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Both universities are founding members of the INCU, an association that provides the WCO and other organisations with a single point of contact with universities and research institutes that are active in the field of customs research, education and training.

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Editorial

In June this year, the World Customs Organization (WCO) held its first conference to discuss the administration and enforcement of excise tax, in recognition of the fact that excise duties represent a significant component of government revenue across the globe. Revenue authorities and the academic community have been encouraging the WCO to focus on this neglected area of revenue administration for several years, and not surprisingly, the conference was well attended, attracting some 160 participants from over 60 countries, including representatives of international organisations, government administrations, commerce and academia.

An important subject for discussion at the *Excise Summit* was the increasing incidence of illicit international trade, particularly in relation to alcohol and tobacco products, and we are pleased to provide a useful overview of the topic in Section 3 of this edition of the *World Customs Journal.*

Several of the conference participants are among the contributors to this edition of the *Journal*, and consequently we are able to bring you a comprehensive insight into current research in the field of excise, including tax policy, harmonisation of duty rates, the impact of trade agreements, excise duty suspension, illicit trade, compliance management and enforcement. Collectively, this represents a significant cross-section of the existing body of knowledge in this important area of research interest.

We have also selected a number of practitioner articles which are likely to be of interest to a broad range of readers, including Tom Doyle's commentary on the need to rethink traditional public sector procurement practices, with a particular focus on customs administrations.

On behalf of the Editorial Board, I would like to thank our many contributors, and also our readership for your positive feedback and continuing support of the *World Customs Journal* which is about to enter its seventh year of production.

David Widdowson
Editor-in-Chief

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Section 1

Academic Contributions

Production, holding and movement of excise goods under duty suspension within the European Union[1]

Harald Jatzke

Abstract

This article provides an overview of the duty suspension procedure under which excise goods can be produced, held and moved within the European Union (EU). The harmonisation of special excise duties in the European Union (EU) is well advanced. Member States are obliged to charge excise duties on energy products, alcohol and alcoholic beverages, and tobacco products. Since 1 January 1993, following the realisation of the internal market and the related abolition of border checks between Member States of the then European Community (now the EU), new legal rules allow trade in excise goods which have not yet been taxed. The examples included provide some guidance on the interpretation of current EU regulations.

1. Introduction

The harmonisation of special excise duties in the European Union (EU) is well advanced. According to EU law, Member States are obliged to charge excise duties on energy products (mineral oil, natural gas and coal), alcohol and alcoholic beverages (beer, wine, intermediate products and spirits) as well as tobacco products (cigarettes, cigars, cigarillos and fine-cut tobacco). Since the realisation of the internal market on 1 January 1993 and the related abolition of border checks between the Member States of the European Community (EC) (now the EU), certain legal rules have been created which make it possible to trade in excise goods which have not yet been taxed. Since goods are stored and moved without duties being charged, there must be adequate supervision to prevent tax evasion. This is ensured by means of special procedures first established in Articles 4 (c) and 15 to 20 of the Directive 92/12/EEC.[2] This was superseded by Directive 2008/118/EC[3] (Excise Directive), which entered into force on 1 April 2010. Directives do not produce direct effect and are only binding in terms of their aims. Accordingly, Member States must transpose them into their national law. Member States therefore had to amend their tax legislation to reflect the aims of these Directives.

Only a limited group of people can deal with untaxed goods. It is only possible to produce and store untaxed goods at specific locations. Goods can be moved from these locations to other tax warehouses or economic participants who hold a special permit. Since 1 January 2011, goods have been moved using an electronic procedure (Excise Movement and Control System [EMCS]). The following provides an overview of the duty suspension procedure under which excise goods can be produced, held and moved within the EU.

2. Purpose of the duty suspension procedure

The Excise Directive does not actually define the duty suspension procedure. Art. 4, no. 7 merely suggests that this procedure is nothing more than a fiscal rule applicable to the production, processing, holding and movement of goods under duty suspension. Due to the fact that the duty suspension procedure does not apply when a customs suspensive procedure or arrangement is available (Art. 3 (4) Excise Directive), Art. 4, no. 7 establishes a new requirement that the goods cannot be subject to any customs suspensive procedure or arrangement. The definitions of 'authorised warehousekeeper', 'tax warehouse', as well as registered and non-registered economic participants suggest that it is only possible to hold excise goods under duty suspension in tax warehouses which are specially designed for this purpose and that movement under duty suspension can only take place between tax warehouses or between a tax warehouse and an authorised economic participant (for example, according to Art. 17 (1) (b) Excise Directive, from a registered consignor to a tax warehouse).

Advocate-General Colomer has compared duty suspension to a canal lock where the excise goods remain until the duty is charged, thereby opening the lock. The term 'duty suspension' is therefore misleading because the suspension refers to the duty itself rather than the act of charging duty which has already accrued. The tax suspension procedure ends once the goods have departed the tax warehouse without them being moved under duty suspension. If the goods are placed under the movement procedure, duty suspension ends once the consignee accepts delivery of the excise goods.

The real significance of duty suspension is that it defers payment for an unlimited period: as long as the goods are under duty suspension they will not be charged duty.[4] The parties to the procedure should be able to have duty charged on the goods as soon as they have been supplied to the consumer or intermediary. At the same time, the duty suspension procedure operates as a fiscal check: as long as the excise goods are under this procedure, they are subject to fiscal supervision. The holder of a duty suspension procedure must provide security. The security to be provided for a movement procedure must be valid in all Member States. If there are irregularities which lead to duties being charged, the security can be confiscated by the competent authority.

3. The tax warehousing procedure

A tax warehouse is a place where excise goods can be produced, processed, held, received or dispatched under duty suspension by the authorised warehousekeeper subject to the conditions stipulated by the competent authority of the Member State in which the tax warehouse is situated. According to Art. 16 (1) Excise Directive, the opening and operation of a tax warehouse are subject to authorisation by the competent authorities of Member States. The latter are empowered to establish detailed procedures on the production (including the obtaining), processing and holding of the goods under duty suspension in a tax warehouse (Art. 15 (1)). In comparison to customs law, they have a wide discretion in this respect. The customs warehousing procedure (including the establishment of certain types of warehouses) is comprehensively regulated in Art. 98 ff. CC and Art. 524 ff. CCIP. There are differences between private and public warehouses. There is express provision for notional warehouses (that is, warehouse type E according to Art. 525 (2) (b) CCIP), which can either be ships on water and aircraft.[5] Since Community goods can also be held in a customs warehouse owing to economic necessity (see Art. 106 (a) CC, Art. 534 CCIP), Member States are permitted to authorise one and the same storage location as a tax and customs warehouse for non-Community goods subject to customs duties.[6]

Excise law provides for traditional tax warehouses (for example, breweries, foundries, refineries or tobacco manufacturing plants). Storage premises, where excise goods are held, processed or repackaged, can also be approved as tax warehouses. A tax warehouse must be situated on a defined, fixed location which rules out means of transport (for example, a tank wagon or tanker) being authorised as tax warehouses, despite the fact that the mineral industry has repeatedly made its needs known in this respect. Excise law does not have a rule comparable to the one in customs law which provides that goods do not necessarily have to be stored at a location authorised as a customs warehouse (Art. 525 (2) (b) CCIP). There is an exception for pipeline networks, however. The so-called NATO pipeline is considered to be a Community tax warehouse which Member States use to hold or extract mineral oil.

It is left to the Member States to determine the authorisation procedure and rules governing the opening of a tax warehouse.

Authorised warehousekeepers can be either natural or legal persons authorised by the competent authorities of a Member State to perform permitted acts in a tax warehouse during the course of their business (Art. 4, no. 1 Excise Directive). This provision rules out the possibility of other persons (for example, private persons) being issued with a tax warehouse authorisation.

Each Member State maintains a data bank with information on authorised warehousekeepers, registered economic operators and tax warehouses in the Community. The legal basis for the System for Exchange of Excise Data (SEED) is found in Art. 22 of the Council Regulation (EC) No. 2073 of 16 November 2004 on administrative cooperation in the field of excise duties. According to Art. 22 (4), a central liaison office or department of each Member State is to ensure that the persons involved in the intra-Community movement of excise goods can obtain confirmation of the information held in the SEED. Prior to dispatch, the tax warehousekeeper can request confirmation that the consignee is authorised to procure the excise goods under duty suspension. The procedure is similar to the VAT identification number and the qualified confirmation of this number in the case of duty free intra-Community supplies.

4. Intra-Community movement under duty suspension

4.1 Consignor and consignee

Generally speaking, when goods are moved under duty suspension, only a warehousekeeper can be the consignor. In response to complaints by Member States concerning this restriction in relation to imports, Art. 17 (1) (b) Excise Directive now allows a registered consignee to open a duty suspension procedure as well. This applies to natural or legal persons authorised by the competent authorities to dispatch excise goods once they have been released for consumption in accordance with Art. 79 CC under duty suspension (Art. 4, no. 10 Excise Directive). This procedural simplification recognises the needs of industry. Before this, the law had restricted the importation of excise goods and their release for consumption insofar as the further movement under duty suspension required there to be a tax warehouse at the customs office of entry whose keeper could open a transit procedure. The registered consignee can act as a tax warehousekeeper despite the fact that they do not have such sites at their disposal. Therefore, it is possible for a transport company or customs agent to perform this function.

Tax warehousekeepers and certain companies can act as registered consignees (Art. 4, no. 9 and Art. 19 Excise Directive). The registered consignee can only hold or forward the goods purchased if they first pay duties. The duties in the country of destination are chargeable once the goods have been received. Those wishing to act as consignees require the special authorisation of the Member State in which they are situated and must provide a security. In the case of exports to third countries, the customs office of departure[7] (but not, however, the customs office of export), which has confirmed the export (report of export to be transmitted electronically according to Art. 25 (1) Excise Directive), will function as the consignee. The consignees can also be participants in a suspensive customs procedure or arrangement according to Art. 84 CC (in cases where the goods are under a customs procedure which is ended in accordance with the customs provisions), as well as armed forces and certain international organisations and bodies (for example, diplomatic representations), which enjoy special status under procedural law.

4.2 The movement procedure using an electronic administrative document (EMCS)

As early as June 2003, the European Parliament and Council decided that the accompanying documents were to be replaced by a paperless, electronic procedure.[8] The EMCS enables an efficient check before the movement starts. Regulation (EC) No. 684/2009[9] establishes the structure and contents of the electronic administrative documents as well as the intra-Community information procedure. As a Regulation is directly applicable within the EU, Member States do not have to transpose it into their respective legal systems.

The consignor of the competent authority has to send a draft of the electronic administrative document using a computerised system. After the review of the data, they will receive a reference code for the transit procedure (Administrative Reference Code [ARC]) consisting of 21 characters. This allows the goods to be identified within the system and their movement traced. The competent authorities of the Member State of departure send the electronic administrative document to the competent authorities of the Member State of destination which forward it to the consignee (tax warehousekeeper or registered consignee). In the case of export, the electronic administrative document is sent to the customs office of export (that is, the customs office to which the export declaration is to be submitted in accordance with Art. 161 (5) CC).

The consignee must print the administrative document which the authority of their Member State has returned to them electronically together with the reference code and make it available to the person who accompanies the movement. It is also possible to use a commercial document bearing the reference code. The documents with the reference code must accompany the entire movement.

After receiving the goods, the consignee (tax warehousekeeper, registered consignee, international organisations, etc., pursuant to Art. 12 (1) Excise Directive) is to lodge an entry declaration with the authorities of the Member State of destination no later than five days after the completion of the movement. This will be checked by the authorities of the destination country and forwarded to the authorities of the Member State of departure which will notify the consignor of the entry. If the goods are exported to a third country or territory of a third country, the authorities of the Member State of export will issue a report of export on the basis of the endorsement drawn up in accordance with Art. 793a (2) CCIP (Art. 25 Excise Directive). In accordance with Art. 20 (2) Excise Directive, the duty suspension procedure ends once the consignee has taken delivery of the goods or the goods have been exported. The report of receipt or – in the case of exports – the report of export, is deemed evidence that the movement of excise goods has ended pursuant to Art. 20 (2) Excise Directive. In exceptional cases (for example, system disruption), it is possible to perform the transit procedure using paper documents. In accordance with Art. 8 Regulation (EC) No. 684/2009, the document bears the title 'Fallback Accompanying Document for movements of excise goods under suspension of excise duty'. Simplified procedures are provided for movements taking place within one Member State or by means of a pipeline. There are also special rules governing the movement of energy products (Art. 22 and 23 Excise Directive). These provisions allow the destination to be changed during movement or the consignment to be split into two or more movements.

4.3 Infringements and irregularities

During the movement of excise goods under a duty suspension arrangement, disruptions to the procedure may occur which lead to the goods being removed from fiscal control and released for consumption. For example, the consignment or part of it may not arrive at the destination and it may not be possible to establish whether the loss of goods occurred at the Member State of destination or departure. This has an impact on tax revenue because it must be determined which Member State is competent to charge duties.

Before the advent of the internal market, such cases were decided according to customs law. However, since the Community transit procedure ceased to apply after the abolition of border checks, it was necessary to find rules to replace it. In the first draft of Directive 92/12/EEC, the EC proposed incorporating provisions on the internal Community transit procedure in EC excise law. This approach is reflected in Art. 20 of that Directive which uses almost the same wording as Art. 34 of Regulation (EEC) No. 2726/90 on Community transit. This is the only area where customs law provisions have survived.

It is against this background that Art. 10 of the Excise Directive must be viewed and interpreted. The provision has formed the subject of proceedings before the European Court of Justice (ECJ) several times. There are three types of cases, of which the first is the least problematic. If an offence or irregularity giving rise to duty occurs during the movement under duty suspension, the duty will be charged in the Member State where the infringement or irregularity occurred (Art. 10 (1) Excise Directive). In this case, the place where the infringement occurred can be established reliably, so that there is no doubt about allocating the competence to charge duty to the Member State where the irregularity or offence was detected. For example, if a customs officer were to find that some excise goods had been removed from a heavy goods vehicle (HGV) in a parking area and an inspection of the bill of lading showed that the goods were being moved under duty suspension, then the goods would have been released for consumption due to an irregular departure from a duty suspension arrangement (Art. 7 (2) (a) Excise Directive). As a result, duty would be payable in this Member State.

If the customs officials merely conclude that the goods must have been lost somehow and there is no evidence that the goods have been removed from the parking area or other location in this Member State, the second alternative of Art. 10 Excise Directive applies. Owing to the detection of an offence or irregularity, the fiction is applied that the act has been committed in the Member State where it was discovered. There is no separate criterion for the incurrence of duty but merely a fiction concerning the place of the offence. Generally speaking, the offence leads to an illegal departure from a duty suspension arrangement so that, in this case, excise duty is also chargeable according to Art. 7 (2) (a) Excise Directive. In the view of Advocate-General Mischo, the internal logic of Art. 20 (2) and (3) of Directive 92/12/EEC also rules out the possibility of the consignor submitting evidence that the procedure has been properly carried out in the second type of case as well.[10]

Art. 10 (4) Excise Directive provides a solution in the event that the consignment or part of it fails to arrive. If the excise goods do not reach the destination and if there have not been any irregularities during the movement which lead to the charging of duties according to Art. 7 (2) (a) Excise Directive, then an irregularity is deemed to have occurred in the Member State of departure (at the time the movement commences). The fiction here relates to the irregularity and location of the offence. In such cases, the competence to charge duties is allocated to the Member State of departure. This would also be the case if it could be established that the goods have actually left the Member State of departure. This is because Art. 10 (4) Excise Directive was designed in such a way that a clear allocation of the competence to charge duties is also made in cases where the goods are moved through several Member States. In the case of movements through Europe, the goods may transit several Member States. Even if it was possible to rule out the charging of duties in the Member State of departure, the problem remains which of the Member States transited would be entitled to charge duties. After all, it would not be possible to establish where the offence exactly occurred. In order to resolve this conflict, the Community legislator has held the Member State of departure to be the Member State which is entitled to charge duties.

Art. 20 (3) of Directive 91/12/EEC stated that the consignor had a period of four months from dispatch within which they could adduce evidence that the duty suspension procedure was properly completed or the place where the offence actually occurred. However, this was held in contravention of Community law.[11] In the case in question, the consignor (an Italian warehousekeeper) received receipts and failed to notice that the official stamp was a forgery. It was only several months later, when the consignor received a tax assessment from the Italian tax authorities, that they became aware of this fact. By that time, however, the four-month time limit had long expired. The ECJ held that the time limit was unreasonable because it infringed the principle that the right of self-defence had to be respected. However, the court did not state what period would be deemed reasonable. The Commission and General Advocate Mischo had suggested that if the consignor had acted in good faith, the time limit should run as soon as they had actually become aware of the offence (for example, through information provided by the customs administration). Arguably, this is an acceptable solution. Art. 10 (4) (2) Excise Directive now grants the consignor or person who has provided security a period of one month from the communication of information concerning the failure of the goods to arrive at the destination to submit evidence that the transit procedure was properly carried out.

If the Member State in which the infringement or irregularity actually occurred is determined within three years from the date on which the accompanying document was issued (that is, from dispatch or the beginning of the movement according to Art. 20 (1) Excise Directive), this Member State will charge excise duty at the rate applicable when the goods were dispatched. Subject to evidence that duty has been paid in this Member State, the Member State which originally charged duties will be bound to grant a refund.

Notes

1 Translated from German by Christopher Dallimore, LL.B (Cardiff), Mag. Iur. (Trier), Dr Iur. (Münster).

2 Council Directive 92/12/EEC of 25 February 1992 on the general arrangements for products subject to excise duty and on the holding, movement and monitoring of such products (O.J. L 76/1).

