

“The Nature of Illicit Trade in Tobacco and Alcohol Products on the EU Eastern Border” by Wieslaw Czy owicz

Summary by Jordan Sanders

EXECUTIVE SUMMARY

- The report analyses the illicit trade in alcohol and tobacco products in Poland, East and Central Europe, and the EU as a whole and makes recommendations aimed at improving the managerial efficiency of the effort to combat this problem.
- The report claims that there is a direct positive correlation between the scale of taxation on tobacco products and higher rates of smuggling.
 - Taxes and legal regulations in Poland and in selected countries in the EU were analysed and the influence on the smuggling of alcohol and tobacco products considered.
- Steep tax requirements create high profit incentives for illicit trade organizers. The report argues that these incentives for producers and smugglers, fuelled by the consumer’s desire for cheaper products, are the main reasons for the illicit trade of alcohol and tobacco.

EUROPEAN UNION EXCISE REGULATIONS ON ALCOHOL AND TOBACCO PRODUCTS

Cigarettes

- Cigarettes produced in the EU and imported from the third countries are subject to:
 - proportional excise (ad valorem) based on the maximum retail price including customs duties
 - specific excise on one stick of product
- The excise tax is defined in relation to average retail price. Average retail price is defined in relation to the total value of all cigarettes released for consumption on the base of retail price including all taxes and divided by the total number of cigarettes released for consumption.
- The specific element of excise has to amount in all of Member States to no less than 5% and no more than 76.5% of the total tax burden affected by adding the specific and proportional excise and Value Added Tax (VAT) levied on the average retail price.

Alcohol and Alcohol Products

- The standard excise rate on alcohol and alcohol beverages is based on 1 hl of pure alcohol at a temperature of 20°C and is defined in relation to the number of hl of pure alcohol.
- The rates may not be less than 50% of the standard, national excise rate and have to be applied equally compared with ethyl alcohol produced in small distilleries in other Member States.

Wine, fermented beverages, and indirect products

- Standard excise levied on non-sparkling wine, sparkling wine and other fermented beverages and indirect products is based on 1 hl of final product. It is necessary to apply the same excise rate in the each category of alcohol beverages.

Beer

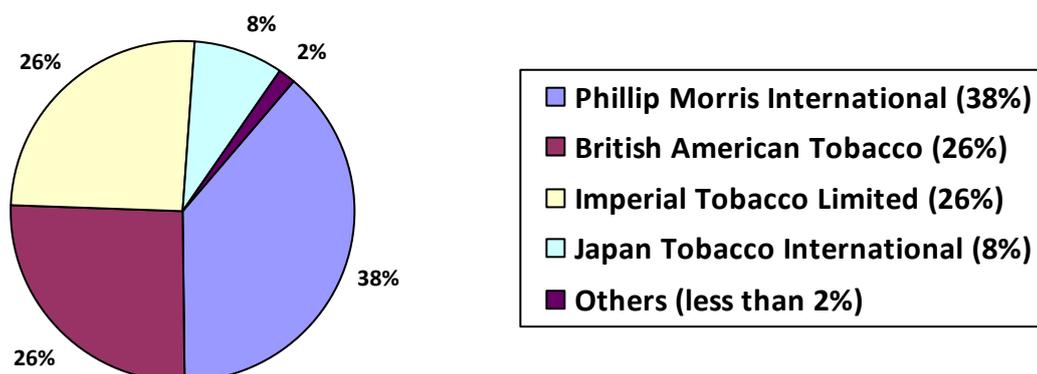
- Two kinds of excise:
 1. Standard: based on number hl/degrees of final product
 2. Reduced: beer produced by independent, small breweries can be charged reduced rates upon the condition that the rates are not applied for plants producing more than 200,000 hl per year and they are no less than 50% of the standard national excise rate (they have to be applied equally compared to production in independent, small breweries in other Member States)

EXCISE ON TOBACCO AND ALCOHOL PRODUCTS IN POLAND

- As shown in a table, the greatest proportion of budget revenues from excise come from the taxation of tobacco products, followed by taxation of distilled products.
- Cigarettes represent the absolute majority of tobacco products, so cigarettes are the main category considered in this report.
- In Poland, tobacco products revenues are regarded by the state budget as the main source of the increase in excise revenues.

