spark uncontrollable smuggling, resulting in lost government revenue and rampant lawlessness. Yet out of hundreds of tobacco tax increases successfully implemented in the world, there are very few cases in which a smuggling problem developed that were large enough to cause a government to reduce taxes.¹²

Opening Markets to Western Brands and Advertising: Some countries, including China, legally restrict the availability of Western brands. While the original intent of these laws may have been to protect domestic tobacco companies, there is strong evidence that the laws also have benefited public health by reducing Western-style marketing of tobacco products to women and young people. Such laws also tend to reduce the quality, competitiveness and appeal of tobacco products themselves, which also reduces prevalence. As the industry publication *World Tobacco* puts it, smuggling has “helped to promote some of the world’s leading brands in markets which had remained closed to foreign imports and where demand for Western cigarettes has continued to grow.”¹³

Reducing Tobacco Control Funding: Cigarette smuggling costs governments tens of billions dollars a year in lost tax and customs revenue.¹⁴ In a growing number of countries, these funds have become a primary source of funding for effective tobacco control programs. Therefore, to the extent that tobacco tax increases are rejected due to concerns about smuggling, even the specter of smuggling robs tobacco control of one of the most promising sources of badly needed funding.

Providing discount cigarettes: Smuggling provides cigarettes at a discount to young people and price-sensitive smokers who might otherwise quit smoking.

Implementing the FCTC

Article 15 of the FCTC obliges ratifying countries to take the following steps:

- Adopt and implement all necessary measures to ensure that all unit packets and packages of tobacco products and any outside packaging of such products are marked to assist Parties in determining the origin of tobacco products;
- Require that tobacco products sold on their domestic market carry the statement: “Sales only allowed in (name of country)” or carry other effective markings to assist authorities in determining whether the product is legally for sale on the domestic market;
- Consider developing a practical tracking and tracing regime;
- Monitor and collect data on cross-border trade in tobacco products (including illicit trade) and exchange information among customs, tax and other authorities;
- Enact or strengthen legislation with appropriate penalties and remedies against illicit trade in tobacco products;
- Ensure that all confiscated manufacturing equipment, counterfeit and contraband cigarettes and other tobacco products are destroyed using environmentally-friendly methods;
- Monitor and control the storage and distribution of tobacco products held or moving under suspension of taxes or duties within its jurisdiction;
- Cooperate with other countries in anti-smuggling, law enforcement and litigation efforts; and
- Adopt measures to enable the confiscation of proceeds derived from the illicit trade in tobacco products.

A Smuggling Protocol is Needed

Although Article 15 of the FCTC provides guidelines for countries to take to reduce smuggling, it lacks detail. Its rather vague and general obligations need to be developed further in a Protocol. A protocol which controls illicit trade in tobacco products is necessary and can follow the example of similar conventions such as the Protocol against the Illicit Manufacturing of and Trafficking in Firearms, Their Parts and Components and Ammunition, supplementing the United Nations Convention against Transnational Organized Crime.¹⁵

A smuggling protocol should elaborate on the following aspects:

Tracing/Tracking system: A tracking system would allow authorities to monitor the movement of tobacco products around the world in order to avoid their diversion into illegal markets. A tracing system would assist in the investigation of illicit trade by identifying the country of export, the final country of destination and the first customer. The ability for authorities to follow

the product is key to identifying where it was diverted and holding those responsible for the diversion accountable.

Markings - Covert and Overt: In order to enable authorities to trace tobacco products and detect illegal trade, markings and codes on the packs, cartons and master cases should be made mandatory. Any prospective system needs to allow for some flexibility to cope with progress in technology but still be unified in order to avoid having a multiplicity of non-compatible tracking and tracing systems.

Record-keeping: Linked to a tracking/tracing system and the use of machine scannable codes and markings authorities must keep computerized records of all shipments, including the country of export, the country of import, transit countries, date of issuance and of expiry of licenses, final destination and amounts of tobacco products traded.

Licensing: A system of export and/or import licensing can be key to empowering customs authorities to keep track of legal transactions and traders.

Payments and bonding system: The onus to prove that tobacco products arrive at their intended end market should be placed squarely on the manufacturers, which should be made financially liable for all taxes and duties until the products reach the final destination and all taxes due are properly paid. During the FCTC negotiations, there were discussions about a bonding system for exporters that would require them to establish and maintain bonds to cover their financial liability.