3 Council Directive 2008/118/EC of 16 December 2008 concerning the general arrangements for excise duty and repealing Directive 92/12/EEC (O.J. 9/12).

4 This is made clear by Art. 15 (2) of the Excise Directive (Art. 11. (2) former edition) which states that the production, processing and holding of products subject to excise duties, where the latter has not been paid, shall take place in a tax warehouse.

5 Henke in Witte, Zollkodex, 5th edn, Art. 98, note 22.

6 Henke in Witte, Zollkodex, 5th edn, Art. 98, note 16.

7 The customs office at which the goods are to be presented before they leave the Community and where they are to undergo customs controls in relation to the application of departure formalities and appropriate controls on the basis of risk analysis (Art. 4, no. 4 (d) CCIP).

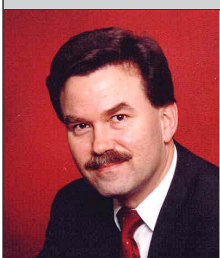
8 Decision No. 1152/2003/EC of the European Parliament and of the Council of 16 June 2003 on computerising movement and surveillance of excisable products (O.J. L 162/5).

9 Commission Regulation (EC) No. 684/2009 implementing Council Directive 2008/118/EC of 24 July 2009 as regards the computerised procedures for the movement of excise goods under suspension of excise duty (O.J. L 197/24).

10 Opinion of 21 March 2001 in the Case C-395/00, ECR 2002, I-11877.

11 ECJ judgement of 12 November 2002 Case C-395/00, ECR 2002, I-11877.

Harald Jatzke



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Harald's PhD thesis in law was titled 'The system of German excise law with regard to the results of the harmonisation of excise duties in the European Union'. He has published widely on national and European excise law.

The legality of non-harmonised excise duties in the European internal market using the Federal Republic of Germany as an example[1]

Sabine Schröer-Schallenberg

Abstract

With the signing of the Single European Act, Member States of the European Union (EU) committed themselves to establishing the internal market by 31 December 1992; a market without internal borders that guarantees the free movement of goods, persons, services and capital. This article examines the regulations relating to the legality of non-harmonised excise duties, using the Federal Republic of Germany as an example. Regulations relating to the taxes on specific products and services are discussed. It is concluded that, even if it is legally possible to introduce non-harmonised excise duties within the internal market, the fiscal supervision of non-harmonised excise duties is weak and difficult to perform, especially in intra-Community trade, and that further harmonisation should be the long-term goal. However, this can only succeed once the EU agrees on uniform rates of duty for harmonised excise goods.

1. Introduction

By signing the Single European Act, Member States committed themselves to establishing the internal market by 31 December 1992.[2] The internal market is an area without internal borders which guarantees the free movement of goods, persons, services and capital.[3] Taxes relating to the consumption of specific goods (historically known as 'excise duties') are of crucial importance for competition and therefore had to be harmonised in the run-up to the internal market.[4]

The harmonisation of regulations relating to excise duty was largely achieved by several Directives.[5] The basis of all harmonised objects of taxation is contained in Directive 92/12/EEC on the general arrangements for excise duty.[6] The range of 'products subject to excise duty' ('excise goods') is limited to energy products, electricity, alcohol and alcoholic beverages as well as manufactured tobacco.[7] The harmonised system of taxation and the abolition of border controls facilitate the intra-Community movement of goods under duty suspension. Accordingly, goods are moved from the country of origin to the country of destination under a duty suspension arrangement and charged duty in the place where they are released for consumption (that is, the 'country of destination' principle). Goods under a duty suspension arrangement have not yet been taxed and are therefore subject to fiscal supervision.

The harmonised law differentiates between duty suspension during storage in an authorised tax warehouse and movement.[8] The old paper-based supervision of a supply under duty suspension has now been replaced by electronic supervision.[9] Accordingly, goods subject to excise duty can only be moved under duty suspension once an electronic administrative document has been opened. As a rule, excise duty is charged once the goods have been released for consumption.[10] In intra-Community trade, the 'country of destination' principle justifies the Member State charging excise duty in the place where the dutiable product has been released for consumption. There are exceptions for private acquisitions: a product charged duty in the originating country and acquired by a private person for personal consumption will be exempt from duty in the country of destination.[11]

Legislation harmonising excise duty is limited to that necessary for the creation and functioning of the internal market. Despite the obligation to achieve harmonisation, the principle of subsidiarity means that national peculiarities continue to play a significant role.[12] Such peculiarities can also include the retention or introduction of new duties on products other than harmonised excise goods.

2. Requirements for non-harmonised excise duty

Since the advent of the internal market it has become clear that the aim is not to abolish all the non-harmonised excise duties in the Community. Rather, it is considered compatible with the aims of the internal market to grant Member States the discretion to retain or introduce national excise duties and systems of collection[13] so that they can compensate any losses resulting from harmonisation efforts by tapping into additional sources of revenue. This discretion of Member States was contained in Directive 92/12/EC, which applied to all harmonised objects of taxation and established general principles of taxation.[14] This was replaced by Directive 2008/118/EC (the Excise Directive) which permits duties on products other than excise goods to continue and harmonises the conditions under which the non-harmonised excise duty of a Member State complies with European Union (EU) law. The legal basis and conditions themselves are found in Art. 1 (2) and (3) Excise Directive (Art. 3 (2) and 3 in the former edition). There is an additional, general restriction contained in Art. 401 of Directive 2006/112/EC,[15] which states that the 'excise duties cannot be characterised as turnover taxes'.[16] Both the general arrangements for value-added tax and excise duties must facilitate the conditions necessary for an internal market without tax barriers.[17]

2.1 Art. 1 (3) Excise Directive (Art. 3 (3) former edition)

According to Art. 1 (3) Excise Directive, Member States may impose duties on products other than excise goods as well as services provided that such taxation does not give rise to any formalities connected with the crossing of frontiers.

2.1.1 Excise duties on other products

The term 'products other than excise goods' in Art. 1 (3) (a) Excise Directive is to be interpreted to the effect that the goods concerned must be different from the 'excise goods' listed in Art. 1 (1).[18] This term includes energy products, electricity, alcohol and alcoholic beverages as well as manufactured tobacco and refers to other Directives for further definition.[19] Unlike Art. 1 (2) of the Directive, which determines the lawfulness of charging other indirect taxes on excise goods, Art. 1 (3) provides for the taxation of goods outside the harmonised catalogue of products. The excise duty in question is presumed to be broad in scope. Being a 'special, product-based tax on consumption', it must only relate to a certain product or group of products in order to qualify as 'other indirect taxes'.[20] The Member States therefore have the right to introduce new excise duties on other goods or to retain a non-harmonised excise duty which existed before the internal market was created.[21]

2.1.2 Tax on services

In addition to the right to introduce excise duties on products other than harmonised excise goods, the Excise Directive gives Member States the right to tax services (including those relating to excise goods) provided the duty in question does not resemble a turnover tax (Art. 1 (3) sentence 1 (b)).[22]

Service. The scope of the Excise Directive largely relates to trade in excise goods rather than services. The fact that Art. 1 (3) sentence 1 b) (Art. 3 (3) in the former edition) relates to services suggests that it is referring to something other than an excise duty. The *trevaux préparatoires* suggests that this supplementary provision was adopted in order to preserve local taxes on consumption and expenditure (for example, duties on restaurants and beverages).[23] This has been confirmed by a judgment of the European Court of Justice (ECJ)[24] in a dispute concerning whether a municipal duty on beverages complied with the Excise Directive.

Whereas the 'additional' taxation of excise products (for example, alcoholic drinks) by a Member State has to comply with the strict requirements of Art. 1 (2) Excise Directive, a duty on services relating to excise goods will be subject to the lower requirements of Art. 1 (3).[25] Accordingly, the taxation of services does not have to serve any special purpose.

In practice, it can be very difficult to tell whether duties are payable on products or services and usually it will come down to the character of the transaction in question. Accordingly, the ECJ bases its decision on the predominant feature of the dutiable transaction.[26] For example, in the case of alcohol drinks sold in bars, cafes, etc., the supply of the excise product would be dutiable because the service provided by the bar owner represents the secondary aspect of the overall commercial activity.[27] The situation would be different if the commercial activity involved the sale of food because the price would be largely determined by the costs of providing the service. If the commercial activity involved the sale of beverages then the selling price of the products would predominate. The ECJ has also held that if alcoholic beverages were sold in a catering context, for immediate consumption on the seller's premises, the supply of services would be dutiable.[28] Such commercial activity involves a number of services which are distinguishable from operations relating to the supply of the products.

'Cannot be characterised as turnover taxes'. According to Art. 1 (3) b) Excise Directive (Art. 3 (3) in the former edition), duties levied on services connected to excise products cannot be characterised as 'turnover taxes'. This prohibition ensures that the tax measures of a Member State do not interfere with the operation of the common system of value-added tax. According to the settled case law of the ECJ,[29] the duty concerned must be general in nature (that is, one which applies to all transactions whether involving products or services). Accordingly, it must be levied generally in respect of transactions for the supply of products and services and calculated in accordance with the price charged. It must accrue at every stage of production and distribution and include the value added of the products and services (that is, the duty payable on a transaction is calculated by deducting the duty paid on the previous transaction). The term 'turnover taxes' in Art. 3 (3) (Art. 3 (3) in the former edition) has the same meaning as that in the VAT System Directive.[30]

A duty will not be considered transaction-related if it only covers a certain category of products as opposed to all transactions in the participating Member State. Therefore, duty charged on the supply of ice cream for consideration (including fruits used as ingredients and drinks) would not represent a transaction-based tax since it is only payable on a limited group of products.[31]

2.1.3 'Must not give rise to any formalities connected with the crossing of frontiers'

In trade between Member States, the imposition of excise duties on goods other than harmonised excise goods, on the one hand, and on services supplied in connection with harmonised excise goods on the other, must not give rise to any formalities connected with the crossing of frontiers in accordance with Art. 1 (3) sentence 2 Excise Directive (Art. 3 (3) sentence 2 in the former edition).

In this context, some commentators take the very restrictive view that any control of cross-border trade (including domestic fiscal supervision performed as part of national tax regimes) is unlawful.[32] However, abandoning all controls on cross-border supplies would mean that duties could only be described as 'local' in nature. This would amount to a prohibition on non-harmonised duties and thereby contradict the Directive's aim. This only requires that the introduction of non-harmonised excise duties does not frustrate the aim of abolishing tax borders within the context of the internal market. It does not mean that Member States have to abandon all controls over cross-border trade. After all, if states are to retain national excise duties, they must have effective means of collection.[33] Arguably, therefore, only control measures imposed in conjunction with the crossing of internal frontiers (that is, routine border controls) are unlawful.[34] Fiscal supervision alone does not restrict trade unlawfully[35] and so it is still possible to perform domestic fiscal supervision over cross-border supplies.

2.2 Art. 1 (2) Excise Directive (Art. 3 (2) former edition)

Art. 1 (2) Excise Directive[36] allows Member States to subject excise goods to other indirect taxes under certain conditions, provided that there is a specific purpose justifying such double taxation. This provision represents an exception and is therefore to be interpreted restrictively.[37]

2.2.1 Specific purpose

There must be a specific purpose for levying an indirect tax on goods already subject to excise duty in order to justify the resultant double taxation. Duties levied for purely fiscal reasons or as a means of reinforcing financial autonomy will not pass the test.[38] The purpose in question must not serve the general needs of public authorities and the duties themselves must not contradict the aims of the Community. Rather, the additional duty must seek to influence the behaviour of consumers and reflect regional and environmental characteristics. Duties levied in the interests of environmental, social and health policies have been recognised as serving specific purposes. The state can meet the requirement of a specific purpose by channelling all revenues to it or by designing the duty in a certain way (that is, its method of calculation).[39]

2.2.2 Principles of taxation in relation to excise duty or value-added tax

The duty must also reflect the taxation principles underlying excise duty or value-added tax. Accordingly, the basis for charging the duty, how it is levied as well as its calculation and fiscal supervision must reflect the requirements of harmonised law. In other words, non-harmonised duties must display the essential characteristics of the European law on excise duty.[40] That is not to say that there has to be a complete correlation: it is sufficient if the indirect tax for specific purposes is designed in a way that accords with one of the two taxation techniques under Community law.

For example, a duty on beverages will not satisfy the basic principles of excise law if its calculation is based on a feature not commonly used in excise law (for example, the value of the goods as opposed to their weight, quantity or alcohol content). Charging duties when the goods are sold to the end consumer would also contradict the general arrangement because, under excise law, duties are normally charged once the goods are released for consumption. There is also no structural similarity to the system of value-added tax if the duties are charged once the goods are sold to the end consumer without the possibility of deductions.[41]

3. Legal situation in Germany

3.1 Preliminary remarks

In Germany, excise duties on sugar, salt, tea and lighting were abolished as from 1 January 1993. Only duties on coffee and natural gas remained as non-harmonised duties. As part of the ecological tax reform, the German government introduced an electricity duty on 1 April 1999 as a non-harmonised duty. This was amended by Directive 2003/96/EC (the ‘Energy Tax Directive’), which considerably expanded the catalogue of harmonised objects of taxation in the energy sector as from 1 January 2004: both natural gas and electricity at the EU level were subjected to compulsory taxation. The inclusion of these goods within the catalogue of harmonised objects of taxation meant that Germany no longer levied non-harmonised duties on electricity and natural gas. One example of a politically motivated tax in Germany was the introduction of a duty on soft drinks containing spirits ('alcopops') in 2004, which is still charged today. Nuclear fuel is also subject to a non-harmonised duty. Since 1 January 2011,[42] Germany has charged duty on the consumption of nuclear fuel for the commercial production of electricity.

3.2 Coffee duty

Both coffee (roasted and instant) and products containing caffeine which enter the German tax territory are subject to coffee duty. Unlike the duty on tea, coffee duty was retained after the creation of the internal market owing to its fiscal importance (it generates revenues of approximately 1.1 billion Euros).[43]

3.2.1 Principles of taxation

The system of taxation reflects the principles of harmonised excise law. Accordingly, the German Act on Coffee Duty (*Kaffeesteuergesetz/KaffeeStG*)[44] also provides for tax warehouses where coffee can be produced, processed and stored under duty suspension. The coffee duty is usually charged when the goods are released for consumption (§ 15 (1) KaffeeStG). The Act also provides for duty suspension when coffee is moved between tax warehouses within the German tax territory. However, as far as the supervision of coffee supplies is concerned, there is no electronic exchange of information using EMCS. Instead, the official form of the accompanying document has to be used (§ 14 (1) in connection with § 1 no. 2 of the German Ordinance on Coffee Duty (*Kaffeesteuerverordnung/KaffeeStV*).[45]

3.2.2 Structure of intra-Community trade

Owing to the absence of harmonisation and compliance with the conditions of Art. 1 (3) Excise Directive, peculiarities within intra-Community trade are unavoidable. It is possible to move coffee from customs warehouses within the tax territory to consignees in other Member States under duty suspension arrangements (§ 9 (1) sentence 1 no. 1 c) KaffeeStG). However, contrary to harmonised law, the person who receives the coffee does not have to fulfil any particular conditions in relation to an acquisition under duty suspension arrangements. As far as the national character of the tax is concerned, there is no obligation on the person who receives the coffee to end the procedure. The intra-Community dispatch of coffee does not require any official papers. Only the warehousekeeper (as consignor) has to prove that the supply has been duly carried out using commercial documents and invoices (§ 16 KaffeeStV).

The legal situation regarding coffee duty where there is a supply into the tax territory is similar. According to § 9 (1) sentence 1 no. 2 KaffeeStG, a warehousekeeper in Germany can acquire coffee from another Member State under a duty suspension arrangement. Thereby, the law allows warehousekeepers in Germany to acquire coffee 'duty free'. However, the national character of coffee duty means that it is not possible to impose obligations on the economic participants in other Member States (consignor) and movements are not required to use official papers or comply with certain procedural rules.

The structure of coffee duty in Germany does not entail any unlawful formalities in connection with the crossing of frontiers and so it complies with the requirements of Directive 92/12/EEC. However, the lack of a uniform procedure between the Member States means that fiscal supervision is limited. As a result, there is a risk that economic participants will circumvent or infringe fiscal requirements in order to claim unjustified duty relief.[46]

3.3 Alcopop duty

Soft drinks containing alcohol (alcopops) are subject to duty[47] in accordance with § 1 (1) sentence 1 of the German Act Imposing a Special Duty on Soft Drinks Containing Alcohol (Alcopops) for the Protection of Young People.[48] Such beverages must use spirits as an ingredient and it is this rather than the alcoholic content that triggers the alcopop duty. Therefore, alcopops are subject to a duty on spirits and well as on alcopops. The alcopops must have an alcoholic content of more than 1.2% volume but less than 10% and be sold in filled, sealed containers ready for sale.[49] The duty payable on one hectolitre (hl) is 5,550 Euros. The alcopop duty means that a 0.275 litre bottle normally sold in shops, with an alcohol content of 5.5%, is subject to a tax rate of 84 per cent.

3.3.1 Taxes for specific purpose

The specific purpose of the alcopop duty introduced by the German government is to improve the protection of young people against the dangers of alcohol consumption.[50] The duty ensures that the price of alcopops is beyond the reach of young people. The Act intends the high rate of tax to put such products out of the reach of children and teenagers. In accordance with § 4 AlkopopStG, the net revenues gained from the alcopop duty are channelled into the anti-addiction program administered by the Federal Centre for Health Education (*Bundeszentrale für gesundheitliche Aufklärung*).

The aim of protecting young people provides justification for the duty because it meets the requirement of a 'specific purpose' in Art. 1 (2) Excise Directive. Therefore, Member States have the right to introduce a new duty on alcopops in addition to the harmonised duty on spirits.

