

ECONOMIC ASPECTS OF TOBACCO PRODUCTS' CONTRABAND

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Introduction

Cigarette smuggling is widespread and well organised that it poses a serious threat to public health, and to government treasuries, which it is costing thousands of millions of dollars in lost tax revenue. Furthermore it is on the increase. The threat to public health comes from two principal directions. First, smuggling makes cigarettes available cheaply, thereby increasing consumption. It causes a massive increase in the burden of disease, especially in poorer countries. Second, the tobacco industry uses smuggling politically to argue against high tobacco taxes (Joossens, Raw 1998).

EU Member States have fiscal revenue from legal tobacco sales of over € 90 billion annually. It is estimated that smuggling costs national and EU budgets more than €10 billion annually in lost public revenue.

The attractiveness of cigarettes to the fraudster lies in the size of the difference between the duty-free and duty-paid price, which leaves room for substantial profit even at the relatively low street prices needed to attract consumers. They are also attractive because they are so easy to handle. Other highly taxed products, such as petroleum products, or even alcohol— also the object of fraud—cannot compete on a tax value per weight basis, or in terms of the conditions required for their transport. One "masterpack" of 10 000 cigarettes is the size of a cardboard box common in supermarkets. A container load of these has a potential tax value of about \$1 200 000, almost all of which is potential profit for the smuggler.

Large-scale smuggling also requires a willing market and a good local distribution network to supply it. Such markets and networks have existed for many years in Italy, where tobacco smuggling is long established and culturally accepted, and in Spain, where smuggling is also well established [1].

Cigarette smuggling is not caused principally by market forces. It is caused by fraud—by the illegal evasion of import duty. By evading duty cigarettes can be sold for about a dollar a pack, considerably cheaper than the official legal price.

Cigarettes are highly taxed in Europe to discourage tobacco use and to fund public-health measures to mitigate the harms from tobacco consumption. At

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higher prices (more precisely, at higher differentials between licit and black-market prices) consumers substitute more toward illicit cigarettes. Illicit retail trade in cigarettes includes counterfeiting and smuggling—either of legally purchased products, from lower-tax to higher-tax jurisdictions, or of entirely non-tax-paid cigarettes. Simple negative correlation exists between licit cigarette prices and the market share of illicit cigarettes in consumption, raising prices in any one country would, on average, lead to substantial increases in the expected illicit market share and volume in that country.

Insights into the relative importance of the effects were revealed in the surveys of governments and industries. The reduction in profitability was the effect that was indicated most frequently by both governments and industry representatives, followed by health and safety concerns. Criminal activity was third in the case of government respondents, while industry highlighted reductions in consumer confidence. OECD survey shows principal effects of counterfeiting and piracy.

Table 1: Summary of principal potential effects of counterfeiting and piracy [2]

Impact area	Principal potential effects
General socio-economic effects	
Innovation and growth	- Reduction in incentives to innovate - Possible negative effects on medium and long term growth rates
Criminal activities	- Increase in flow of financial resources to criminal networks, thereby increasing their influence in economies
Environment	- Substandard infringing products can have negative environmental effects - Disposal of counterfeit and pirated products has environmental consequences
Employment	- Shift of employment from rights holders to infringing firms, where working conditions are often poorer
Foreign direct investment	- Small, negative effects on levels of foreign direct investment flows; possible effect on structure of foreign direct investment
Trade	- Negative effects on trade in products where health and safety concerns are high
Effects on right holders	

Sales volume and prices	- Reduction of rights holders' sales volumes - Downward pressures on prices
Brand value and firm reputation	Erosion of brand and firm value
Royalties	Diminished flow of royalties due to rights holders.
Firm-level investment	- Adverse implications for R&D and other creative activities - Reduced firm-level investment
Costs of combating counterfeiting and piracy	- Costs are incurred for: (1) investigatory work; (2) public awareness initiatives; (3) technical assistance to governments; (4) litigation to fight infringements; and (5) modifications to product packaging to deter counterfeiting and piracy
Scope of operations	- Downsizing of rights holders operations - Increased risk of going out of business
Effects on consumers	
Health and safety risk	- Substandard products carry health and safety risks ranging from mild inconveniences to life-threatening situations
Consumer utility	- Consumers who unknowingly buy counterfeit/pirated products are generally worse off - Consumers who knowingly purchase counterfeit/pirated goods are generally not in a position to properly evaluate the quality of the product; there is substantial risk that utility will fall short of expectations
Effects on government	
Tax revenues	- Lower tax and related payments (such as social charges) by rights holders - Weak collection of taxes and related charges from counterfeiters/pirates
Costs of anti-counterfeiting activities	- Costs are incurred for enforcement and public awareness initiatives, and for development and maintenance of legal frameworks

These effects have different time distribution, shown on the following table.

