



Tobacco smuggling – a briefing paper

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Introduction

Approximately one in three internationally traded cigarettes is sold illegally with the avoidance of duty. The effect is to push down the price, increase demand and undermine national and international tobacco control regulations. The impact is to have a harmful effect by increasing tobacco use. Tobacco smuggling is not a victimless crime.

The majority of illicit cigarettes are traded in pubs, clubs, factory floors, car boot sales or on the street. The completely unregulated distribution networks exploited by smugglers make effective regulation of tobacco sales impossible, and increase the availability of tobacco to children and young people.

It is estimated that sales of illicit tobacco products in the UK cost the exchequer almost £3 billion annually in lost revenue¹ – equivalent to one penny off the basic rate of income tax – that would otherwise be used to fund schools, hospitals and other public services. In addition to the harm done by smuggling to the UK taxpayer, illicit sales of tobacco also damage honest shopkeepers. Surveys carried out by the Tobacco Alliance suggest that over 80% of retailers have seen their tobacco sales affected by smuggling with almost a quarter seeing a dramatic decrease. 70% of retailers are very concerned about the impacts of cross-border shopping and smuggled tobacco, and nearly 40% have considered closing their businesses.²

Sources of illicit tobacco

There are three main sources of illicit tobacco in the UK:

- **Large scale container fraud of genuine cigarettes.** A 40 foot container can hold around 10 million cigarettes. Organised smuggling usually involves the diversion of large consignments of cigarettes onto the black market while the product is in transit. By diverting the cigarettes while they are in the wholesale distribution chain – where they are carried untaxed – this form of large scale smuggling generally avoids all taxation. Memoranda of Understanding with UK tobacco companies have had some success in reducing the prevalence of this kind of smuggling.³
- **Counterfeit cigarettes.** Normally smuggled on the same kind of scale as the container fraud described above, counterfeit cigarettes normally originate in either Eastern Europe or East Asia, particularly China. Often manufactured from tobacco rejected by genuine tobacco companies, the counterfeit cigarettes are smuggled into the UK in containers purporting to contain goods such as computers or foodstuffs. As the proportion of smuggled tobacco from genuine sources declines, the proportion of counterfeit cigarettes and tobacco continues to rise.⁴ The entire supply chain of counterfeit tobacco is illicit, meaning that there is no legitimate company with whom the government can work to address it; enforcement is the only solution.

- **Small scale trafficking of EU duty paid tobacco** from continental Europe, particularly France and Belgium. While individuals can legitimately bring in up to 3200 cigarettes for personal consumption, there is also a considerable volume of illicit “bootlegging”, often carried out by the so-called “white van man”. While white van man is responsible for only a small proportion of illicit cigarettes, the EU duty paid trade accounts for the majority of smuggled hand rolling tobacco. In 2003/04, the illicit market share of hand rolling tobacco was 55%, with the cross-border shopped share accounting for another 14%. Thus, less than one-third of the hand rolling tobacco smoked in the UK that year had UK duty paid on it.⁵

Of these three sources, the cross-Channel bootlegging may be the most visible to the public eye, but this trade makes up only a small minority of the illicit tobacco trade in the UK. HM Revenue and Customs estimates that large scale container fraud accounts for between 70% - 80% of illicit cigarette imports, with small scale bootlegging accounting for much of the rest.⁶ The proportion of large scale cigarette smuggling accounted for by counterfeit cigarettes increased from 15% in 2001/2 to 54% in 2003/4.⁷

Why does smuggling happen?

While the large scale fraud is driven by the difference between the untaxed cost of tobacco (extremely cheap) and the duty paid retail price in the UK, the cross-Channel traffic is driven by the smaller differential between UK duty paid and EU duty paid price. The tobacco industry argues that cutting the duty paid on tobacco would cut tobacco smuggling. But smuggling takes place in all parts of Europe, not only in those member states with high tobacco duties. Historically, the countries with the greatest smuggling problem have been those Mediterranean countries with low duties. Scandinavia, with higher than average tobacco taxes, has much less smuggling than in many other parts of Europe.⁸

Cross border bootlegging is driven by cross border tax differentials. Large scale container fraud, which accounts for the bulk of the illicit tobacco trade, is driven by the difference between duty free and duty paid prices; were tobacco duties to be harmonised across all EU member states, this form of tobacco smuggling would continue.