3.3.2 Design

In accordance with the criteria of Art. 1 (2) Excise Directive, the AlkopopStG states that the provisions of the German Spirits Monopoly Act apply *mutatis mutandis* to taxation and related procedures[51] (§ 3 (1) AlkopopStG). This means that the provisions and principles of the harmonised law on excise duty apply. Alcopops can be produced in a tax warehouse under duty suspension. The duty becomes payable when the goods leave the warehouse and are released for consumption. The tax debtor is generally the warehouse which releases the goods or the manufacturer of the alcopops. The measurement used is a specific unit (hl). According to the principle of indirect taxation, the duty is passed on to the consumer via the sale price. The alcopop duty is therefore designed in accordance with the Community legislation on excise duty.

3.3.3 Peculiarities in intra-Community trade

Since the alcopop duty takes the form of a non-harmonised duty, peculiarities apply when the interests of other Member States are involved. This applies when alcopops are moved within the Community and exported to third countries.[52] In such cases, the legal principles governing the similarly non-harmonised coffee duty apply; § 3 (2), the AlkopopStG states that the provisions of the Coffee Duty Act are to apply *mutatis mutandis*.[53]

3.4 Nuclear fuel duty

As of 1 January 2011, Germany introduced a duty on nuclear fuel owing to the extension of the lifespan of nuclear power stations.[54] Along with the duties on coffee and alcopops, this is the third non-harmonised duty that currently applies in Germany.[55] According to § 12 of the German Act Imposing a Duty on Nuclear Fuel (the 'KernbrStG'), this duty will expire on 31 December 2016. The Federal Ministry of Finance estimates that this duty will generate almost 2.3 billion Euros a year.

3.4.1 Foundations

The duty is triggered by the initial usage of fuel elements or rods and the ensuing chain reaction (§ 5 (1) sentence 1 KernbrStG).[56] It concerns a process whereby the fission of nuclear fuels causes neutrons to release additional neutrons, which produce further nuclear fission. The heat (energy) generated by nuclear fission is transformed into electrical energy. The operators are the tax debtors. In reference to the holder of an authorisation pursuant to § 7 (1) of the German Atomic Energy Act (*Atomgesetz/'AtomG'*), the operator is the person who holds an authorisation to operate a plant which performs the fission of nuclear fuel for the commercial production of electricity. The duty imposed on one gram of nuclear fuel is 145 Euros (§ 3 KernbrStG).

The duty on nuclear fuel has encountered harsh criticism on constitutional grounds and there are doubts about whether it is lawful. This is apparent both in the literature[57] and in court decisions.[58] For example, it has been questioned whether a duty on nuclear fuels really can be described as an excise duty. If this is not the case, the fundamental question then arises as to whether the Basic Law grants the Federation the competence to introduce a tax which is not expressly provided for in Art. 106 GG.

3.4.2 Compliance with EU law

Besides complying with constitutional requirements, a non-harmonised duty must also comply with the requirements of EU law. As far as the German duty on nuclear fuel is concerned, there are doubts in this respect.[59]

If the nuclear fuel duty involves a harmonised object of taxation, then it must be justified by a specific purpose in accordance with Art. 1 (2) Excise Directive. In this respect, is not enough to argue that it serves revenue collection. The question about whether the elements of nuclear fuel represent an 'energy product' or comparable product provokes controversy.[60] The nuclear fuel elements do not come within the scope of Art. 2 (1) Energy Tax Directive, which provides a definition of 'energy products', or the wording of its catch-all provision in Art. 2 (3). Neither can it be said that nuclear fuels are used as 'fuels' pursuant to energy tax law because this requires the driving of an internal combustion engine or gas turbine. According to the Directive, a product intended to be used as fuel for heating must consist wholly or partly of hydrocarbons. Nuclear fuel does not exhibit such characteristics.[61] Therefore, it does not represent a substitute product as referred to in Art. 2 (3) Energy Tax Directive. Even if nuclear fuel does display a certain connection to the excise product 'electricity', the taxation of 'nuclear fuel' nevertheless involves a product other than excise goods.[62]

Accordingly, the duty is not to be assessed according to Art. 1 (2) Excise Directive but Art. 1 (3) instead. The stricter criteria imposed by Art. 1 (2) – due to its reference to 'specific purposes' – do not apply.

Art. 1 (3) Excise Directive states that the taxation must not give rise to formalities connected with the crossing of frontiers. Under the Nuclear Fuels Act, only the operator of the atomic energy plant within the tax area is to be taxed and this does not affect cross-border trade. However, a non-harmonised duty must not infringe EU law. Doubts as to the conformity of this Act concern 'output taxation' in light of Art. 14 (1) (a) Energy Tax Directive.[63] According to this provision, the Member States are, as a rule, obliged to grant tax exemption to energy products which are used in the production of electricity. In order to prevent double taxation, the 'input' (energy products) is tax free, whereas the 'output' (electricity) is taxable. Since electricity is already taxed in Germany, it is argued that imposing a duty on nuclear fuel as an input amounts to double taxation, which is illegal under European law.[64] However, this argument would only hold true if the principle contained in Art. 14 Energy Tax Directive also applied to other goods and products which (like nuclear fuel) do not fall within the scope of the Directive. Leaving aside the wording of the legislation, such an interpretation would contradict the catch-all provision relating to other products in Art. 2 (3) Energy Tax Directive. Generally speaking, this provision does not include all products which are used for energy purposes: products used for heating, for example, are restricted to hydrocarbons. Jatzke[65] justifiably points out that, according to Art. 2 Energy Tax Directive, Member States only intended to regulate the taxation of energy products used in the production of electricity and not to make any binding prescriptions in respect of other goods. Since the nuclear fuel duty cannot be characterised as a value-added tax, it complies with EU law.[66]

4. Conclusions

Even if it is legally possible to introduce non-harmonised excise duties within the internal market, 'going it alone' like this prevents the creation of a true internal market.[67] In addition, the fiscal supervision of non-harmonised excise duties is weak and difficult to perform, especially in intra-Community trade. The circumvention of procedural requirements owing to the lack of controls also opens the door to abuse. For these reasons, further harmonisation should be the long-term goal. However, this can only succeed once the EU agrees on uniform rates of duty for harmonised excise goods.

Notes

1 Translated from German by Christopher Dallimore LL.B (Cardiff), Mag. Iur. (Trier), Dr. Iur (Münster).

2 See Art. 8a EEC; now Art. 26 (1) TFEU (Treaty on the Functioning of the European Union).

3 Art. 26 (2) TFEU.

4 Seiler in Grabitz, Hilf & Nettelsheim , Das Recht der Europäischen Union Teil I, EL 43, March 2012, Art. 113 TFEU para. 43; Schröer-Schallenberg 1995, Harmonisierung der sonstigen Verbrauchsteuern in Birk (ed.) Handbuch des Europäischen Steuer- und Abgabenrechts, § 27, pp. 709 ff. with further references.

5 For an overview, see the index of legal sources on European law in Bongartz & Schröer-Schallenberg 2011, Verbrauchsteuerrecht, 2nd edn, XXVII, XXVIII.

6 Originally, Council Directive 92/12/EEC of 25 February 1992 on the general arrangements for products subject to excise duty and on the holding, movement and monitoring of such products, O.J. L 76/1; Directive 92/12/EEC was superseded by Council Directive 2008/118/EC of 16 December 2008 concerning the general arrangements for excise duty and repealing Directive 92/12/EEC, O.J. L 9/12 (‘Excise Directive’).

7 Art. 1 (1) Excise Directive.

8 For further details, see Bongartz & Schröer-Schallenberg 2011, (fn. 4), pp. 54 ff. with further references.

9 Excise Movement and Control System (EMCS); see Art. 21 ff. of Directive 2008/118/EC, Regulation (EC) 684/2009 of 24 July 2009 implementing Council Directive 2008/118/EC in regard to the computerised procedures for the movement of excise goods under suspension of excise duty (‘EMCS Regulation’), O.J. L 197/24.

10 See Art. 7 Excise Directive.

11 See Art. 32 Excise Directive.

12 Concerning the authority for harmonisation, see Art. 113 TFEU (formerly Art. 99 EEC Treaty); see Wolffgang in Lenz, EC Treaty, Art. 93, para. 10; Schröer-Schallenberg 2009, Die Rechtsentwicklungen des Verbrauchsteuerrechts nach Inkrafttreten des Binnenmarktes zum 1.1.1993, in Festschrift Kompetenzen und Verantwortung in der Bundesverwaltung – 30 Jahre Fachhochschule des Bundes für öffentliche Verwaltung, München, pp. 707, 708 with further references.

13 Concerning the development, see Jatzke 1997, Das System des deutschen Verbrauchsteuerrechts, Berlin, pp. 48 ff. with further references; Jatzke 2012, Grenzen des mitgliedstaatlichen Steuererfindungsrechts am Beispiel der Kernbrennstoffsteuer, ZfZ, pp. 150, 151.

14 Bongartz & Schröer-Schallenberg 2011, Verbrauchsteuerrecht, p. 15 (para. B 10).

15 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, O.J. L 347/1.

16 See VG Cottbus of 4 May 2010, ref. no. 1 L 358/09 concerning the compatibility of entertainment tax with European law regarding the element ‘characterised by turnover tax’, with further references.

17 ECJ Judgment of 11 November 1997, Case C-408/95 (Eurotunnel SA u.a./SeaFrance), ECR 1997 I-6315 at 6340, 6346.

18 See ECJ of 9 March 2000, Case C-437/97, (EKW and Wein & Co.), ECR 2000 I-1157 at 1189, 1202; VG Frankfurt of 9 April 2002, ref. no. 10 E 3678/98.

19 That is, concerning energy products and electricity: Directive 2003/96/EC of 27 October 2003 restructuring the Community framework for the taxation of energy products and electricity O.J. L 283/51; concerning alcohol and alcoholic beverages: Council Directive 92/83/EEC on the harmonisation of the structures of excise duties on alcohol and alcoholic beverages, O.J. L 316/21 and concerning tobacco: Directive 2011/64/EU of 21 June 2011 on the structure and rates of duty applied to manufactured tobacco, O.J. L 176/24.

20 Jatzke 1997, p. 50 with further references.

21 Jatzke 1997, p. 47 f.

22 The character of a turnover tax may be doubtful in this case; see Friedrich, Das neue Verbrauchsteuerrecht ab 1993, DB 1992, 2000, 2001; Jatzke 1997, p. 51 f.

23 Concerning the background, see Jatzke 1997, p. 51 f.; Stobbe 1993, Die Harmonisierung der besonderen Verbrauchsteuern (Teil 1), ZfZ, pp. 170, 172; see also VG Frankfurt, judgment of 9 April 2002, ref. no. 10 E 3678/98.

24 ECJ, judgment of 9 March 2000, Case C-437/97, ECR 2000 I-1157.

25 ECJ, judgment of 10 March 2005, Case C-491/03, ECR I-2025: a tax on services is not subject to the stricter requirements of Art.3 (2) of Directive 92/12/EEC (now: Art. 1 (2) Excise Directive); see also Hess, VGH, judgment of 14 October 2005, ref. no. 5 UE 819/05, DÖV 2006, p. 398; NVwZ-RR 2006, p. 354.

26 ECJ of 2 May 1996, Case C-231/94 (Faaborg-Gelting-Linien), ECR 1996, I-2395 at 2406, 2395, para. 12-14.

27 Concerning the infringement of Community law by a tax on beverages, see VG Frankfurt, judgment of 9 April 2002, ref. no. 10 E 3678/98.

28 ECJ of 10 March 2005, Case C-491/03, ECR I-2025.

29 ECJ, judgment of 7 May 1992, Case C-347/90 (Bozzi), ECR 1992 I-2947; judgment of 16 December 1992, Case C-208/91 (Beaulande) ECR 1992 I-6709 at para. 12; judgment of 17 September 1997, C-130/96 (Fazenda Publica/Solisner Estaleiros Novais SP), ECR 1997, I-5053, 5070; judgment of 3 October 2006, C-475/03 (Banca Popolare di Cremona), ECR 2006, I-9373, 9460.

30 VG Cottbus, judgment of 4 May 2010, ref. no. 1 L 358/09 with further references.

31 ECJ, judgment of 9 March 2000, Case C-437/97 (EKW and Wein & Co.), ECR 2000 I-1157.

32 Arndt, Rechtsfragen einer deutschen CO²-/Energiesteuer, pp. 120 ff.

33 Jatzke 1997, p. 49.

34 Beermann 1993, Das Verbrauchsteuer-Binnenmarktgesetz, DStZ, p. 259.

35 Jatzke 1997, pp. 48 ff.

36 See Art. 3 (2) of Directive 92/12/EEC: concerning the development and controversy surrounding the lawfulness of the taxation, see Jatzke 1997, pp. 46 ff.

37 Stated expressly in the Opinion of Advocate General A Saggio of 1 July 1999 in Case C 437/97; ECR. 2000 I-1157, at 1189; VG Frankfurt, judgment of 9 April 2002, ref. no. 10 E 3678/98.

38 ECJ judgment of 9 March 2000, C-437/97, ECR 2000 I-1157.

39 Opinion of General Advocate A Saggio of 1 July 1999 in Case C-437/97, ECR I-1157 at 1189, 1176.

40 Seiler in Grabitz, Hilf & Nettelsheim, Art. 113 AEUV, para. 44.

41 ECJ, judgment of 9 March 2000, Case C-437/97, ECR 2000 I-1157, at 1207.

42 Kernbrennstoffsteuergesetz/'KernbrStG' (*Act providing for a duty on nuclear fuel*) of 8 December 2010, BGBl. I 2010, 1804.

43 See detailed arguments in Bongartz & Schröer-Schallenberg 2011, Verbrauchsteuerrecht, pp. 409 ff. (paras. L 1 ff.).

44 Kaffeesteuergesetz/'KaffeeStG' (*Act providing for a duty on coffee*) of 15 July 2009, BGBl. I, p. 1870) amended by an Act of 21 December 2010 (BGBl. I p. 2221).

45 Verordnung zur Durchführung des Kaffeesteuergesetzes/'KaffeeStV' (Ordinance implementing the Act providing for a duty on coffee) of 5 October 2009 (BGBl. I, p. 3262) amended by Ordinance of 1 July 2011 (BGBl. I, p. 1308).

46 Glockner, Kaffee zum Spottpreis? – Zur Problematik des Kaffeesteuerrechts, BDZ 2011, F 53-F 57: providing a detailed study using the coffee tax as an example.

47 Concerning the question of constitutionality, see FG Düsseldorf of 28 April 2005, ref. no. 4 V 481/05 A, ZfZ 2005, p. 313; rejecting an application for interim measures preventing the entry into force of the Act providing for a tax on alcopops, BVerfG of 4 August 2004, 1 BvQ 28/04.

48 Gesetz über die Erhebung einer Sondersteuer auf alkoholhaltige Süßgetränke (Alkopops) zum Schutz junger Menschen/'AlkopopStG') (*Act providing for a special duty on soft drinks containing alcohol (alcopops) in order to protect young people*) of 23 July 2004 (BGBl. I, p. 1857) amended by the Act of 21 December 2010 (BGBl. I, p. 2221).

49 Concerning the individual requirements of the tax object, see Bongartz & Schröer-Schallenberg 2011, Verbrauchsteuerrecht, pp. 422 ff. (para. M 5 ff.) with further references.

50 Pfab 2006, Die Besteuerung von Alkopops, DStZ, p. 249; Schmidt & Theis 2004, Die neue Sondersteuer auf Alkopops, ZfZ, p. 329.

51 Gesetz über das Branntweinmonopol/'BranntwMonG' (*Act on the monopoly over spirits*) of 8 April 1922 (RGBl. I, pp. 335, 405), last amended by the Act of 16 July 2011 (BGBl. I, p. 1090).

52 For the details, see Bongartz & Schröer-Schallenberg 2011, pp. 425 ff. (paras. M 21 ff.).

53 See comments on the Coffee Duty Act under III. 2. b.

54 Kernbrennstoffsteuergesetz/'KembrStG' of 8 December 2010 (BGBl. I, p. 1804).

55 Jatzke 2010, Die Kernbrennstoffsteuer – ein Exot im deutschen Verbrauchsteuerrecht, ZfZ, p. 278; Waldhoff 2012, Die Kernbrennstoffsteuer als Verbrauchsteuer und die steuerrechtliche Typenlehre, ZfZ, p. 57; Wernsmann 2012, Verfassungsfragen der Kernbrennstoffsteuer, ZfZ, p. 29.

56 For details concerning the structure of the duty, see Jatzke 2010, ZfZ, p. 278 with further references; Bongartz & Schröer-Schallenberg 2011, Verbrauchsteuerrecht, pp. 430 ff. (paras. N 1 ff).

57 Schoenfeld 2011, Kernbrennstoffsteuer formell verfassungswidrig?, Aw-Prax, pp. 415 ff.; Stein & Thoms 2011, Energie-und Stromsteuerrecht: Gesetzliche Entwicklungen 2010, BB, pp. 471, 476.

58 FG Hamburg, judgment of 19 September 2011, ref. no. 4 V 133/11, ZfZ 2011, Beilageheft 4 (October 2011) p. 56; contra, FG Bad.-Württemberg judgment on 11 January 2012, ref. no. 11 V 2661/11; ref. no. 11 V 4024/11, ZfZ 2012, Insert no. 2 (April 2012) p. 22; the BFH rejected the application for a suspension of enforcement concerning the determination of nuclear fuel duty: see ruling of 9 March 2012, VII B 171/11, ZfZ 2012, p. 109; see also Bruch & Greve 2012, Die Kernbrennstoffsteuer im Fokus der Finanzgerichtsbarkeit, BB, pp. 234 f.; Seer 2012, Vorläufiger Rechtsschutz bei ernstlichen Zweifeln an der Verfassungsmäßigkeit eines Steuergesetzes, DStR, pp. 325 ff.