Table 2: Timing of the main potential effects of counterfeiting and piracy on key impact areas

	Short term	Medium and long term
General socio-economic effects		Innovation and growth Criminal activities Environment Employment Foreign direct investment Trade
Effects on right holders	Sales volume and prices Royalties	Sales volume and prices Brand value and firm reputation Firm-level investment Costs of combating counterfeiting and piracy Scope of operations
Effects on consumers	Health and safety risk Consumer utility	Consumer utility
Effects on governments		Tax revenues Costs of anti-counterfeiting activities Corruption

Economic aspects of tobacco contraband in Bulgaria

Bulgarian Institute for Market Economy (IME) focused on illegal trade by making a detailed overview of available estimates for Bulgaria and presenting the lost revenues to the country's budget. These estimates make it possible to speculate on the financial flows of illegal trade, that is to say, on the resource that has found itself in the criminal structures of this activity [3].

- Estimates of lost revenue for the budget are based on available data on the quantities of illegal cigarettes. These estimates actually calculate how much the proceeds would have been if these cigarettes were consumed legally. Similar calculations are made by different stakeholders and similar

to these results can be found in the database of individual companies in the industry;

- Estimates of revenue from illegal trade should not be confused with lost tax revenue. This account no longer assesses hypothetical variants (if illegal cigarettes were consumed legally), but assesses the market for the actual consumption of illegal cigarettes. For this purpose, data are available on the quantities of illegal cigarettes and assumptions about the prices at which they are placed – a low threshold of 50% for legal products and a high threshold of 70% for legal products.

The amount of illegal trade could be calculated through the existing widely accepted Empty Packages Surveys. In the first year of EU membership (2007), the survey of empty packages in Bulgaria shows a share of illegal cigarettes of 11.1%. Consumption of 19.7 billion pieces represents almost 2.2 billion illegal cigarettes in 2007. In this first year of EU membership, revenues from illegal trade in Bulgaria amounted to 140-190 million cigarettes. The exact amount depends on the price of illegal cigarettes for which there is no definitive data and a threshold of 50 to 70% of the average price of legal cigarettes was used.

In 2008 and 2009, the excise burden and the price of cigarettes were increased by the government, leading to an increase in illegal trade to 16.4% in 2009. At that time, the total market was in the range of 19.8 billion pieces (similar to 2007), but smuggled cigarettes are now about 3.3 billion cigarettes (an increase of over 1 billion compared to 2007). This leads to a doubling of revenues from illegal trade to BGN 260-360 mln.

The big bang, however, occurred in 2010 when the nominal excise burden jumped by nearly 50%. The government decided to overtake the agreed with EU rate of increase in excise duty and as a result the legal market prices rose by 42%. The effect of this sharp rise is not surprising – the illegal market rised sharply from 16.4% to 30.7% in total consumption. Higher prices also lead to a general decline in licit consumption – from 19.8 billion to 15.6 billion pieces, with illegal cigarettes already reaching 4.9 billion pieces – they virtually doubled from 2.3 billion short cigarettes in 2007. The revenues in the illegal market reached the record 450-640 million BGN.

After 2010, there is a lull in the excise policy and the softening of prices. In this period, there has also been a rapid decline in illicit trade, which drops to 20.1% in 2011 and to 15.5% in 2012, to 2.7 and 2.1 billion illicit cigarettes in 2011 and 2012. Most of it also could be explained by the government counteraction measures. Consumption, following the sharp decline in 2010, shows another year of decline in the total amount of cigarettes consumed (legal and illegal) to 13.4 billion pieces in 2011 and the retention of these levels by 2014. The legal market is relatively stable over the period 2010-2014 (about 11 billion pieces), while the illegal market shrinks doubled, and overall consumption is also falling.