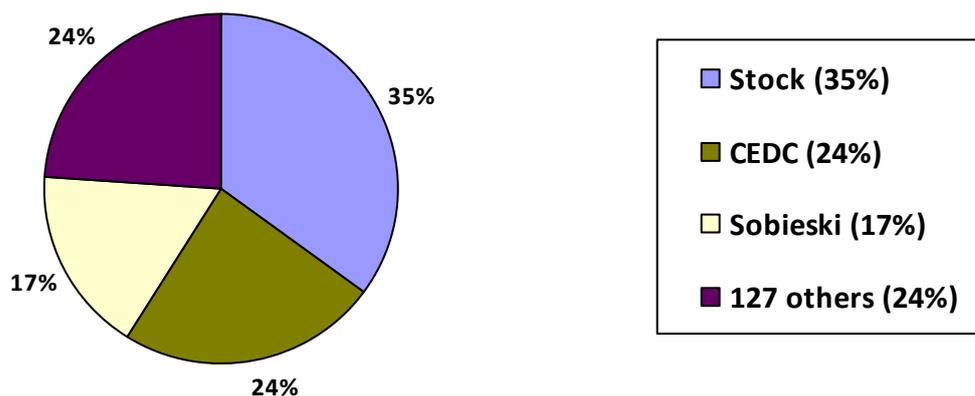
LEGAL PRODUCTION OF TOBACCO AND ALCOHOL PRODUCTS

Main producers of tobacco products in Poland in 2010



- The total net value of the alcohol products market in Poland in 2011 was an estimated 8 billion USD.
- The distilled products market is dominated by vodka. Vodka amounts to more than 90% market share in distilled products.

Main producers of vodka in Poland in 2010



- Poland is the fourth largest beer market in Europe in terms of consumed quantity. Beer sales amount to 51% of the total sale of alcohol products in Poland.
- Three main international producers of beer: Heineken, SAB Miller, and Carlsberg (together, they control 82% of the beer market)

PREDOMINANT FORM OF ILLICIT TRADE IN TOBACCO PRODUCTS IN SELECTED COUNTRIES

- In most states and territories, producers of cigarettes and distilled products do not sell their products directly. They only sell to distributors and wholesalers which deliver products through the supply chain to consumers.
 - The quantity of cigarettes sold is reduced in every stage of this chain; primary mass transport of cigarettes is divided many times till the moment when it is delivered to a seller who then sells cigarettes in cartons and packs to individual consumers. Such a complicated net likely causes lack of transparency and creates gaps which forgers may exploit to introduce counterfeited products into the supply chain.
- Counterfeited commodities are usually transported in containers through the same systems of distribution which are used for the transport of original products. Counterfeited products are either declared irregularly or carriage documents are illegally changed before arriving at a destination.

Smuggling methods

- Shipments irregularly declared as shipments of other kind of commodities
- Presenting for customs clearance false customs documents including certificates of origin
- Reloading in free trade zones
- Using of so-called “covers” (secret hiding-places) in various means of transport (ships, containers, cars, carriages)
- Smuggling by post (traditional post deliveries as well as courier ones) using also e-trade
- So-called “ant smuggling” exceeding permitted limits but also transport in personal luggage and in own clothes.

Further information on smuggling

- Unlike in the case of drugs and other illegal substances which must be hidden before a sale, legal and counterfeited cigarettes can be stored in a relatively open way once smuggled into a market of destination, which means that the costs of storage and distribution are relatively low.
- Main markets of destination for criminal organizations seem to be high taxed and extremely absorbent markets in the EU (the United Kingdom market seems to be the most attractive)
- The internet has become a popular tool for consumers purchasing tobacco products.
- In some towns, especially those located near borders where there are differences in tax levels across the border, individuals may bring small quantities of cigarettes across the border for sale. Though in isolation this practice seems insignificant, these small scale cases likely account for significant quantities of smuggled goods since many people participate.

- In the late 1990s, producers of original goods increased control over distributors and retail sellers ensuring less access to original products for smugglers.
- Still, it remains relative easy for forgers to access the most developed factories producing cigarettes, so there has been a growth of production and smuggling of counterfeited products in the past decade.

EXPERIENCES OF SELECTED EU MEMBER STATES OF TAX REGULATIONS AND FUNCTIONING OF THE ILLICIT TRADE OF TOBACCO PRODUCTS

- Smuggling in East and Central Europe has grown. It has been assisted by integration processes within the framework of the EU and Schengen area.
 - Removal of the EU external border control burden accompanied by the lifting of controls on internal and customs borders facilitated smuggling.