59 Stein & Thoms 2011, BB, pp. 471, 477 with further references; compare with detailed justification in Jatzke 2012, ZfZ, pp. 150 ff.

60 See Stein & Thoms 2010, BB, pp. 471, 477; concerning this problem, see Schoenfeld 2011, Aw-Prax, pp. 415, 421.

61 For an extensive investigation of these questions, see Jatzke 2012, ZfZ, S. 150, 153.

62 Jatzke 2010, ZfZ, p. 278 with further references.

63 Stein & Thoms 2011, BB, pp. 471, 477; Schoenfeld 2011, Aw-Prax, pp. 415, 421.

64 See Stein & Thoms 2011, BB, pp. 471, 477.

65 Jatzke 2012, ZfZ, pp. 150, 154 f.

66 Jatzke 2012, ZfZ, pp. 150, 155.

67 Schrömbges 1990, Auf dem Weg zur Beseitigung der Steuerschranken in der EG?, ZfZ, p. 136.

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Trade in goods subject to excise duties which have been released for consumption in other Member States[1]

Analysis with reference to Directive 2008/118/EC and German excise law

Matthias Bongartz[2]

Abstract

This article examines the legal provisions applicable in the European Union (EU) when goods are traded and/or moved between Member States and compares those provisions with German law on excise duties. A range of circumstances and interpretations is provided. Specific reference is made to the differences between goods moved for 'commercial' purposes and those moved by a private individual and the likely application or exemption of excise duties. Other examples are also provided of circumstances where duty is applicable and in cases where duty would be exempt.

1. Overview of the European Union (EU) legal provisions

Directive 92/12/EEC[3] drew a distinction between goods under duty suspension arrangements and those released for free consumption. However, unlike the German legislation on excise duties, this Directive did not define 'free consumption'. The harmonisation of excise duties led to the provision of duty suspension arrangements in order to realise the internal market. Their main purpose is to eliminate the intra-Community tax borders in trade with excise products. Although the majority of movements are made under duty suspension, the internal market also requires the remaining intra-Community movements to be taken into account in recognition of the fact that not all economic participants can claim duty suspension and in order to promote trade in goods which do not (or no longer) qualify for duty suspension. In addition, the competence to raise revenue lies with the individual Member States. Owing to this competence, the duties must ultimately be charged in the Member State where, for tax purposes, the excise product has been released for consumption and remained. Therefore, the 'country of destination principle' also applies to goods released for consumption.

The original provisions of Directive 92/12/EEC showed that trade was not the Community legislator's primary concern.[4] There was no clear distinction between the types of trade in goods released for consumption.[5] Directive 2008/118 (the Excise Directive) which repealed Directive 92/12/EEC does not contain any major amendments. However, its improved regulatory structure makes it easier to differentiate the various types of movements.[6] Art. 33 of the Excise Directive ('holding of goods in another Member State') regulates the important situation where goods released for free consumption in one Member State 'are held' for commercial purposes in another Member State. In contrast, Art. 32 ('acquisition by private individuals') underlines that acquisitions in another Member State by private individuals are subject to the 'country of origin principle', where the individual has acquired the goods for his/her own use and moved them into another Member State himself/herself. Duties are only charged once (that is, in the Member State where the goods were acquired). The third possible movement is regulated by Art. 36 Excise Directive (Distance Selling). The German regulation refers to mail order transactions

(‘Versandhandel’). The country of destination principle also applies to distance selling so that duty is charged (again) once the excise product has been delivered to the Member State of destination.

The Excise Directive provides the basis for claiming excise duty which is important where an irregularity occurs in another Member State during movement (see Art. 38 (1)). Previously, this had only applied to the movements of excise products under duty suspension to ensure the charging of duty in justified cases. When this legal concept was transferred to movements involving excise products released for consumption, the competence of Member States to charge taxation may have been the most important consideration. This is sometimes taken into account where an irregularity occurs in a Member State before duty has been charged. In accordance with the provision for excise products under duty suspension (see Art. 7 (4) Excise Directive) no (new) excise duty will be charged where goods are lost or destroyed under certain circumstances (see Art. 37 Excise Directive).

Arts. 34 and 35 of the Excise Directive establish the duties of the individuals involved and the accompanying document to be used. There have not been any amendments so it is still possible to use the simplified accompanying document under Regulation (EEC) 3649/92. The introduction of the Excise Movement and Control System (EMCS) only affects trade in goods under duty suspension (that is, not goods which have been released for free consumption).[7]

The country of destination principle has been transposed into German law having regard to the competence of individual Member States to charge duties under similar circumstances on excise goods which have already been released for consumption in another Member State and are generally dutiable. In accordance with the requirements of Community law, the German provisions distinguish between acquisition and holding for commercial purposes, acquisition by private individuals and mail ordering. With a few exceptions, the provisions are largely identical.

2. Duty charged on holding goods for commercial purposes (Art. 33 Excise Directive)

2.1 Overview of the Directive

The charging of duty is regulated in Art. 33 (1) Excise Directive. Duties are charged on excise goods which have already been released for consumption in one Member State and are being held for commercial purposes in another Member State where they are to be delivered or used. The method of movement is irrelevant for charging duty; it is the holding of the goods which is the crucial factor. In this respect, paragraph 2 underlines that the relevant German provisions determine the conditions for charging duty and the applicable duty rate.

Art. 33 (1) sub-para. 2 Excise Directive also provides a definition of ‘holding for commercial purposes’, absent in German excise law.

In addition, Art. 33 determines who is liable to pay duty (para. 3): where transit is carried out for commercial purposes (para. 4), excise goods are held on board a ship or aircraft travelling between two Member States (para. 5), or excise duties are to be reimbursed or remitted in the Member State where the goods were released for free consumption.

2.2 The structure of German regulations

According to German excise law, excise products are subject to duty when they are acquired, released for consumption in another Member State, held in the tax territory for the first time or consumed.[8] With the exception of the provision in tobacco duty law (which reflects the existing duty labelling system), the respective paragraph 1 concerns an acquisition for commercial purposes whereas the catch-all criterion of paragraph 2 concerns the initial holding or consumption for commercial purposes.[9] Therefore, national law follows Arts. 7 and 9 of the Directive 92/12/EEC rather than Art. 33 of the Excise Directive. According to the clearer wording of the new Directive, excise products which have already been released for consumption are subject to excise duty when they are held in another Member State for commercial purposes in order to be delivered or used there.[10]

2.3 Goods which have already been released for consumption in a Member State

According to both the Directive and German law, goods are only subject to duties on release for consumption. It is not possible to determine the excise status of goods in another Member State by sole reference to German law, since it is the national law of the Member State in question which is relevant. The excise legislation of all Member States must respect the requirements of Community law (as is the case in Germany). The excise status is to be determined according to the Excise Directive since this forms the basis of harmonisation. Accordingly, a finding under Community law that energy products have been released for consumption in one Member State can influence the status of excise goods in other Member States.

The relevant provision in this respect is Art. 7 (2) of the Excise Directive. It defines the term ‘release for consumption’ which triggers the charging of duties according to paragraph 1. Accordingly, energy products which have departed from a duty suspension arrangement are deemed to have been released for consumption. This will be the case if goods are removed from the tax warehouse and there is no subsequent movement under a duty suspension arrangement or the latter ends with the registered consignee. This situation also includes consumption within a tax warehouse. The words ‘including irregular departure’ (Art. 7 (2) (a) Excise Directive) make clear that a release for consumption can also take place when moving the goods under a duty suspension arrangement if an irregularity has occurred in another Member State (Art. 10 (1) Excise Directive). If it is not possible to determine where the irregularity occurred, the irregularity (and with it, the release for consumption) will be deemed to have taken place in the Member State where it was detected (Art. 10 (2) Excise Directive). Similarly, energy products are deemed to have been released for consumption if they were produced outside a duty suspension arrangement (Art. 7 (2) (c) Excise Directive). An importation, including one which is unlawful (for example, smuggling) will also give rise to a release for consumption if the goods were not immediately placed under a duty suspension procedure.

Art. 7 (2) (b) Excise Directive also considers goods to have been released for consumption if they are held outside a duty suspension arrangement where excise duty has not been charged pursuant to the applicable provisions of Community and national law. At least under the German system of duty, it is highly contentious whether such a situation amounts to a release for consumption. According to, for example, Art. 7 (2) (a) Excise Directive, the holding of excise goods outside a duty suspension arrangement can only follow (that is, cannot trigger) a release for consumption. Rather, the provision appears to permit the charging of ‘additional’ duties if this is not possible using existing methods of taxation.[11] The fact that it is combined with the charging of duties appears to support this. The provision does not provide any new information about when the goods are released for consumption in another Member State. There is no comparable rule in national excise law. Finally, the requirement ‘free consumption in another Member State’ will always be met if excise goods enter the tax territory of another Member State directly and are not under the duty suspension procedure.

2.4 Holding for commercial purposes

Although the term ‘holding’ is not defined, it is generally accepted within the context of the Excise Directive that it requires actual power of disposal over the goods.[12] As a rule, this also applies to goods which the person exercising the power of disposal is not actually aware of.

This view reflects the regulatory purpose of Community law. In particular, regulating the conditions under which duty is chargeable for holding goods which have already been subject to duty in another Member State serves to recognise the competence of individual Member States to charge duties and the related country of destination principle. The crucial element is the tax territory within which the dutiable consumption is to take place. It would be more difficult to make a clear designation if subjective elements also had to be considered because these can differ depending on the Member State concerned.

In general, German excise law 'defines' the element 'for commercial purposes' by distinguishing it from the 'duty free' introduction for private purposes (§ 20 BierStG). There is a commercial purpose if the requirements for an acquisition by a private individual are not met (§ 19 BierStG). By contrast, the Energy Taxation Act provides a separate criterion for levying duties in such cases (see § 16 (2) EnergieStG). Consequently, the German regulations also meet the Directive's requirements. As in national law, the Directive also includes cases not covered by the provision relating to an 'acquisition by private individuals' (Art. 32 Excise Directive) and which are therefore not subject to the country of origin principle.[13] This is achieved by the definition of 'held for commercial purposes' introduced by Art. 33 (1) sub-para. 2 Excise Directive. Accordingly, goods are also held for commercial purposes if a private individual does not acquire excise goods for his/her own use but holds and moves them himself/herself.

2.5 Exceptions to 'holding the goods'

An exception applies (largely for practical reasons), if the excise goods are 'only' moved through the tax territory. If transit is properly carried out, the country of destination principle will not apply either. It can also be deduced from the exception that 'holding the goods' does not require a link to excise duty law. For example, the 'holding' does not have to be for consumption and it would be sufficient if the goods were only held for transportation. On the other hand, Art. 33 (4) Excise Directive does require that the movement be made under cover of an accompanying document in accordance with Art. 34. This exception promotes the creation of an internal market, especially in the case of movements which pass through several Member States insofar as it avoids multiple duties and related duty relief.

Art. 33 (5) Excise Directive provides an additional exception for excise goods held on board a ship or aircraft making sea crossings or flights between Member States (see, for example, § 20 (2) sentence 2 no. 2 BierStG). The condition for this is that the goods are not to be offered for sale. Subject to these conditions, goods can be moved through a tax territory duty free. Where such exceptions apply, duties would be payable since the duty free regulations have been repealed.[14]

3. Excise duty on distance selling, Art. 36 (mail order transactions)

Mail order is another form of trade in excise goods which have been released for consumption in other Member States and is subject to the country of destination principle.[15] Accordingly, goods which enter the tax territory by mail order will also be subject to German duties.[16] Mail order transactions have not been separately regulated (see § 23 TabStG) owing to the special rules on tobacco duty. As a result, it should not make any difference to the competence to charge duty whether the excise goods were acquired from a trader within the tax territory or by a trader in another Member State, provided that the exception concerning the introduction of goods for private purposes does not apply (acquisition by private persons, for example, § 19 BierStG).[17]

In the national legislation, paragraph 1 describes who the distance seller is and paragraph 2 lists the requirements for levying duty. As with an acquisition for commercial purposes, duties are charged on a legal transaction between two persons, the essential difference being that the consignee is usually a private individual. Thereby, the intra-Community movement of goods is based on a commercial activity of the mail order seller and this is the factor which determines whether duty is chargeable.

3.1 Mail order sellers

In accordance with Art. 36 (1) Excise Directive, the German provisions require that the goods supplied be already released for consumption in another Member State. Furthermore, all regulations expressly require that the trader also be established in this Member State. A similar requirement is not found in Art. 36 (1). However, as in national law, Art. 36 (1) implies that the excise goods have been supplied from another Member State (that is, owing to the reference to an acquisition by a private individual established in another Member State). Arguably, these regulations suggest that a mail order transaction does not exist if the seller is established within the tax territory. Generally speaking, this might mean that the delivery to the end customer is not made from another Member State and that the goods have already been introduced from another Member State or are already being held for commercial purposes.

The mail order seller must deliver the goods to a private individual. According to the Directive, the individual cannot be an authorised warehousekeeper or a registered consignee since only small businesses can operate as such. Art. 36 of the Excise Directive clarifies the situation by stating that the individual in question is not allowed to carry out an independent economic activity. The purpose of the provision suggests that such a finding will not be sufficient by itself. Rather, there must be no connection between carrying on an independent economic activity and ordering the goods. Arguably, only this interpretation can ensure that the requirement of a private individual is really satisfied. The finding must be based on objective circumstances. The German regulations adopt a legal fiction: buyers who do not hold themselves out as being the customer whose intra-Community acquisitions are subject to the provisions of the VAT Act, are deemed to be private individuals (see, for example, § 21 (1) sentence 2 BierStG). The wording suggests that the circle of relevant individuals is wider since it is not only the objective circumstances which predominate: the buyer's conduct can also be of crucial importance. It is debatable whether this also applies in cases which already fall within the scope of regulations governing the acquisition and holding of goods for commercial purposes. Theoretically, this may be so if a trader orders goods from a mail order seller for their business but does not inform the latter of this fact. However, the parties themselves (in this case the purchaser) cannot determine whether one and the same intra-Community movement involves a mail order sale or acquisition. Taking the relevant Directives into account, it might not be possible to prove the existence of a mail order transaction.

The dispatch must be made by the distance seller who either performs the supply himself/herself or employs third parties to do so. The 'principal' in charge of the supply must be the mail order seller. Exactly how the supply is arranged is unimportant. The rules do not require that the goods be delivered to respective buyers as individual consignments or that the consignments involve a supply from another Member State.[18]

3.2 Competing regulations

The two regulatory areas affecting the intra-Community trade in goods released for consumption which are subject to the country of destination principle (that is, holding and acquisition for commercial purposes and mail order transactions), require that the dutiable goods physically cross borders. The classification of goods under tax law partly depends on the position of the consignee. In addition, there must be criteria relating to the prior holding of the goods which must reflect commercial purposes rather than consumption. This necessarily leads to the term 'holding' (technically formulated as a catch-all provision), which also applies to cases that satisfy the characteristics of a mail order transaction once they have been performed. At the same time, the compulsory requirement of a movement to a private individual (whether by the distance seller himself/herself or by a third party he/she employs) as part of the mail order transaction represents a holding for commercial purposes. This unavoidable overlap justifies the view that the rule on mail order transactions – which only affects a certain part of intra-Community movements – is the more specific.[19] The relevant provisions of the Directives also appear to point in this direction. Accordingly, the introduction 'without prejudice to Art. 36 (1)' (that is, the rule on mail order transactions) in Art. 33 (1) (that is, regulating the holding and acquisition for commercial purposes) Excise Directive, suggests that this provision remains unaffected and therefore takes priority. The national regulations on excise duties provide similar clarification by referring to the fact that the catch-all provision on the acquisition for commercial purposes (see, for example, § 20 (2) BierStG) does not extend to cases of mail order transactions either.

4. No duties in the case of complete destruction or irrevocable loss

Prior to the Excise Directive, there were no rules governing the complete destruction or irrevocable loss of excise goods and such events did not have any effect under tax law. Now, however, Art. 37 (1) Excise Directive provides that if such events occur in the Member State of destination, excise duty does not become payable in this Member State. The rule 'only' affects new duties which may arise owing to a change in the competence to levy duties. This exception covers all intra-Community movements of excise goods which have been released for free consumption and could incur duties. This results from the reference to Art. 33 (1) (holding for commercial purposes) and Art. 36 (1) (mail order transactions) Excise Directive. Complete destruction may be due to the properties of the goods, unforseeable events, force majeure or an authorisation issued by the competent authorities. It may also occur if the location of the loss cannot be determined (Art. 37 (1) sub-para. 2 of the Excise Directive). Here, it would be necessary to submit sufficient evidence to the competent authority of the Member State in which the loss was discovered. In this exceptional situation, the duty would only be charged if the loss were not discovered in the Member State of departure.

In German excise law (with the exception of the Act on Tobacco Duty) the provisions on acquisitions for commercial purposes or mail order transactions refer to a similar exception which prevents duties arising on release for consumption.[20]

Owing to this reference, the national law also suggests that excise goods will be deemed completely destroyed or irrevocably lost if they can no longer be used per se. This is only expressly stated in the exception to the charging of duties when goods are released for consumption (see Art. 7 (4) sub-para. 2 Excise Directive). Another relevant difference is that, according to national law, duties will not arise if the requirements of the exception are met (see § 20 (3) in conjunction with § 14 (3) BierStG: 'Die Steuer entsteht nicht …'). In comparison, the Directive provides that the excise duty will not be not chargeable (see Art. 37 (1) Excise Directive). The scope of the Directive is arguably more comprehensive since this wording also covers cases where the destruction or loss of goods has only occurred after the conditions for charging duty have arisen. In this case, duty would not be charged even if it was payable. On the other hand, the wording of the German provisions suggests otherwise – which would reflect the system of excise duty up to now. This shows that the timing of individual events can have serious consequences.