Criminalization of counterfeiting of and contraband in tobacco products, as well as the removal and alteration of markings would help deter illicit activities.

Campaign for Tobacco-Free Kids

Resources on the Web:

Two sites with a comprehensive set of links on smuggling:

ASH UK

http://www.newash.org.uk/ash_o74gmwsh.htm

Non-Smokers' Rights Association

<http://www.nsra-adnf.ca>

¹ Framework Convention Alliance. The FCTC and Tobacco Smuggling: NGO Briefing for the International Conference on Illicit Trade in Tobacco, New York, July 30 – August 1, 2002. Washington, DC: Framework Convention Alliance; 2002. Available from: http://newash.org.uk/files/documents/ASH_344/ASH_344.html.

² Joossens L, Raw M. Turning off the tap: the real solution to cigarette smuggling. The International Journal of Tuberculosis and Lung Disease. 2003; 7(3):214-222.

³ Western Europe has the highest cigarette prices in the world – in 1996 they were four to five times higher than in Africa, the Middle East and Eastern Europe – yet, despite these high prices, smuggling is generally lower here than

in other regions of the world. Source: Joossens L, Raw M. How can cigarette smuggling be reduced? *BMJ* 2000; 321:947-950.

⁴ Canada Department of Justice. Government of Canada Announces Legal Action Against Tobacco Companies. Press Release. 2003 Aug 13. Available from: http://canada.justice.gc.ca/en/news/nr/2003/doc_30962.html.

⁵ Beelman M. Philip Morris Accused of Smuggling, Money-Laundering Conspiracy in Racketeering Lawsuit. The Center for Public Integrity. 2000 May 23. Available from: <http://www.public-i.org/report.aspx?aid=510>.

⁶ Richards M. Ecuador files suit against several tobacco companies. Associated Press. 2000 Jun 6. Available from: http://www.polkonline.com/stories/060600/bus_ecuador.shtml.

⁷ Doward J. Smuggling claims hit tobacco giant. *The Observer*. 2005 Jan 9. Available from: http://observer.guardian.co.uk/uk_news/story/0,6903,1386134,00.html.

⁸ Joossens L. Smuggling and Cross-border Shopping of Tobacco Products in the European Union: a Report for the Health Education Authority, London [monograph on the Internet]. London: Health Education Authority (now called the National Institute for Health and Clinical Excellence); 1999. Available from: <http://www.nice.org.uk/page.aspx?o=502023>.

⁹ Office Européen de Lutte Anti-Fraude (OLAF) - European Anti-Fraud Office [homepage on the Internet]. Brussels: OLAF; c2007. Available from: http://europa.eu.int/comm/anti_fraud/index_en.html.

¹⁰ ASH UK. European Commission and Philip Morris International sign a 12 year agreement to combat contraband and counterfeit cigarettes [monograph on internet]. London: Action on Smoking and Health UK; 2004. Available from: http://www.newash.org.uk/ash_mj6wrl14.htm.

¹¹ Jha P, Chaloupka FJ. Curbing the Epidemic: Governments and the Economics of Tobacco Control. Washington: World Bank; 1999. Available from: <http://www1.worldbank.org/tobacco/reports.htm>.

¹² Only in Canada (1994) and Sweden (1998) have governments raised tobacco taxes and then lowered them due to smuggling concerns. In Canada it has now been shown conclusively that the tobacco industry itself was actively involved in facilitating much of the smuggling. The tobacco industry leveraged its success in Canada to help defeat major price increases proposed in the United States in 1994 and 1998, and has used the “Canadian example” globally as a lesson, as well as a threat, to governments that consider significant tobacco tax increases.

¹³ World Tobacco. World Tobacco File 1996. London: dmg world media (uk) Ltd.; 1997.

¹⁴ Bonner R, Drew C. Cigarette Makers Are Seen as Aiding Rise in Smuggling. *New York Times*. 1997 Aug 25. Available from: <http://query.nytimes.com/gst/fullpage.html?res=9F00EFD91E3EF936A1575BC0A961958260>.

¹⁵ United Nations General Assembly (GAOR). A/RES/55/255. 2001 Jun 8. Available from: http://www.unodc.org/pdf/crime/a_res_55/255e.pdf.