The tobacco industry (see below) makes its money when it first sells its products to distributors. The more cigarettes they sell, the more money they make. So there are “perverse incentives”⁹ for the tobacco industry to collude with those involved in smuggling, if not in smuggling itself. Smuggling reduces the price of tobacco, pushing up the demand and increasing the profits that accrue to the tobacco industry. There is therefore a powerful incentive for the tobacco industry to carry on colluding with the black market, particularly if their involvement is not contrary to the letter of the law. Recent agreements between the European Union and two of the world’s largest tobacco companies seek to remove this incentive by forcing them to pay very high seizure payments for their smuggled products seized by law enforcement agencies.

Tobacco industry complicity

In the past, there have been well documented cases of UK tobacco companies exporting tobacco to countries where there is little market for their product. In 1997, UK companies exported over 1.5 billion cigarettes to Andorra, a small Pyrenean country with a population of only 63,000. Either every man, woman and child in Andorra was smoking over 60 British cigarettes every day, or the cigarettes were going somewhere else. The companies who exported them were well aware that the cigarettes were being smuggled back into the UK. This exchange formed part of a BBC television programme in 1998:¹⁰

Gallahers spokesperson: *“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.”*

Interviewer: *“I suggest it is within your control, because you could stop supplying them,”*

Gallahers spokesperson: *“That would do nothing to influence the degree of smuggling because the smugglers would just bring back somebody else's product.”¹¹*

Nor was Gallahers the only UK company to treat smuggling as just another lucrative business opportunity. Kenneth Clarke, the former Tory Health Secretary, Chancellor of the Exchequer and Deputy Chairman of BAT (British American Tobacco) was equally candid about his company's involvement in illicit markets. Writing in the Guardian in 2000, Mr Clarke stated that:

“Where any government is unwilling to act or their efforts are unsuccessful, we act, completely within the law, on the basis that our brands will be available alongside those of our competitors in the smuggled as well as the legitimate market,”¹²

This extraordinary statement sat uncomfortably alongside Mr Clarke's claim that his company was: *“a good corporate citizen which maintains high ethical standards”*.¹³

The apparent complicity of the tobacco industry in smuggling was one of the areas investigated during the House of Commons Health Select Committee's inquiry into the Tobacco Industry and the Health Risks of Smoking in 2000. During the inquiry, it became clear that although all the tobacco companies claimed to be opposed to smuggling, both BAT and Gallahers were complicit in the illicit trade in tobacco to one degree or another.¹⁴

In 2002, the UK Government drew up Memoranda of Understanding with the UK companies in an attempt to address tobacco smuggling. Memoranda were drawn up between HM Customs and Excise on the one hand, and BAT¹⁵, Imperial¹⁶ and Gallahers¹⁷ on the other. These memoranda are voluntary,

rather than legally binding, arrangements. None of the MoU require the companies to make seizure payments to compensate for lost government revenue that occurs as a result of smuggling.

The voluntary nature of these arrangements contrasts with the legally binding anti-smuggling agreement¹⁸ reached in 2004 between the European Commission and ten European member states, and Philip Morris International. This agreement required PMI to pay around \$1.25 billion to the EC over 12 years, and ends all legal actions brought by the European Commission with regard to contraband cigarettes. The cash paid by PMI is seen as being less significant than the fact that PMI will be heavily penalised if it fails to control smuggling of its cigarettes.¹⁹

The UK did not sign the European Commission agreement with Philip Morris, claiming that the agreement is not necessary due to PMI's small market share in the UK, that the agreement is incompatible with the Finance Act and that it does not add value to the existing MoUs between the UK Government and various tobacco companies. These arguments do not stand up to scrutiny and the UK Government faces calls to reconsider its position²⁰, particularly with regard to the recent EC agreement with JTI²¹; Japan Tobacco's acquisition of Gallahers, which has a 40% share of the UK cigarette market²², means that JTI is now a major player in the UK tobacco market. The UK is the only member state not to have signed the agreement with JTI.