5. Irregularities during the movement of excise goods released for consumption in other Member States

Prior to the Excise Directive, a similar criterion for charging duties had only existed in relation to movements under duty suspension. However, Art. 38 Excise Directive transfers the legal concept underlying this rule to intra-Community movements which have already been released for consumption. The rule aims to ensure that there is also a change in the competence to charge duties if such goods are supplied for consumption to another Member State but the movement cannot be carried out properly. In these cases too, the country of destination principle applies. This is justified since even if the irregularity concerned falls within the scope of the applicable legal provisions (as in the case of a 'regular' movement) in the country of origin, it will no longer be possible to point to a consumption which justifies the charging of duties. As a result, this provision closes a gap in the legal regime.

5.1 Scope

The regulations apply to movements which would have given rise to duties had they properly been carried out.[21] This is the acquisition and holding for commercial purposes (see, for example, § 20 BierStG) and mail order transactions (see, for example, § 21 BierStG). Tobacco duty law does not deal separately with liability for duties in the event of irregularities, since this is already dealt with by the existing rule on liability (see § 23 (1) TabStG).

5.2 Irregularity

The event which triggers the charging of duties is the occurrence of an irregularity during movement. However, this must take place within the tax territory since, having regard to the country of destination principle, there would otherwise be no reason for changing the competence to charge duties. There is an irregularity if an event occurs which prevents the movement or part of the movement from being performed. Reference to the definition of an irregularity in relation to the movement under duty suspension ensures terminological uniformity (see, for example, § 22 (2) in connection with §13 (1) BierStG). It also ensures that (as with the movement under duty suspension) complete destruction or loss is not deemed an irregularity. Duty is chargeable when the irregularity occurs. This is systematically correct and acceptable provided duty has not become chargeable under 'normal' conditions. Owing to systematic reasons, additional duties might not be charged if the irregularity only occurs after a buyer has moved goods which they received outside the tax territory into the tax territory.

6. Acquisition by private individuals

In this case, the regulations will apply the country of origin and not the country of destination principle (as with acquisitions for commercial purposes and mail order transactions).[22] Within the Community, there is no change in the competence to charge duties in such cases. Accordingly, the Directive also provides that excise duties will only be charged in the Member State of acquisition (see Art. 32 (1) Excise Directive).

6.1 Own use

As a rule, national relief only applies to excise goods in free circulation in another Member State which are acquired by a private person. The acquisition must serve the individual's own use. In order to perform this assessment, the legislator has adopted the criteria listed in Art. 32 (2) Excise Directive.[23] The following aspects have to be considered: the position in commercial law; the reasons the owner has for holding the goods; the location of the goods; type of transportation documents accompanying the goods as well as the properties or quantity of the goods. Quantity tends to be used because it is generally easy to establish. Threshold quantities are established by the Customs Code Implementing Provisions and if they are exceeded, there is an irrebuttable presumption that the excise goods have been moved into the tax territory for commercial purposes.[24] This does not involve duty-free allowances since the overall circumstances may indicate an introduction for commercial purposes even though the stated quantities have not been exceeded. On the other hand, an introduction can also be made for private purposes, despite the fact that the threshold quantities have clearly been exceeded.

If the excise goods introduced into the tax territory are to be consumed by the private individual himself/herself, there is little doubt that the 'own use' requirement is satisfied. This is not the case where the goods are intended to be a present for a third person (souvenirs), since ultimately they are to serve the needs of a third person. Here, the question is whether consumption for 'own use' is the predominant reason for charging duties. If so, it would be impossible to pass the goods on to someone else – even if there was no consideration involved. However, if this really was the legislator's intention, it would surely have been better expressed by reference to 'own consumption'. However, neither the Directive nor national legislation contains such wording.

6.2 Moved into the tax territory 'himself/herself'

The requirement 'himself/herself' is only satisfied if the private person has acquired the goods for his/her own use and personally moves them into the tax territory.[25] Having the goods moved does not justify applying the country of origin principle. However, this also means that excise goods in the form of household effects, which are moved from one residence to another, will attract duties if a forwarding company has been employed to perform the move.[26]

6.3 Legal consequences

According to the wording, excise goods are duty free. However, this is declaratory in nature and only serves to clarify matters since this 'legal consequence' does not result in any duty being charged. In the classical case, duty will be chargeable in the absence of a duty exemption. However, there is no reason to charge duties if a private individual moves goods into the tax territory which are intended for his/her personal use.

The comparable 'duty exemption' under energy taxation law is subject to more extensive restrictions partly due to road security considerations. If they are not complied with, duty will be chargeable in accordance with Art. 31 (4) Excise Directive. The other statutes on excise duty do not need a separate duty liability clause in the event that the 'requirement for exemption' is not met because such cases are already covered by the provisions governing acquisition and holding for commercial purposes.

Notes

1 Translated into English from German by Christopher Dallimore, LL.B (Cardiff), Mag. Iur. (Trier), Dr. Iur. (Münster).

2 This analysis is based on the author's comments in Bongartz & Schröer-Schallenberg 2011, Verbrauchsteuerrecht, and in Bongartz (Hrsg.), Kommentar zum EnergieStG und StromStG.

3 Council Directive 92/12/EEC on the general arrangements for products subject to excise duty and on the holding, movement and monitoring of such products of 25 February 1992, O.J. L 76/1 was superseded by Council Directive 2008/118/EC concerning the general arrangements for excise duty and repealing Directive 92/12/EEC.

4 According to one study, the share of goods released for free consumption of the total volume of trade in excise goods is approximately 3%: see Jatzke 2009, ZfZ, p. 121.

5 Concerning the difficulties of interpretation, see Scheuer 2000, ZfZ, p. 255; Jarsombeck 2001, AW-Prax, p. 419.

6 Jatzke 2009, ZfZ, p. 121.

7 See Schröer-Schallenberg & Bongartz 2009, Überblick über die Einführung von EMCS, ZfZ, p. 161.

8 § 23 TabStG; § 149 BranntwMonG; § 20 SchaumwZwStG; § 29 iVm § 20 SchaumwZwStG; § 20 BierStG; § 17 KaffeeStG; § 15 EnergieStG; § 34 iVm § 15 EnergieStG. The terminology is not uniform in all Acts; the title to § 15 EnergieStG refers to a 'Verbringen'.

9 For the details, see Bongartz & Schröer-Schallenberg 2011, Verbrauchsteuerrecht, pp. 102 f.

10 See Jatzke 2009, ZfZ, p. 121, who argues that Art. 33 (1) Excise Directive contains a standardised criterion for the incurrence of duties.

11 See Schröer-Schallenberg 2002, Besitz einer verbrauchsteuerpflichtigen Ware als Anknüpfungspunkt für eine Steuerentstehung?, ZfZ, p. 293.

12 See also judgment of the BFH of 10 October 2007 VII R 49/06, ZfZ 2008, pp. 85; 86.

13 See Jatzke 2009, ZfZ, p. 121.

14 Until 30 June 1999, Art. 28 of Directive 92/12 granted Member States corresponding duty free sales. After the expiry of the transition instrument, the Commission provided a procedure in a Communication (1999/C99/08, O.J. C 99/20) which could prevent the realisation of a criterion for the incurrence of duty in another Member State, see Jatzke 2009, ZfZ, p. 121.

15 According to Jansen 2010, ZfZ, p. 89 this instance of mail order selling involves a sub-category of the introduction for commercial purposes.

16 § 150 BranntwMonG; § 21 SchaumwZwStG; § 21 BierStG; § 18 KaffeeStG; § 18 EnergieStG.

17 Figuratively speaking, Schröer-Schallenberg 1993, ZfZ, p. 305 f., correctly describes the acquisition by private persons as holiday traffic (Reiseverkehr).

18 Judgment of the BFH of 14 April 2003 VII B 267/02, BFHE 202, p. 91, ZfZ 2003, p. 269 f.; decided differently by the lower court: see judgment of the FG Munich of 26 June 2002 3 K 5449/99.

19 Referring to the statutory reasons for § 11 KaffeeStG in the Excise Duties – Internal Market Act/'Verbrauchsteuer-Binnenmarktgesetzes' (BT-Drucks. 12/3432, p. 94) the BFH held that in cases of mail order transactions, the duty was only chargeable on delivery despite the fact that the goods were held for commercial purposes prior to delivery (BFH 24 November 2009 VII B 223/08, ZfZ 2010, pp. 136, 138).

20 § 149 (3) BranntwMonG; § 20 (3) SchaumwZwStG; § 20 (3) BierStG; § 17 (3) KaffeeStG; § 15 (2) a EnergieStG.

21 § 151 BranntwMonG; § 22 SchaumwZwStG; § 22 BierStG; § 19 KaffeeStG; § 18 a EnergieStG.

22 § 22 TabStG; § 148 BranntwMonG; § 19 SchaumwZwStG; § 19 BierStG; § 16 KaffeeStG; § 16 EnergieStG.

23 § 22 (2) TabStG; § 148 (2) BranntwMonG; § 19 (2) SchaumwZwStG; § 19 (2) BierStG; § 16 (2) KaffeeStG. These criteria have not been adopted by the Energy Taxation Act (Energiesteuergesetz) owing to special restrictions.

24 Quantity thresholds: 800 cigarettes, 200 cigars, 400 cigarillos or 1 kg smoking tobacco, § 39 TabStV; 10 l spirits, § 38 BrStV; 60 l sparkling wine, § 33 SchaumwZwStV; 20 l intermediate products, § 44 SchaumwZwStV; 110 l beer, § 34 BierStV; 10 kg coffee or goods containing caffeine, § 23 KaffeeStV.

25 ECJ 23 November 2006 case C-5/05, ECR 2006, I-11075-11124, ZfZ 2007, p. 19 f.

26 Regarding this and similar special cases, see Scheuer 2000, ZfZ, p. 256, who also identifies a gap in the provisions concerning the introduction for private purposes.

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Tackling cigarette smuggling with enforcement: case studies reviewing the experience in Hungary, Romania and the United Kingdom

János Nagy[1]

Abstract

This paper provides an overview of the approaches taken to address cigarette smuggling and focuses on the experiences of Hungary, Romania and the United Kingdom to reduce illicit trade in tobacco products. The author identifies the significance of highly taxed tobacco products as contributors to government revenue and the efforts made to stabilise that market. The impact of campaigns to highlight health considerations, coupled with legislation to enable customs authorities and police departments to enforce the law can help to reduce the illegal trade in tobacco products. However, if national governments raise sharply, in a short period of time, the excise duty on, for example, cigarettes, illegal activities may rise. An important lesson learned is that the tobacco industry, if consulted by governments, can contribute to the success of law enforcement and reinforced controls by sharing critical information with customs and excise authorities and cooperating more closely with government agencies.

1. Introduction

Tobacco products represent a very special and important group of the highly taxed excisable goods contributing significantly to government revenue and constituting a relatively stable market in many countries. Therefore, it is important to understand the nature of this market and the mechanisms of effects of the most important factors influencing changes.

These factors include reduction in demand or education of people on the one hand; the reduction of illegal supply or enforcement of regulations on the other hand; and finally, government policies, tax and excise practices. We will see that a strong correlation exists among the above three factors. This article is to introduce my research focused on periods of significant changes: sharp increases in rates of excise duties and, as a consequence, sharp increases in smuggling activities and the growing share of the illicit market. Such sharp increases in duties could be triggered by enhanced needs to collect more revenue for governments, or by fundamental changes in the geopolitical situation, political requirements and in the important factors of the economic environment.

It is worth noting that at periods of widespread economic crises (like the world economic and financial crises these past years) the need for more revenue by governments and raising duties on excisable goods is almost a natural phenomenon. There are several and relatively popular arguments (for example, luxury product, health considerations) available to governments to justify the raising of duties on cigarettes. Another good example is the massive enlargement of the European Union (EU) in 2004 and 2007 when 12 countries joined the EU under the obligation to raise their duty level significantly within a short period of time up to the minimum rate required by the standards of the EU. This requirement was an important factor in the fast increment in duty rates both in Hungary and Romania.

However, this study will focus on enforcement and will present three good practices where more effective customs controls played a key role in curbing cigarette smuggling, securing a stable cigarette market for the industry and the revenue expected by the government. The Global Excise Forum co-hosted by the World Customs Organization (WCO) and the International Tax and Investment Center (ITIC) in Brussels on 2-3 July 2012 provided an opportunity to share the first findings of this study undertaken by the author and to review recent positive experiences in three European countries: in Hungary, Romania and the United Kingdom (UK). The author relies mainly on his own notes concerning Hungary, and, if not indicated otherwise, facts are based on information received through direct interviews with key managers responsible for the development and implementation of anti-cigarette smuggling programs of customs administrations in the three countries.

2. Hungary

2.1 Background

The period researched in Hungary covered the years 2000 to 2012.

Hungary's geographical situation is very sensitive, sharing common borders with seven countries three of which form part of both the EU and the Shengen zone (Austria, Slovakia and Slovenia), while Romania is a member of the EU but not of Shengen, and Croatia will soon become a member of the EU. Serbia and Ukraine are outside the EU. The level of excise duties is significantly higher in Austria, practically the same in the other EU members (Romania, Slovakia and Slovenia) and Croatia, but much lower in Serbia and Ukraine creating a lot of incentive for smuggling of cigarettes from these latter two countries.

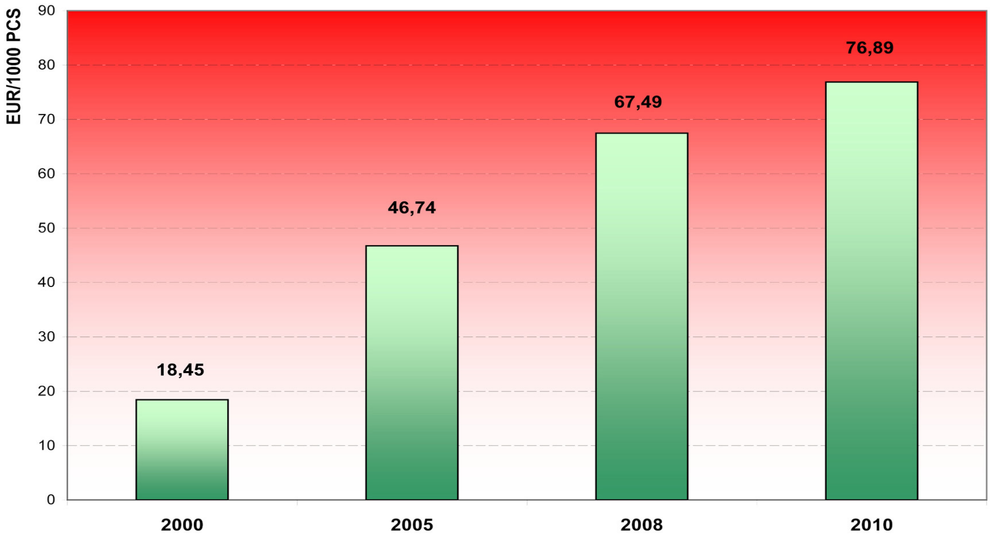
Romania is a special case (see also section 3, which deals specifically with the situation in Romania) as historically the level of cigarette excise duties was lower than the minimum EU rate between accession to the EU by neighbouring Hungary, Slovakia and Slovenia in 2004 and by Romania in 2007. It is worth mentioning that both Hungary and Romania successfully negotiated under their respective EU accession agreements transitional periods and got temporary derogation from under the application of the EU minimum rate of excise duties for cigarettes in order to ensure a softer landing in the EU with regard to increasing cigarette prices. This was also the basis for Hungary to introduce a temporary limitation on the duty free importation of cigarettes from Romania (and Bulgaria that joined the EU with Romania at the same time) until the end of 2009 to protect the cigarette markets in the other 25 EU countries from distortion by the transitional low cigarette duties and prices in Bulgaria and Romania.

Nevertheless, the incidence of excise duties has grown sharply in Hungary since 2000. Table 1 shows this evolution of quantitative rate for the Most Popular Price Category (MPPC) cigarettes for 1,000 sticks in Euros.

As a consequence, cigarette prices soared by 80% between 2000 and 2005 giving rise to smuggling activities from Romania, Serbia and Ukraine. The growing black market reduced the size of the legitimate market by 30% in the same period; meanwhile, the demand for hand-rolling tobacco quadrupled due to the lower rate of duty compared to cigarettes. The duty content of cigarettes is still three to four times higher in Hungary (eight to ten times higher in the UK) as compared to Serbia and Ukraine in 2012 although the latter two are slowly but steadily closing up.

The share of the illicit market quickly reached an alarming level of 25% in 2005. Immediate intervention was imperative from the customs and excise administration to change the negative trends and the catastrophic forecasts for the coming years.