In 2015 and 2016, illicit trade declined to around 7% of the market as a result of increased controls, especially in 2015. In practice, in 2016, account is also taken of the lowest levels of consumption of illegal cigarettes – about 1 billion pieces. However, the revenues of the illegal market remain serious – BGN 120-170 million for 2016. The last available report from 2018 shows significant decrease of illicit tobacco trade in Bulgaria as well as a tendency for reduction. The detailed breakdown of EPS is shown below.

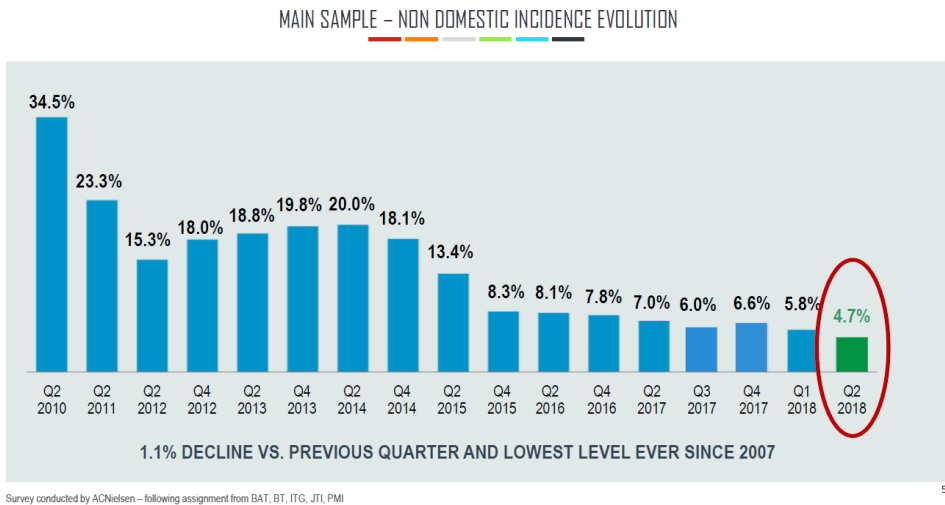


Fig. 1. Non domestic incidence evolution for the period 2010-2018. [4]

Related risks and losses for Bulgaria are similar as in the world:

- crowding – out effect
- corruption
- fueling of gray economy
- non-payment of taxes and social security contributions
- cost of counteraction
- health costs
- related crimes.

For the entire 10-year period (2007-2016), the revenues of the illicit cigarette market in Bulgaria are in the range of BGN 2.5-3.5 billion (EUR 1.2-1.7 billion). The latter is an IME assessment based on the revenue data of the Customs Agency and data on illegal trade from annual Project Sun reports [5]. This is a huge resource that finances criminal groups and inevitably leads to corruption at all levels of government, including the highest. The latter comes to show that the illegal cigarette market not only negatively affects the legitimate cigarette market

and leads to lost budget benefits but also has a negative effect on the work of the institutions and the rule of law in the state.

Notes

[1] Ibid

[2] THE ECONOMIC IMPACT OF COUNTERFEITING AND PIRACY – ISBN 978-92-64-04551-4 © OECD 2008

[3] Pravo i iekonomika na nezakonnata targovia s tyutyunevi izdelia v Bulgaria, Institut za pazarna iekonomika, www.ime.bg

[4] Empty cigarettes packs survey Q2 2018 anti-illicit cigarette trade initiative

[5] KPMG, Project Sun: A Study of the Illicit Cigarettes Market in the European Union, Norway and Switzerland (2017 edition), <https://assets.kpmg.com/content/dam/kpmg/lt/pdf/project-sun-2017-report.pdf>

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The Economic Impact of Counterfeiting and Piracy, OECD, 2008

ECONOMIC ASPECTS OF TOBACCO PRODUCTS' CONTRABAND

Abstract

Smuggling of cigarettes has serious economic aspects. It affects tax and excise revenues, increases social spending on health care, government spending for counteraction. Tobacco smuggling and revenues from tobacco smuggling support other criminal activities and act in symbiosis with them. This report addresses the principal effects and influences of smuggling of tobacco products, and in particular their impact in Bulgaria.

Key words: tobacco contraband, smuggling, economic aspects, taxes

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