In 2005/6, around 200 million of the 2 billion cigarettes seized by UK Customs were Gallahers brands (which include Benson & Hedges and Silk Cut). Had the JTI agreement been fully in force at the time, Gallahers would have had to pay the UK Government some £100 million in seizure payments. The MoU that was in force at the time required no such payment to be made.²³

The role of organised crime and terrorism in the illicit tobacco trade

Tobacco smuggling has strong links with terrorist and paramilitary organisations and with organised crime syndicates. The enormous profits to be made by evading tobacco duties make smuggling an attractive option for unscrupulous criminal interests. Both the Provisional IRA²⁴ and the splinter group the Real IRA²⁵ have been linked with tobacco smuggling as a way of raising money to fund their activities. Italian Mafia operatives are also involved in the smuggling of tobacco into the UK, as are Russian and eastern European criminal gangs²⁶, which have been implicated in smuggling illegal drugs as well as people trafficking. Chinese Triads are central to the traffic to the UK of counterfeit cigarettes produced in highly sophisticated factories in the Far East.²⁷ In the United States, Racketeer Influence and Corrupt Organisation (RICO) legislation designed to combat Mafia and organised crime activity has been used to prosecute tobacco companies engaged in smuggling tobacco with organised crime syndicates.²⁸

The popular perception of the cigarette bootlegger as a modern day Robin Hood²⁹ must be challenged. The great majority of tobacco smuggled into the UK benefits terrorists, gangsters and highly organised criminal gangs. Anyone

who smokes smuggled or counterfeit cigarettes is funding – either directly or indirectly – the activities of these criminals.

Impacts of tobacco smuggling

Tobacco smuggling is not a victimless crime. It undermines the UK Government's policy of using tax to maintain the high price of tobacco and help to reduce smoking, especially among the young. By importing into the country large quantities of tobacco that has not been subject to UK duty, smugglers increase demand for cigarettes and tobacco,³⁰ particularly among those on low incomes who already suffer significant health inequalities as a result of smoking.³¹ There is considerable evidence that smuggled tobacco is targeted at the most vulnerable groups: young people and those on low incomes, and that the cost of tobacco is a major factor in any decision to start or quit, or in relapse.³² Low cost smuggled tobacco weakens the influence of price on these decisions.

Smuggling also deprives the UK Exchequer of around £2.9 billion each year.³³ The tobacco industry claims that smuggling is caused by high UK tax rates, and argues that cutting UK tobacco duties would help to tackle smuggling. However, national policy in this arena must focus on improving public health by reducing smoking rates. The evidence from Canada and Sweden (see below) shows that lowering taxes has a significant impact on smoking rates, and it is likely that the only reason that tobacco companies wish to see lower duties is to increase demand for their products.³⁴

Canada and Sweden both tried to address tobacco smuggling by cutting tobacco taxes. In February 1994, the federal government in Canada significantly reduced their tobacco taxes in an attempt to tackle cross border smuggling, and offered incentives to provinces to follow suit. There was a real terms reduction in cigarette prices of around one-third. Combined federal and provincial tax revenues fell by around C\$1.2 billion, while smoking rates increased sharply. The prevalence of smoking among teenagers rose from 16% to 20%.³⁵ Cutting tobacco taxes in response to smuggling and to the vested interests of the tobacco industry may significantly undermine public health policies.

Sweden's experience was similar to that of Canada. Significant tax increases were followed by anecdotal reports of an increase in smuggling activity, and the tax increases that had been applied between December 1997 and August 1997 were repealed in August 1998. As a result of this move, tobacco revenues fell and the incidence of smoking increased once more.³⁶ The Swedish experience shows that while tax increases are effective in reducing the incidence of smoking, it might be counter-productive to impose very high increases over a short period of time.³⁷

Those interests who portray tobacco smuggling as a problem caused simply by high national tax rates fail to take into account the much more complex factors that influence the wider illicit tobacco trade. National taxes will have little impact on the illicit trade of counterfeit tobacco.

How can tobacco smuggling be most effectively addressed?