Table 1: Excise duty level of cigarettes in Hungary



Source: Hungarian Customs & Finance Guard (HC&FG)

2.2 Action against cigarette smuggling

From 2005, a number of action plans were specifically designed and implemented to reduce smuggling activities. The measures included:

- transfer of customs staff from west to the eastern borders
- more security elements on excise stamps for cigarettes
- application of excise controls and sanctions at the border crossings from 2006 (seizure of vehicles used for smuggling as a guarantee for the payment of outstanding excise duties)
- limiting the duty free imports to two packs at road crossing points from 2009
- limiting the duty free imports to only one occasion per week from 2012
- reinforcement of integrity of customs officers through education and more controls, investigations
- a new system of motivation, paying direct and automatic premiums to customs and police officers detecting illegal shipments of cigarettes
- creation and deployment of mobile teams effecting controls any place inside the country
- organisation of excise controls along the Romanian border during the transitional period of 2007-09
- closer cooperation with police and immigration in intelligence and internal investigations
- deployment of one stationary X-ray to screen all railway wagons arriving from Ukraine, and a number of mobile X-ray units for the control of trucks and containers
- modernisation of training of cigarette detector dogs and their handlers, and the provision of assistance to other countries in the development of their own detector dog programs (Romania and Cyprus)
- reinforced controls along the green borders (between two border crossing points) through joint patrols with border guard/police
- more cooperation with sister law enforcement organisations in other countries on bilateral bases (Romania, Ukraine), multilateral bases (together with the Netherlands in relation to Ukraine) through EU institutions (OLAF, Europol, Eurojust) and the Southeast-European Cooperative Initiative/Centre

for Fighting Cross-border Crime, and last but not least

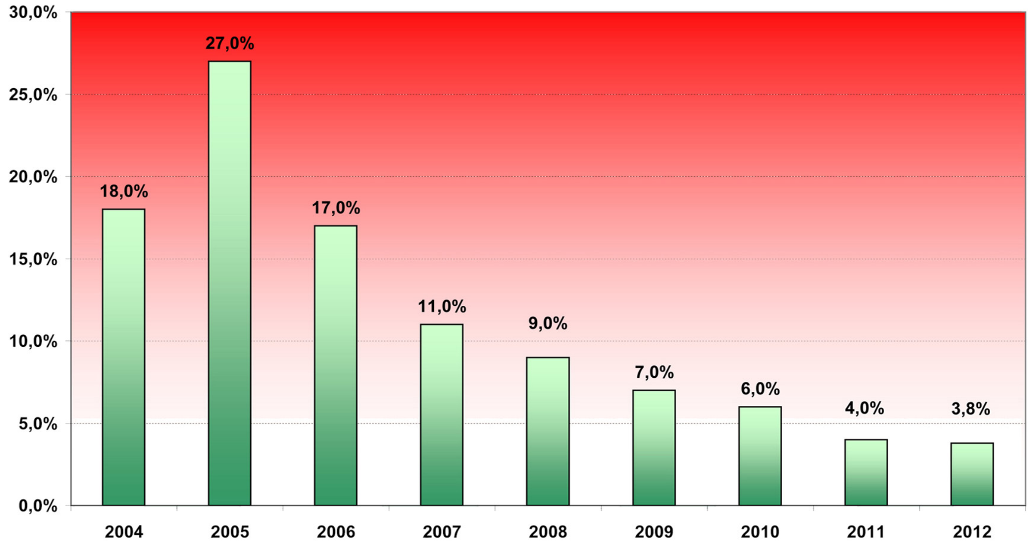
- more cooperation with the Hungarian tobacco industry in sharing information.

It should be emphasised that a new field management style including fast reactions to changing smuggling patterns, detailed control protocols issued and explained to the frontline customs officers, and strict controls by line managers contributed to a large extent to the success of operations.

2.3 The positive results

The success is clearly demonstrated by the results of an independent research ordered regularly by the Hungarian Association of Tobacco Industry and undertaken each year (at the same time – in May, applying the same method – empty boxes) by the market research company GfK into the share of the illicit market. Table 2 shows the very convincing data of this research.

Table 2: Share of illicit cigarette market in Hungary

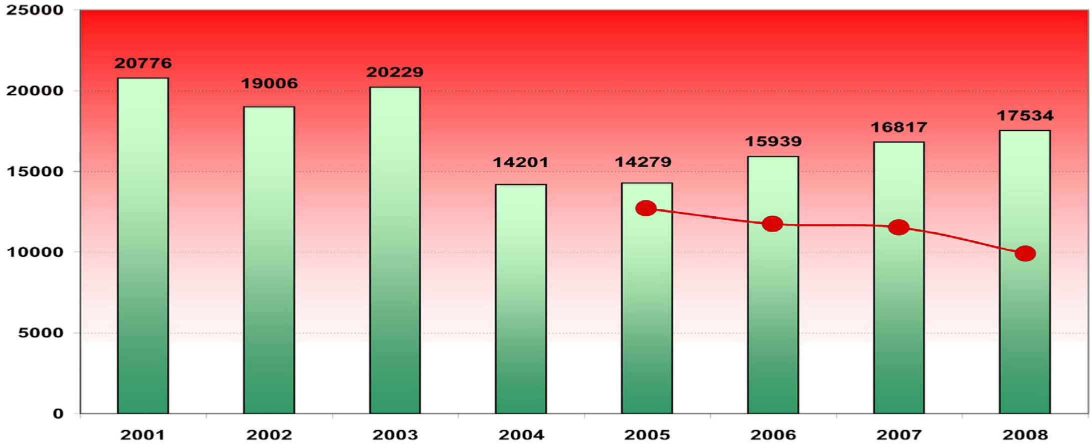


Source: Hungarian Customs & Finance Guard (HC&FG)

As a result of the successful fight against cigarette smuggling the legal market started to pick up and against the original negative outlook, proved to be evolving. In Table 3, the red line (from 2005 to 2008) indicates the expected further shrinking of the market without strong intervention from Customs & Finance Guard and the green columns indicate the factual evolving of the taxed cigarette market.

The series of operations successfully saved the Hungarian cigarette market and one-third of the excise revenue which together with other taxes from the tobacco industry represent about 3% of all central government revenue.

Table 3: Cigarette consumption: the taxed market (in million sticks)



Source: Hungarian Customs & Finance Guard (HC&FG); GfK Research ordered by the Hungarian tobacco industry

3. Romania

3.1 Background

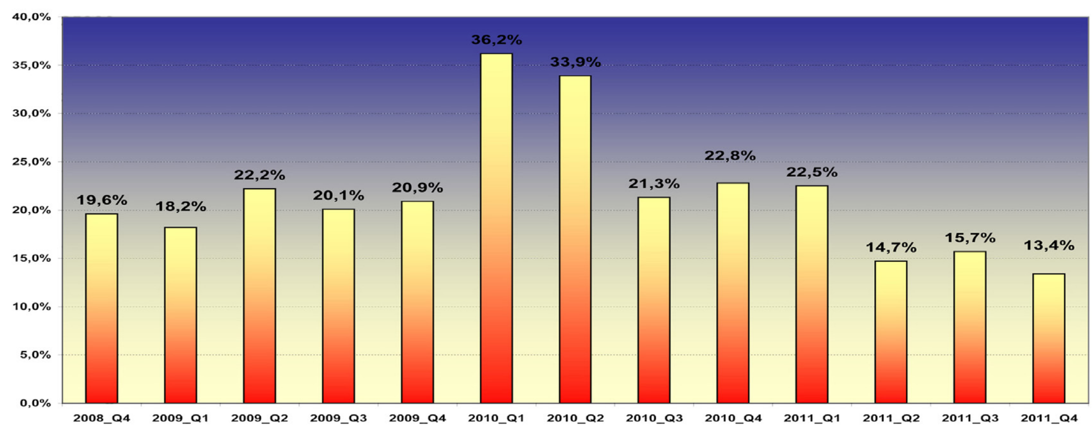
The study covered the years 2009 to 2011. The reason behind this is that Romania recorded the worst year of a growing black market of cigarettes in the first quarter of 2010 and a number of measures followed to solve the problem.

Romania joined the EU in January 2007 and had to raise its rate of excise duty on cigarettes to the minimum rate expected by the EU after a three-year transitional period that expired at the end of 2009.

Table 4 clearly shows that after a sharp increase of the duty rate the share of the illicit cigarette market grew to a record 36% at the beginning of 2010, according to an estimate from Japan Tobacco International (JTI).

Smuggling activities from Ukraine, Serbia and Moldova were on the rise, threatening the collapse of the legitimate market. Smuggling through the green borders, representing up to 85% of all cigarettes smuggled, seems to be a very challenging job for the Romanian authorities.

Table 4: Share of illicit market in Romania



Source: Romanian National Customs Authority (RNCA)

3.2 Actions against cigarette smuggling

The Romanian customs administration drew up two strategies to tackle cigarette smuggling. The first governed activities of the customs authorities from 2010 to 2012, and the second, from 2012, is a plan currently under implementation. The first action plan was targeted to:

- create a better legislative framework
- strengthen the administrative capacity of Customs
- focus on specific and more effective controls to curb cigarette smuggling.

The second action plan currently in force sought more cooperation from the Financial Guard, Border Police, and the Intelligence and Internal Protection services. The strong support from high level decision makers, ministers, and the commitment from heads of sister and cooperating agencies was extremely important to the success of the implementation of the various actions. The decision from the High Council on Country Defence setting the prevention of and combating tax evasion as a top priority proved to be a decisive factor.

The measures applied under the two strategies include:

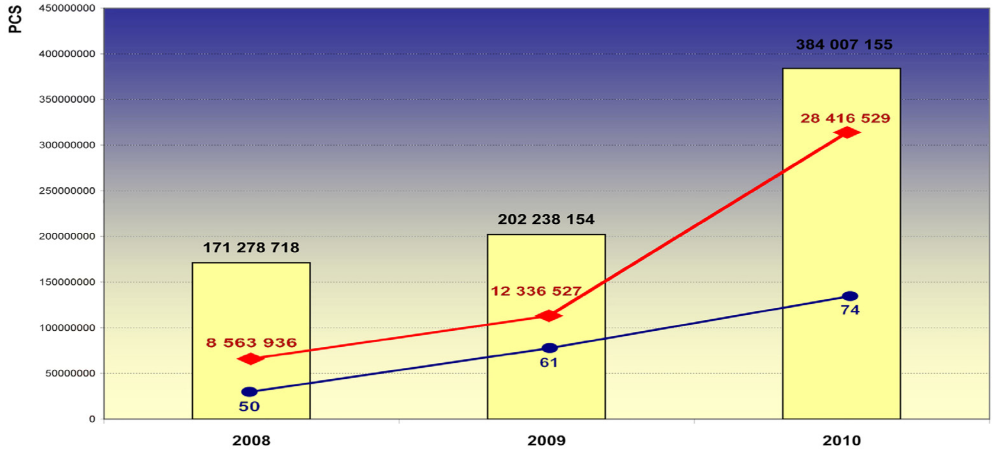
- changes in laws and regulations to allow the seizure of vehicles modified for smuggling purposes
- restrictions on duty free importation
- redefinition of the terms ‘smuggling’ and ‘excise fraud’ to allow more effective investigation and prosecution
- restrictions on the activities of tax free shops selling duty free cigarettes at the Romanian land border crossing points
- new legislation to allow financial institutions to cooperate with Customs and release information needed to ensure efficient intelligence, investigations and prosecution
- speeding up of court proceedings related to cigarette fraud
- amendment to legislation allowing the successful investigation of excise fraud committed by foreign citizens
- amendment in appropriate legislation criminalising the marketing and selling of excisable goods inappropriately marked or without proof of origin
- introduction of intelligent seals containing useful information
- implementation of a new system of monitoring and risk management.

It is important to note that key players of the industry (JTI, BAT and PM) were consulted in the course of drafting the action plans. One member of the industry (JTI) directly contributed to the training of cigarette detector dogs to the value of EUR30,000 resulting in the deployment of 38 new canine teams. A number of new X-ray scanners supported the carrying out of faster, non-intrusive controls of customs enforcement. The newly created 110 mobile units were equipped with new vehicles and communication tools. Training in their use took place in the new training facility in Giurgiu. The reorganisation of the customs service in July 2010 helped to enhance the effectiveness of activities.

Cooperation from other law enforcement agencies was instrumental in achieving success, particularly in the management of a central cigarette seizure database by police, and the creation of joint customs/police anti-smuggling teams. The cooperation from police was essential also in gathering quality intelligence and fighting corruption. Similar cooperation with other countries, the neighbouring countries in the first place and with international organisations like the EU and the Southeast European Law Enforcement Center (SELEC – formerly Safety Environmental Control Inc. [SECI]) was also indispensable.

Table 5 contains statistics on the quantities of cigarettes seized (in sticks – yellow columns), the amount of excise duties due on the seized cigarettes in the same years (in Euros – red upper line), and the level of excise duties for 1,000 sticks (also in Euros – blue lower line).

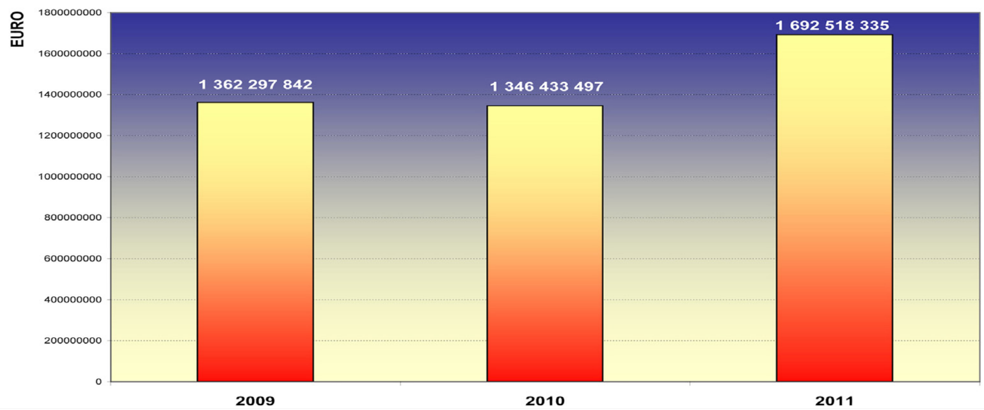
Table 5: Statistics on Romania



Source: Romanian National Customs Authority (RNCA)

The ultimate objective of the action plans was, of course, to stabilise the market and ensure law and order by collecting the excise revenue on the cigarettes sold on the legitimate market. Table 6 shows the evolution of excise duty revenue on cigarettes from 2009 to 2011 (in Euros), clearly demonstrating that the investment in improved customs control capacities paid off very well.

Table 6: Excise duty revenue on cigarettes



Source: Romanian National Customs Authority (RNCA); Novel Research

4. United Kingdom

4.1 Background

The background and the situation in the UK differ greatly from the previous two countries.

The UK excise duty level has been traditionally one of the highest compared to the rest of the world. This level has been increased further by the long term decisions of UK governments to reduce smoking for health considerations rather than for raising excise revenue. However, independently from the motivation behind the effects of sharply raising duties on cigarettes, have been the same: more smuggling and higher share of the illicit market threatening not only the excise revenue but also the failure to reduce smoking.

Even though the UK lies far away from the European countries that are the champions, having the lowest rates of excise duties on cigarettes, still the UK is one of the most popular target countries for smugglers due to its high duties and prices.

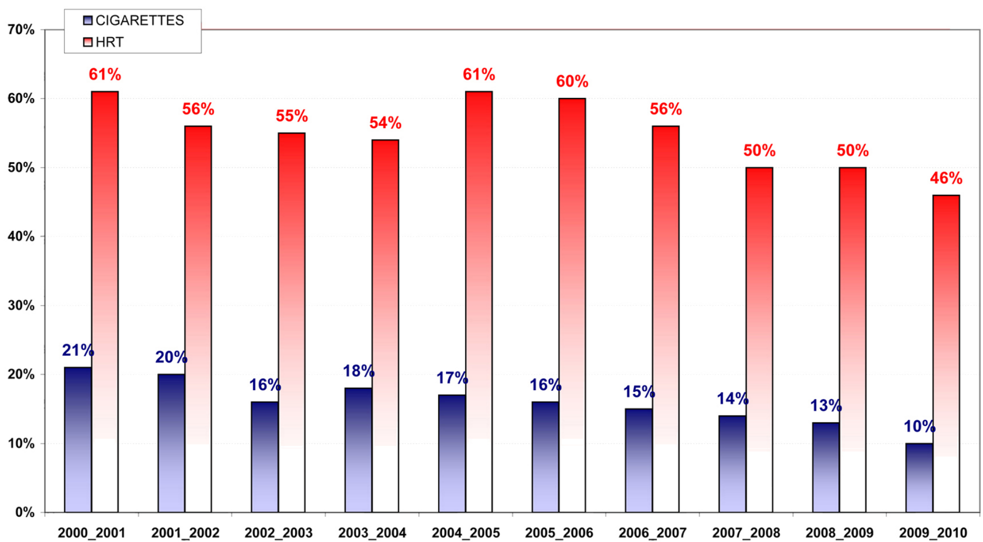
This factor does not affect only illegal imports from countries having very low rates of excise duties outside the EU. The relatively high difference in prices triggered both organised and small scale, but widespread (so-called ant trade) from across the Channel.

As an important trading nation and having major container hubs and sea ports, the high volume of cargo and in particular the high number of containers arriving in the UK, make the country vulnerable to smuggling. The practice of export of legitimate cigarettes and the subsequent re-importation of the same consignment created a lot of headache for customs officers. As soon as this type of fraud had been reduced, counterfeit cigarettes were on the rise in the market produced and brought in mainly from outside Europe. The share of counterfeit cigarettes among the confiscated large consignments was “only” 15% in 2001-02, but it was already 48% in 2003-04. (It is interesting to note that the share of counterfeit cigarettes on the Hungarian illicit market is below 0.1% at any time.)

My study covered the critical period from 2000 to 2011 and followed the implementation of four strategies from March 2000, through 2006 and 2008, until the strategy adopted in April 2011 and still in force. The published policy has been to increase the cigarette excise duty level each year at the beginning by 3%, later by 5%. In order to offset the expected growth in smuggling and other illegal activities the strategy foresaw the reduction of the illicit market by one-third in three years.