Examples of the growing smuggling problem

- The following cases show that quickly introducing high tax increases may cause a rapid short-term increase of budget revenues, but then consumers will move their demand to the black economy, which will cause long-term reduction of the legal market and budget revenues.
 - In Latvia, the increase of the excise tax rate in order to meet the rates required by the EU negatively influenced the size of legal sales (dropped by two and half times in the period 2007-2010). In this period the illegal market increased four times, which decreased budget revenues.
 - In Ireland, significant taxation changes caused an increase of retail price by 31% accompanied by reducing of legal sales of cigarettes by 16%. In 2009, the size of the black economy increased by 25%.
 - In Romania, due to a high increase of the tax burden, the quantity of cigarettes sold in the black market rapidly increased from 7.1 billion in 2002 to 10.3 in 2010. This amounts to 35% of total Romanian cigarette consumption.

Examples of strategies to combat smuggling

- In the UK in 2002, a strategy based on active counteractions against the black market and on relating the excise rate to the level of inflation was introduced. Since then, the illegal cigarettes market has shrunk from 21% to 11%, and in the last 5 years tobacco tax receipts have increased from £8 billion to £9.5 billion.
- In Hungary in 2004, effective controls at the Ukrainian border were introduced since this was the main source of cheap cigarettes smuggled to Hungary. The black economy shrunk from 25% in 2005 to 7% in 2008.

SUMMARY OF THE REPORTS CONCERNING INFLUENCE OF PROCESS AND TAXES ON ILLICIT TRADE OF TOBACCO PRODUCTS IN THE WORLD

- The influence of taxes and high producers' profits and the price of cigarettes caused by them on the extent of illegal trade is a subject of controversy.
- This influence is not undoubted and is clearly dependent on many factors facilitating or impeding smuggling and illegal trade in a defined country, such as: level of corruption, existence of international and domestic criminal groups, ability of customs and police services to detect smuggling and illegal production, severity of punishments, differentiated prices between the country and its neighbours.
- Therefore, the interpretation of results is difficult.

CHARACTERISTICS OF SMUGGLING ROUTES INTO THE EU

Baltic countries

- The number of smuggled sticks has consistently increased in Lithuania, and 2010 trends suggest that Lithuania is a transit country. Cigarettes mainly come from Russia via Latvia, Kaliningrad, or Belarus aimed at smuggling to the EU customs territory.
 - At the same time there was a decreasing trend of actors in the Ukraine using Lithuania as a transit channel to the EU.
- The world economic crisis is one of basic reasons for the increase in the activity of criminal groups in this region. The Baltic countries were especially affected by the decrease of GDP with consequent cuts in the strength of the services responsible for assuring state border security. These cuts enabled Russian criminal groups to arrange criminal transit to Western Europe (through Belarus and Poland) and to Finland and Estonia.

East European countries

- Ukraine is an important supplier of cigarettes smuggled to the EU countries. Cigarettes of Ukrainian origin go mainly to the Netherlands, Belgium, Germany, France and Czech Republic.

Balkan States

- Romania has a long-standing problem with smuggling, with most illegal cigarettes coming from Moldova and Ukraine. Romania is the main transit country for cigarettes smuggled to France, Germany, Great Britain and Austria.

EFFECTS

Financial effects

- Illegal cigarette consumption amounts to annual losses to national and EU revenues of approximately 12.5 billion Euros according to a 2012 report by KPMG LLP.

Social and legal effects

- There are risks to law and order and social problems connected to the concentration of criminal groups in certain areas (e.g. around border check points).
- Smuggling of tobacco products creates the ability for criminal groups to influence multiple areas of state activity

- NOTE: The absolute majority of EU citizens are in favour of all the policy measures listed in the question. 76% of respondents supported putting picture health warnings on all packages of tobacco products, and 73% supported introducing security features on packs to limit sales of smuggled or counterfeit products.