Tobacco smuggling is an international phenomenon, and requires an international solution. A Protocol on the Illicit Trade in Tobacco Products has been proposed for the World Health Organisation's Framework Convention on Tobacco Control; key measures of the protocol are likely to include:

- an international system that enables the tracking and tracing of tobacco products that would further secure the distribution system and assist in the investigation of illicit trade;
- licensing schemes for participants in the tobacco business;
- 'know your customer' laws, which oblige participants in the tobacco business to identify their customers and keep records of transactions;
- obligations for tobacco manufacturers to control their supply chain with penalties for those that fail to do so;
- anti-money laundering laws;
- criminal and civil sanctions that are sufficient to deter individuals and entities from participating in illicit trade;
- programmes to enhance the capacity of law enforcement bodies to combat illicit trade;
- programmes to increase cooperation and technical assistance with respect to the investigation and prosecution of offences and the sharing of information.³⁸

The legally binding agreements entered into by the EU and both Philip Morris International and Japan Tobacco International give both of these companies clear incentives to address the smuggling of their products. Payments of up to 400% of the duty on tobacco products seized are payable by these companies.

In addition to the international measures described above, it is also incumbent on national governments to prioritise action to tackle smuggling. HM Revenue & Customs produced a Tackling Tobacco Smuggling Strategy in March 2000, with an updated version in March 2006. During the first four years of the strategy, the illicit tobacco market share declined from 21% to 16%. While smuggling overall has declined, the proportion of counterfeit tobacco has increased as smugglers turn from genuine products to the more readily available counterfeit tobacco products.³⁹ This development has led to different challenges for the law enforcement agencies charged with tackling tobacco smuggling.

Spain, a country with a historically very high level of tobacco smuggling activity, has managed to drastically cut its smuggling problem, not through cutting taxes but by concerted law enforcement including the use of intelligence, international cooperation and heightened customs activity.⁴⁰ The UK could learn from this experience and tackle smuggling through targeted enforcement, led wherever possible by good intelligence from local tobacco control and public health sources.

Conclusion

Tobacco smuggling undermines public health policy and increases demand for tobacco (particularly among vulnerable groups already subject to serious health inequalities). It also undermines tax policy and deprives the UK Government of billions of pounds of tax revenues while at the same time channelling enormous amounts of money towards criminal, terrorist and organised crime interests.

Tobacco companies profit from tobacco smuggling, and it is only in recent years that they have been forced into agreements with the UK government that oblige them to take action to keep their products out of the illicit trade. But these agreements are voluntary and non legally binding, unlike the agreements between the European Union and two of the world's largest tobacco companies. The UK is the only EU member state that has consistently refused to sign up to these agreements.

In spite of their previous well-publicised involvement in tobacco smuggling, the big tobacco companies claim to be opposed to smuggling activities. They also have a vested interest in maximising demand for their product. So it is not surprising that the bodies representing the tobacco industry cite smuggling as a reason for the UK Government to reduce the duties charged on tobacco.⁴¹ This is a wholly disingenuous argument, that ignores considerable evidence that smuggling has historically been more prevalent in countries with a lower tax burden on tobacco. Unsurprisingly, this argument also ignores the likely impact on government policies to reduce smoking rates and improve the nation's health.

The experiences of Canada and Sweden, where concerns about smuggling brought about a reduction in tobacco taxes leading to a significant increase in smoking rates as well as a significant fall in tax revenues, demonstrate that there is insufficient justification for allowing smuggling to erode tax policies that have contributed to reducing demand for tobacco⁴². Tobacco smuggling is a law and order issue, and must be treated as such. Tobacco smuggling should be addressed via a two pronged approach; firstly, legally binding agreements (both at a national and international level) forcing the tobacco industry to pay punitive seizure payments that remove any incentive for them to collude in the illicit tobacco trade, and secondly, for law enforcement agencies (again, at both a national and international level) to increase their efforts to stop this hugely damaging criminal activity.

The proposed Protocol on Illicit Trade in Tobacco Products offers a coherent international framework that will facilitate efforts to tackle tobacco smuggling. The example of the Spanish authorities, who, by treating tobacco smuggling as a law enforcement issue, managed to cut smuggling without cutting taxes, demonstrates the potential of concerted and effective anti-smuggling policies.

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