The evaluation of the situation showed that the UK government was losing GBP2.5 billion of tobacco-related revenue in 1999 due to the consumption of untaxed cigarettes (HMRC 2000, p. 5). The size of the illicit market grew from 18% in 1999-2000 to 21% in 2000-01 (HMRC 2000, p. 13). According to a Customs estimate 70-80% of illegal cigarettes arrive in the UK in freight and lorries, and the remainder mainly by ferries across the Channel (HMRC 2000, p. 5). The problem of smuggling of hand-rolling tobacco seems to be a special case in the UK with a relatively high rate of smuggling. The share of illicit hand-rolling tobacco in the market was close to 80% in 1999. Table 7 shows the fall in the share of hand-rolling tobacco in the illegal market from 61% in 2001 to 46% in 2010 and that of cigarettes from 21% in 2001 to 10% in 2010 (HMRC 2000, Chart 4, p. 5).

Table 7: Illicit market share (percentage)



Source: HM Revenue & Customs, Measuring Tax Gaps, Official Statistics Release, 21 September 2011, pp. 25, 26, middle-point of estimates range

4.2 Implementation of the four Strategic Papers

The UK Customs & Excise department embarked on a wide sweeping and focused reform to reinforce its capacities to tackle financial fraud and specifically cigarette smuggling as from 2000. The major elements of this reform are:

- changes in the organisational structure and priorities, including the integration into a single revenue authority leading to the establishment of HM Revenue & Customs (HMRC)
- further reorganisations: closer cooperation in border controls with HM Border Agency/Border Force and the creation of the Serious Organised Crime Agency from 2013 focusing attention on important and dangerous criminal activities
- deployment of X-ray scanners
- application of fiscal marks on cigarette packs to assist controls
- staff deployed at critical control points to reinforce control capacities by raising the staffing level of HMRC.

Important changes occurred in policies; the seizure of vehicles used for smuggling became automatic.

The adoption in 2006 of the Supply Chain Legislation made sure that cigarettes are produced only for the legitimate markets preventing fraud with re-importation. A new type of fiscal penalty has been introduced for fraud under this law and for failure to apply the fiscal marks as required by legislation (HMRC 2006, pp. 9-10).

These measures also ensured the disclosure by the cigarette industry of important information to HMRC.

Stronger and closer cooperation from the tobacco industry, allowing tracing of legitimate shipments, played an important role in the success of the anti-smuggling strategies.

The UK governments heavily invested in enforcement and controls ensuring the extra financial resources under the various strategies to cover the expenses of the extra 1,000 personnel and technical aids to detection. Under the first strategy, GBP209 million was made available for the years 2000 to 2003 to reinforce controls by HM Customs & Excise. Under the latest strategy a further GBP25 million was specifically devoted to the fight against cigarette smuggling.

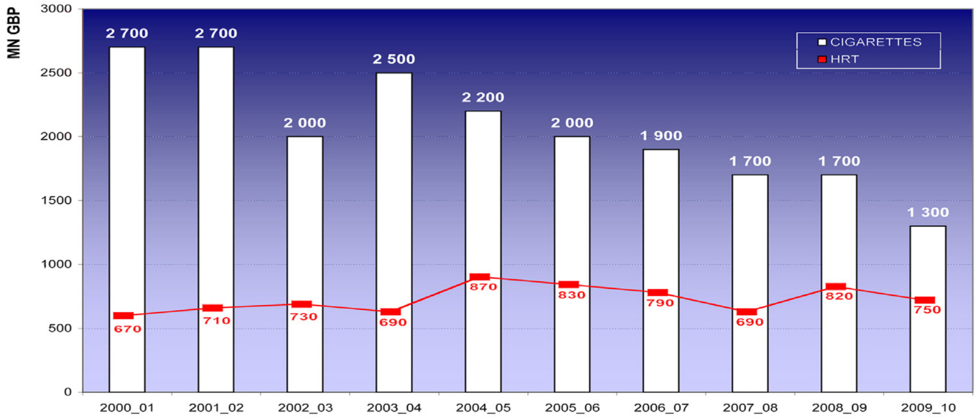
Finally, I have to emphasise that a strong publicity campaign to educate the general and the smoking public is a peculiarity of the UK cigarette anti-smuggling strategies.

Similarly to the other two countries, cooperation with other law enforcement agencies in foreign countries, including the extensive use of customs attachés employed abroad, contributed significantly to the increase in seizures and successful prosecutions.

The expectation in return is to raise GBP7 billion extra revenue for the UK government's budget in the next five years.

Table 8 demonstrates the positive result of the strategies reducing significantly the losses of the UK budget through cigarette fraud.

Table 8: Duty + VAT unpaid



Source: HM Revenue & Customs

5. Conclusions

The following are the main lessons that can be drawn from the cases presented above of the three countries:

1. If national governments decide to raise the excise duty of cigarettes relatively sharply within a short period of time, it is very likely to give rise to illegal activities, including the smuggling of cigarettes. Therefore, as far as possible, the same extent of increase should be implemented over a longer period and in a predictable way to avoid the shock to the cigarette market.
2. Adequate political support, financial and human resources should be made available to the customs and excise departments to efficiently tackle cigarette fraud.
3. The tobacco industry should be consulted by the governments to identify the best timing and methods of implementing the change in cigarette policies and taxation. The tobacco industry can contribute to the success of law enforcement activities and reinforced controls by sharing critical information with customs and excise and cooperating more closely with government agencies.

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Note

1 This paper was prepared in July 2012; the findings, interpretations and views expressed are those of the author.

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The linkage between tax burden and illicit trade of excisable products: the example of tobacco

Adrian Cooper and Daniel Witt

Abstract

Illicit trade in tobacco is now a global phenomenon. Experience across both advanced and developing economies demonstrates that the key economic drivers influencing the illicit tobacco trade are excessive tax levels, usually resulting in a sharp decline in cigarette affordability, and organised crime's willingness to supply given the opportunity to gain large profits from tax avoidance. However, when cigarette affordability is taken into account, excise levels and revenues can be increased while consumption is reduced and the illicit trade is kept in check. The clear implication is that recommendations for a 'one size fits all' global excise tax incidence target of 70%, as proposed by the World Health Organization (WHO), would be very destabilising if implemented. Excise incidence is flawed as the basis for setting tax policy, as the WHO has acknowledged in its own country research. International experience, including that of the European Union (EU) accession countries, clearly shows that countries which have implemented the sort of substantial tax increases that the WHO's proposals would imply have seen a sharp rise in illicit trade in cigarettes, damaging the long-term tax base and undermining public health objectives.

1. Introduction

The World Health Organization's (2003) *Framework Convention on Tobacco Control* defines the illicit trade in tobacco as: 'any practice or conduct prohibited by law and which relates to production, shipment, receipt, possession, distribution, sale or purchase including any practice or conduct intended to facilitate such activity'.[1]

Illicit trade in tobacco is now a global phenomenon, covering all continents, and high- and low-income countries alike. According to the Framework Convention Alliance (2008), approximately 11% of the world cigarette market in 2006 was illicit, resulting in annual government revenue losses of over USD40 billion. KPMG (2012) estimates that 10.4% of all cigarettes consumed in the European Union (EU) in 2011 were illicit, with the annual EU-wide tax loss due to cigarette smuggling reaching approximately EUR11.3 billion.

The illicit trade in tobacco not only undermines government tax revenues. It also weakens public health initiatives to curb tobacco consumption by making cheaper cigarettes available in an unregulated environment where they may be sold to minors. Legitimate manufacturers and suppliers of tobacco products are impacted as, in addition to lost income, illicit trade distorts competition in the market, undermining investment in innovation, distribution, brand equity and employment. Moreover, the development of the illicit market for cigarettes strengthens the infrastructure that can be used to support increased illicit activity in other markets. The World Economic Forum (2012, p. 5) indicates that increases in illicit activity foster the development of additional criminal activity, through expansion driven both by profits gained and by ‘competitive violence with rival groups and with law enforcement’ to protect illicit markets. As Shelley notes, terrorists are increasingly drawn towards illicit cigarettes for funding as ‘it commands limited attention from law enforcement [and] terrorists seek to secure funding in ways that draw the least attention to themselves’ (Shelley 2009, p. 4).

The International Tax and Investment Center (ITIC) and Oxford Economics have analysed global excise taxation issues since 1996. Our research has focused on excise taxation structures and rates, the relationship to compliance rates, the development of legitimate versus illegitimate markets, and government revenues. ITIC regularly brings together government and parliamentary officials with independent experts and industry representatives to discuss the findings of our studies and their implications for policy reforms.

In this paper, we draw on that research to examine the linkage between tax burden and illicit trade of excisable products, using tobacco as an example. In section 2 we begin by discussing the important influence that the affordability of cigarettes – which is heavily influenced by the excise burden – has on illicit trade. We then illustrate this with case studies in section 3. The destabilising impact of sharp increases in excise burden and the resulting deterioration in affordability has not prevented some organisations, such as the World Health Organization (WHO 2011a), from recommending that excise taxes should be increased in all countries to at least 70% of retail prices. We set out some of the key flaws in this ‘one size fits all’ proposal in section 4, and in section 5 highlight lessons in this regard from the experience of the accession countries which have joined the EU since 2004. Our conclusions are in Section 6.

2. The influence of affordability of illicit trade in tobacco

In a January 2003 ITIC-Oxford Economics study, *The relationship between taxation, consumption and smuggling of tobacco*, we introduced the concept of ‘affordability’ as a key underpinning principle for tobacco tax policy design. This study measured the overall affordability of cigarettes as a proportion of daily disposable income per capita required to purchase one pack of 20 cigarettes. Further ITIC-Oxford Economics studies on the EU (2006) and the ASEAN (2005) region utilised the affordability concept as a means of evaluating the appropriate weight of tobacco taxation to ensure countries at different levels of development are not forced to apply the same level of excise burden.

Building on these analyses, the ITIC publication, *The Illicit Trade in Tobacco Products and How to Tackle It* (2011) further explored the linkage between excise tax levels, affordability, tax collections and illicit trade in tobacco. The major finding of this study is that the economic drivers influencing the illicit tobacco trade are excessive tax levels, usually resulting in a sharp decline in cigarette affordability prompting consumers to switch to cheaper illegal alternatives, and organised crime’s willingness to supply given the opportunity to gain large profits from tax avoidance.

Often the extent of cigarette smuggling in a country is explained by the extent of corruption, and weaknesses in governance and law enforcement. We would challenge the claim that these factors are more important in influencing smuggling than consumer affordability. As we show in the next section, the experiences of the UK, Germany, France, Canada, Ireland and Singapore – some of the least corrupt countries in the world with very effective law enforcement and administration (Transparency International 2011) – demonstrate that high excise tax burdens which lead to a decline in affordability can generate a serious problem with illicit trade.

Whilst strong penalties for large-scale smuggling and heightened enforcement are key devices to tackle the illicit trade in high-tax countries, it is also necessary to monitor tax and price levels in neighbouring countries to limit cross-border flows which, due to their low-quantity/high-frequency nature, are particularly difficult to control.

Using affordability as a measure of the effect of cigarette taxation is advantageous for policymakers as it provides a guide to the potential effect of excise policies on market stability (which can be measured by the level of illicit trade in a market). In theory, governments continuously monitor the scale of the illicit trade when increasing excise taxes, enabling them to act quickly if the illicit market shows signs of growth by, for example, slowing or suspending tax increases while implementing stronger enforcement measures. However, the past experiences of most countries indicate that governments tend to act only after the illicit trade has become endemic – a point when such action is too late.

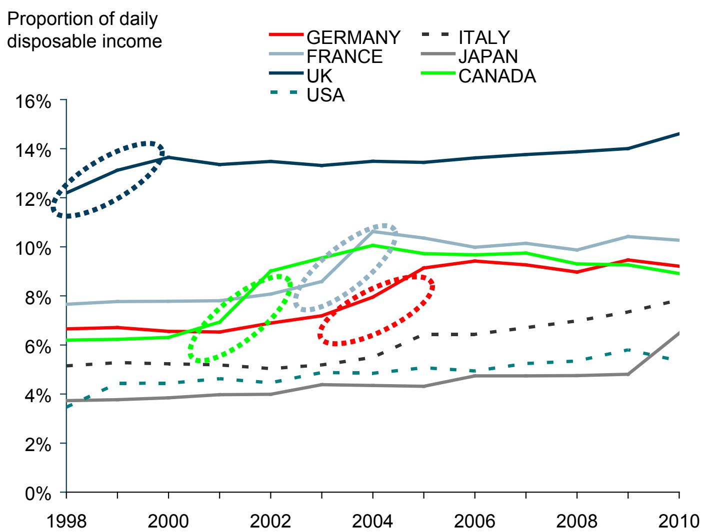
3. International experience illustrating the linkage between affordability and illicit trade

The experiences of countries and regions around the world provide a broad bank of evidence as to how different approaches to tobacco taxation can result in different outcomes for the tobacco market. In this section, we look first at the contrasting experience of the so-called G7 economies (US, Japan, Germany, France, UK, Italy and Canada), and then present case studies from Malaysia, Singapore and Ireland.

3.1 G7 country experiences

Between 1995 and 2010, there was diversity in the rate at which G7 nations increased their excise duties levied on tobacco. The cigarette markets of Canada, France, Germany and the UK have all experienced marked increases in excise duty and prices. This resulted in a marked deterioration of affordability and an expansion of illicit trade (see Figures 1 and 2).

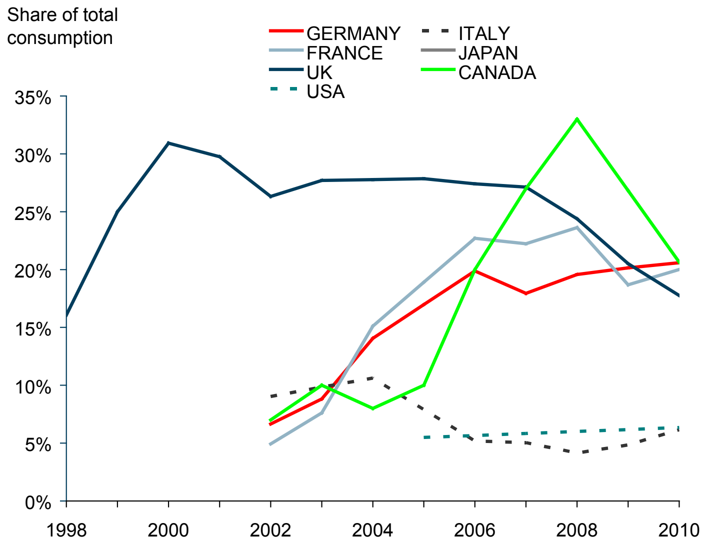
Figure 1: Evolution of cigarette affordability in selected G7 countries, 1998-2010



Source: Oxford Economics; European Commission; 'The tax burden on tobacco, smoking and health'; Action Foundation Statistics Canada; Industry Data for Japan

Note: Prices are MPPC (most popular price category) for all except Canada and US, where WAP (weighted average price) data are used (for Canada prices are for Ontario and Quebec provinces).

Figure 2: Development of non-duty-paid market in selected G7 countries, 1998-2010



Source: Oxford Economics; Euromonitor; KPMG; GFK; German Industry Association; Physicians for a smoke-free Canada

Between 1995 and 2000 the UK had a policy of very marked above-inflation excise duty increases, raising the tax burden on cigarettes by 50%. This policy caused a rapid decline in the affordability of cigarettes, with the cost of purchasing a pack of 20 cigarettes increasing to over 13.5% of daily disposable income in 2000. These duty increases, coupled with the introduction of the EU Single Market (free movement of goods and people), caused the non-domestic duty-paid (NDDP) market to double to 31% of all consumption in 2000, up from 16% in 1998 (although notably this increase did not occur until 1998, rather than immediately after the initial excise increase was implemented). During the period of rapid excise increases, smoking incidence in the UK remained relatively unchanged – falling only marginally, from 28% of the population in 1998 to 27% in 2000 (Office for National Statistics 2010). From 2000 until 2010, the government reverted to a policy of limiting excise increases to inflation, ensuring affordability remained stable. At the same time, it implemented a strategy to tackle tobacco smuggling raising penalties and investing in significantly increased enforcement activity – spending almost GBP100 million annually on wages and salaries for 2,000 anti-smuggling staff (Taylor 2009). As a result, the illicit share of the market fell to 12% for cigarettes and 60% for fine-cut (an average of 20% of consumption) by 2010. Since 2000, smoking incidence has also declined, falling to 21% by 2009.

In a similar manner, the French and German governments both increased excise duty rapidly between 2003 and 2005. Over the period, French excise duty rates increased by 35%, reducing cigarette affordability by 21%, while German duties also increased by 35%, causing cigarette affordability to fall by 27%. As a result, the NDDP sector increased dramatically to reach 23% of total consumption in France and 20% in Germany by 2005, while smoking incidence remained unchanged in Germany (Statistisches Bundesamt 2012) and increased in France (Institut national de prévention et d'éducation pour la santé 2012). In recent years excise increases have been more restrained with Germany introducing a five-year inflation-linked tax plan in 2011. Consequently, little change has been witnessed in affordability and the NDDP market share has stabilised (albeit at a much higher level than before the initial excise increases).

Sudden increases in excise duty in Canada drove a similar rapid decline in the affordability of cigarettes between 2001 and 2002, with the cost of cigarettes rising by 30% relative to incomes. The impact of the deterioration in affordability was not immediate, with the illicit sector not starting to expand rapidly until 2005; however, it did expand to a point where almost one-third of consumption was illicit. Euromonitor (2011) points to the presence of Native American reservations, and their tax-free status, as a primary conduit for this growth. Since peaking in 2008, the illicit market share has dropped back to 20% as a result of increased enforcement measures, including legalisation of previously illegal production facilities and greater internal border enforcement.