CURRENT MEASURE TO COMBAT ILLICIT TRADE OF TOBACCO PRODUCTS

- International organizations that work to combat illicit trade of alcohol and tobacco products:
 - World Health Organization (WHO) through the Framework Convention on Tobacco Control
 - World Customs Organization - Customs Cooperation Council (WCO-CCC): focuses on controls for technical and procedural aspects of international trade of alcohol commodities
 - Organization for Economic Cooperation and Development (OECD): focuses on taxing
 - DG Taxation and Customs Union - TAXUD and the European Anti-Fraud Office-OLAF: main instruments of the European Commission for controlling and combatting illicit trade

COOPERATION BETWEEN CUSTOMS SERVICES IN THE FIGHT AGAINST TOBACCO SMUGGLING

- In 2004, the EU accepted a settlement under which Philip Morris International agreed to implement certain anti-smuggling measures and pay up to \$1.25 billion over the course of 12 years. The company had to improve the monitoring of its sales, distribution, and vendors and its record keeping, and pay fines if its cigarettes continue to be smuggled in large quantities.
- In 2007 and 2010 the European Union signed similar agreements on the control of illegal trade of cigarettes with Japan Tobacco International (JTI), British American Tobacco (BAT) and Imperial Tobacco Limited (ITL). Accordingly, packages containing 10,000 or more cigarettes, produced all over the world, are marked with unique codes.

RECOMMENDATIONS FOR SOLUTIONS AND ACTIVITIES TO INCREASE THE MANAGERIAL EFFICIENCY OF ACTIONS TO COMBAT ILLICIT TRADE IN TOBACCO PRODUCTS

1. The most complex institutional, legal, and organizational approach is presented by the World Health Organization FCTC in the Protocol to Eliminate Illicit Trade of Tobacco Products. The required measures foresee:

- the introduction of a license system of all actors participating in the tobacco industry
 - control of duty free zones
 - a system of tracking and tracing from place of production to all points of sale
 - the ability to identify systems of payments at all of stages of the supply chain and distribution
 - severe control procedures of selection of stakeholders and participants within the process of delivery to ensure that all of participants are credible
2. The focus should now be on tracking more than tracing, because tracking (using technologies like barcodes, RFID, invisible inks, physical finger-printing, CVS verification systems) is real-time.

Current preventative measures employed by the "Big Four" (PMI, BAT ITL, JTI)

- A tracking system now called Codentify was originally created at the request of Philip Morris International (PMI) by the ELCA, a company that uses CVS code.
- PMI marks master cases packages or cartons with embedded codes or other markings that contain information about the date of manufacture of the product, manufacturing plant, the machinery used to manufacture, and the work shift in which the product was manufactured.
- The problem with the unique marking of higher level packaging is that smugglers know the new PMI coding system, so they may repackage cigarettes into new higher level packaging or reuse visible codes. Secondly, PMI does not mark unit packs, so final customer do not see any of above mentioned information.
- Based on the agreement with the EU, PMI must continue research and development into the technology of packaging and marking codes in order to improve the system.
- The Codentify solution is owned by PMI, but despite holding patents, PMI made the very unusual move of giving free licenses to BAT, JTI and Imperial Tobacco (ITL).
 - Additionally, the Big Four agreed in to use a common strategy to convince governments to replace "outdated" tax stamps with a digital verification of stamp duty tax based on Codentify.

Problems

- None of the Big Four links pack codes with the codes on cartons or higher level packaging. Although such a link is possible, it seems that the interest of the largest tobacco companies in undertaking it is low. This opens the door for "ant smuggling" (large number of people moving relatively small amounts of untaxed tobacco products).
 - The IBM report asserted that regular independent audits are necessary to fix this problem.

BENEFITS OF OBLIGATORY INTRODUCTION OF TRACKING AND TRACING METHODS

- To increase the managerial efficiency of the fight against illicit trade, it is essential to introduce, as soon as possible and to the fullest extent, solutions which take account of both:
 - the FCTC Protocol against illicit trade in tobacco products, particularly Article 8 (tracking and tracing) with the use of the agreements concluded with business and other government agencies and international partners
 - the obligation to have an integrated and entirely government-controlled system to monitor production and trade in tobacco products (should be installed independently from producers and distributors at all production sites and on each production line)
- Results achieved by other countries who have already introduced track & trace methods such as Brazil, Turkey, Malaysia, Morocco or California in the USA, confirm the effectiveness of these modern methods of combating illegal trade. Implementing these methods should not require much additional government spending, because manufacturers and distributors of these products are required to cover the cost of implementing the systems
- In Poland, assuming that the volume of illicit trade for tobacco is between 11.5% and 15.4% and that the level of illegal trade of distilleries is around 10% (both according recent estimates), reducing illicit trade even by as little as 30% would result in additional tax revenue of over €250,000 per year. This extra revenue could then be allocated to further development of control infrastructure which would likely lead to even better returns in subsequent years.