In contrast, the other three G7 countries adopted different approaches over the same period. The US, Italy and Japan have implemented excise increases that have had less sudden impact on the affordability of cigarettes. All three have seen affordability declines over the period but their gradual nature has mitigated any adverse consequences. Therefore, despite a doubling of excise duties (in the US's case excise rates in some states increased more than fourfold over the period), the illicit sector in the US and Italy has remained small, while industry reports no illicit market in Japan. Furthermore, all three saw smoking incidence decline significantly between 1995 and 2010, by one-fifth to 19% in the US (Centers for Disease Control and Prevention 2011), by 9% to 23% in Italy (ISTAT 2011), and by a third to 24% in Japan (Japan Tobacco Inc. 2010).

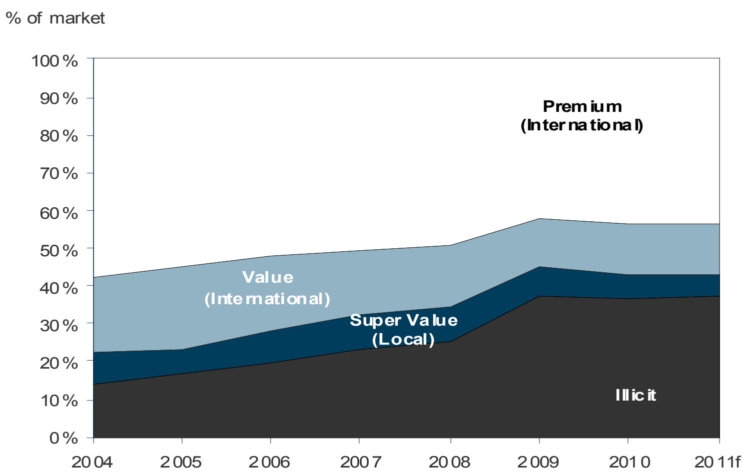
The experience of the G7 countries highlights that rapid increases in the excise rates levied on tobacco have not dramatically reduced smoking prevalence, and have resulted in substantial increases in illicit trade. The experience of the G7 countries also shows that once the illicit trade is established, slowing the growth of excise rates is not sufficient to reduce it – where countries have been successful in tackling the illicit trade, such as in the UK, significant resources have been required.

3.2 Malaysia

In 2002, excise duty on 1,000 cigarettes in Malaysia stood at MYR43.2. Subsequently, the Malaysian government began to increase excise taxes sharply. By 2010, excise duty had been increased over 430% to MYR230 per 1,000. As a result of the increases in excise duty, excise tax incidence on cigarettes increased from 19% in 2001 to 45% in 2010, and the average price of legal cigarettes has more than doubled from MYR4.14 per pack in 2001 to MYR8.90 per pack in 2010.

The increase in the price of legal cigarettes prompted consumers to switch to illicit sources of supply (see Figure 3). In 2002, Malaysian smokers consumed 19.5 billion legal cigarettes. By 2010, this had declined 31% to 13.5 billion. The decline in legal sales was mainly driven by the surge in consumption of illicit cigarettes, which reached 8.8 billion in 2010. As a result, the illicit market share rose from 21% in 2002 to 39% in 2010.

Figure 3: The composition of the Malaysian cigarette market



Source: Nielsen 2011

Tackling the growth in the size of the illicit market is a priority of the Customs department. Neither has it gone unnoticed by the Health Ministry. Health Minister, Datuk Seri Liow Tiong Lai, said: 'We need to address the sale of counterfeit cigarettes as it is an emerging scourge in the country. Apart from evading taxes, the distribution of such contraband could pose a serious health risk to smokers'. He continued, 'We will intensify our crackdown of such illicit cigarettes by also roping in relevant enforcement agencies' (*The Star* 2011).

Acknowledging the massive illicit trade problem and the impact of excessive cigarette taxation, the government decided to halt the trend of steep excise hikes by freezing excise in its 2012 budget. The Malaysian Prime Minister made the following statement on 9 October 2011, the day after the budget announcement: 'We can't increase the price of cigarettes sharply when the use of illegal cigarettes has reached 40%. This level is too high. If there is a sharp increase in the price of cigarettes, the percentage of those who smoke illegal cigarettes will continue to rise'.[2]

3.3 Singapore

The Singaporean experience with cigarette excise tax over the past ten years can be broken down into two distinct periods:

- 2000 to 2005 was a period of sharp excise increases
- since 2005 there has been no excise increase.

Between 2000 and 2005, Singapore's government increased excise duty on cigarettes from SGD150 per 1,000 cigarettes to SGD352 (the highest in Asia) – an average increase of 19% a year, with the excise tax incidence reaching close to 65% in 2005. Driven by these increases, the average price of duty-paid cigarettes rose dramatically over the period (62%).

In response to the price changes, duty-paid volumes fell from 3.2 billion sticks in 2000 to 2.0 billion in 2005 (or by 37%). Excise duty receipts initially rose by 48% but declined by 20% between 2003 and 2006. Equally significant was the growth in the illicit trade and, although no official statistics are available, it is evidenced by the government's subsequent response.

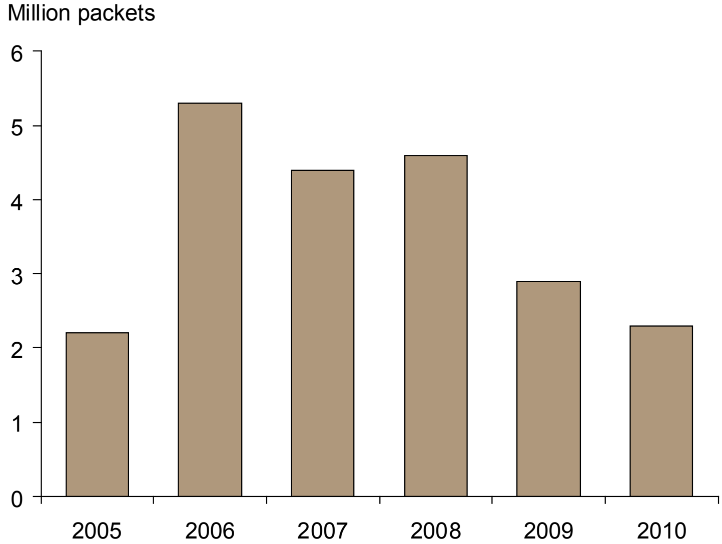
To curtail the growth in the illicit market, the government opted to hold excise duty constant in nominal terms. In his 2006 Budget Speech, Prime Minister and Minister for Finance Lee Hsien Loong commented: 'I seriously considered raising tobacco duties, but have reluctantly decided against it because we are already seeing revenues declining, not because people are smoking less but because smuggling has gone up' (Loong 2006, paragraph 2.75).

In addition, the government began to implement more stringent penalties for those caught in possession of illicit cigarettes. In 2008, Singapore Customs began enforcing a minimum SGD500 fine per package of illicit cigarettes found in consumers' possession. Singapore Customs also recognised that public education must accompany enforcement for it to remain sustainable. It has run awareness road shows and campaigns to counter illicit cigarette trading in the country (Singapore Customs 2008).

Singapore Customs (2011) shows seizures of illicit cigarettes reached a peak of 5.3 million packets in 2006. They have subsequently been on a downward trend, standing at 2.3 million cigarettes in 2010 (57% below the 2006 peak, see Figure 4). Although little is known about the success rate of enforcement efforts, the downward trend in seizures is consistent with a decline in the size of the illicit market.

Duty-paid volumes reached their nadir in 2006 at 1.8 billion sticks. The tax freeze at 2005 levels, coupled with investment in strong enforcement, has led to a recovery in duty-paid volume and a decline in smuggling. The illicit trade market share fell to 15.9% in 2010 from 22% in 2006. However, it is still much higher than in the years prior to the steep tax increases.

Figure 4: Singapore Customs seizures of non-duty-paid cigarettes



Source: Singapore Customs

3.4 Ireland

Between 2000 and 2009, the Irish government increased excise duty on cigarettes by 76%, from EUR148 to EUR261 per 1,000 cigarettes. Consequently, the price of a packet of 20 premium cigarettes rose from EUR4.83 in 2000 to EUR8.45 in 2009 when the excise tax incidence reached 62%.

The increase in the price of legal cigarettes led to a sharp fall in demand. Economists at the Office of the Irish Revenue Commissioners – Reidy and Walsh (2011) – have recently estimated the price elasticity of demand for duty-paid cigarettes to be minus 3.6, meaning that a 1% increase in price results in a 3.6% decline in the consumption. They argue: 'At first glance, the high elasticity estimated might seem like a clear sign that higher taxation is effective at reducing cigarette consumption. However, a detailed reading of the analysis suggests this is not the case. … It is quite likely that price increases cause consumption of taxed cigarettes to decrease and the consumption of untaxed cigarettes to increase' (Reidy & Walsh 2011, p. 24).

The impact of the increases in the price of legal cigarettes is evident in Irish Tobacco Manufacturers Association (2011) data which shows that the illicit market in Ireland has increased from 0.5 billion cigarettes in 2005 to 1.8 billion in 2010. With the volume of legal cigarettes declining by 23% over the same period, the illicit cigarette market share has increased from 8% in 2005 to 30% in 2010.

The growth in the illicit consumption of cigarettes has prompted a response from the authorities. In the December 2009 Budget speech, citing his responsibility to protect the tax base, Minister for Finance Brian Lenihan said: 'I have decided not to make any changes to excise on tobacco in this Budget because I believe the high price is now giving rise to massive cigarette smuggling' (Lenihan 2009, p. A18).

4. The WHO proposal for excise incidence for cigarettes of at least 70 per cent of retail prices

Despite the clear link between excise burden, affordability and the illicit trade in tobacco, some major global institutions, including the World Bank and WHO, have long argued that ‘tax increases are the single most effective intervention to reduce demand for tobacco (Jha & Chaloupka 2000). To this end, the World Bank, WHO and the Bloomberg Initiative to Reduce Tobacco Use recommend applying excise taxes to achieve a given incidence target (the excise burden as a proportion of total sales price). The WHO’s recently published *Technical Manual on Tobacco Tax Administration* promotes what it claims is best practice in tobacco tax policy, recommending that ‘countries should set excise tax incidence to be at least 70% of the retail price of a packet of cigarettes’ (WHO 2011a, p. 11).

Even allowing for the WHO’s misguided belief that one tax policy is suitable for all countries independent of their stage of economic and social development or their fiscal priorities, the policy of achieving an excise incidence of 70% is flawed for several key reasons:

4.1 It contradicts WHO policy recommendations

While the *Technical Manual* recommends a minimum excise tax incidence target for tobacco tax policy, this is not an issue on which the WHO is itself consistent in its advice. For example, in *Tobacco Policies on Tobacco Products in Thailand: The Way Forward*, published by the WHO, it argues: ‘… it is the retail price of cigarettes that affects the consumption decision of smokers, not the share of tax in the retail prices. Thus, the focus on the level of retail prices is more important than the share of all taxes in retail prices’ (WHO 2011b, p. 10). It goes on to set out evidence to show that ‘… the share of all taxes in the retail price of cigarettes is not important for tobacco control’ (WHO 2011b, p. 11). And it concludes, ‘… there is no reason why the shares of all taxes in the cigarette retail prices have to be in a particular range. The focus should be on the increase in the retail price of cigarettes rather than the share of all taxes in the retail price’ (WHO 2011b, p. 26).

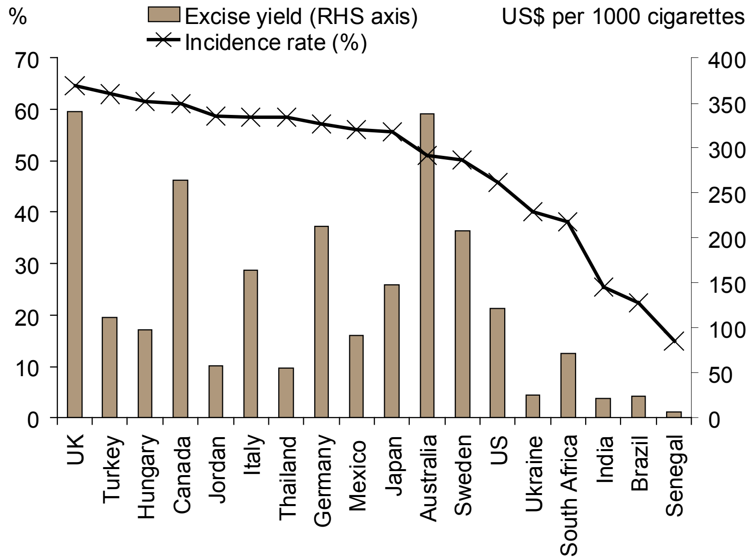
So, the WHO’s own research, when applied at a country level, directly contradicts the general recommendations that it makes in its *Technical Manual*. That in itself illustrates the problems with the type of global tax policy that the *Technical Manual* advocates, as well as raising questions about the WHO’s own commitment to the proposals set out in its *Technical Manual*. More importantly, the WHO’s country research underlines the weaknesses of excise tax incidence as a basis for framing tobacco taxation. It therefore directly contradicts the recommendations of the *Technical Manual* – and for good reason.

4.2 Tax incidence is no guide to the tax yield, retail price or affordability of cigarettes

An excise tax incidence target does not provide a useful guide to the tax yield on cigarettes (that is, the absolute amount of tax levied in cash terms). This is because very different levels of excise yield on cigarettes can be consistent with apparently very similar levels of excise tax incidence.

This problem with excise tax incidence is clear when we look at the relationship between excise tax incidence and yield across different countries, as illustrated across a broad sample in Figure 5. Among the countries shown, excise tax incidence ranges from 65% in the UK (left hand side of Figure 5) to 15% in Senegal (right hand side of Figure 5), but shows no correlation with the excise yield. For example, Australia has the second highest excise yield but its excise incidence rate is around the mid point of the countries included.

Figure 5: Excise tax incidence vs excise yield on comparable international brand cigarettes in 2011Q1[3]



Source: Industry data

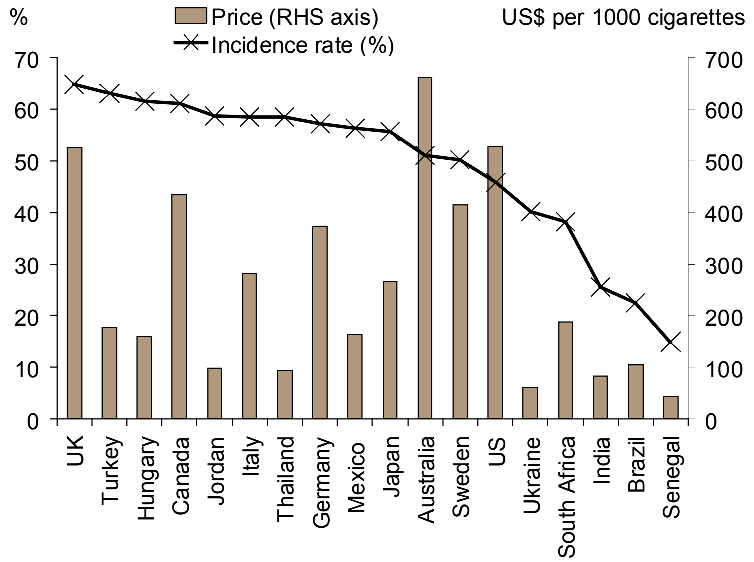
Note: Data for excise incidence in the charts only include excise taxes and exclude other taxes.

Similarly, there is no correlation between excise tax incidence and the retail price of cigarettes, as shown in Figure 6. The countries with the highest excise incidence (left hand side of Figure 6) do not have the highest cigarette prices. Indeed, some of the countries with significantly lower excise incidence are among those with the highest cigarette prices. This can be due to the fact that many developed countries also apply VAT on top of the excise tax, sometimes at very high rates. In Sweden the nominal rate of VAT is 25%, which multiplies any excise tax increase or manufacturer price increase. Its excise tax incidence is 50.2% and the total tax incidence is 70.2%, while the retail price is USD8.06 per pack. In comparison, in Cuba there is no VAT and the excise tax is fully specific so there is no multiplier effect of tax increase passing through to price increases. Although the excise tax incidence and total tax incidence in Cuba are both 87%, the retail price is only USD0.30 per pack.

The absence of a simple relationship between excise tax incidence and either the monetary excise yield or the retail price of cigarettes led the EU to move away from a tobacco taxation policy focused primarily on an excise incidence target (set at 57% of retail selling price). The European Commission noted, 'However the 57% rule has not prevented the perpetuation of wide differences in rates and retail price levels. Since it became clear that application of a minimum percentage alone would not bring about greater approximation, an additional minimum of EUR64 per 1000 cigarettes of the most popular price category (MPPC) (EUR60 until July 2006) was introduced by Directive 2002/10/EC' (European Commission 2007).

This 2002 Directive also introduced an exemption from its 57% excise incidence requirement for countries in which the excise yield on cigarettes exceeded EUR95 per 1,000 sticks (now EUR101 per 1,000 sticks). In doing so, it recognised the absurdity of a policy that implied that Sweden was failing to meet its obligations under the EU tobacco tax Directive[4] even though it had one of the highest monetary excise tax yields on cigarettes among EU Member States; and it effectively acknowledged that the main focus in tobacco tax policy should be on the excise yield rather than on the excise incidence. This was reconfirmed in the 2011 Directive[5] which set a minimum excise yield of EUR64 per 1,000 for all cigarettes irrespective of their retail selling price.

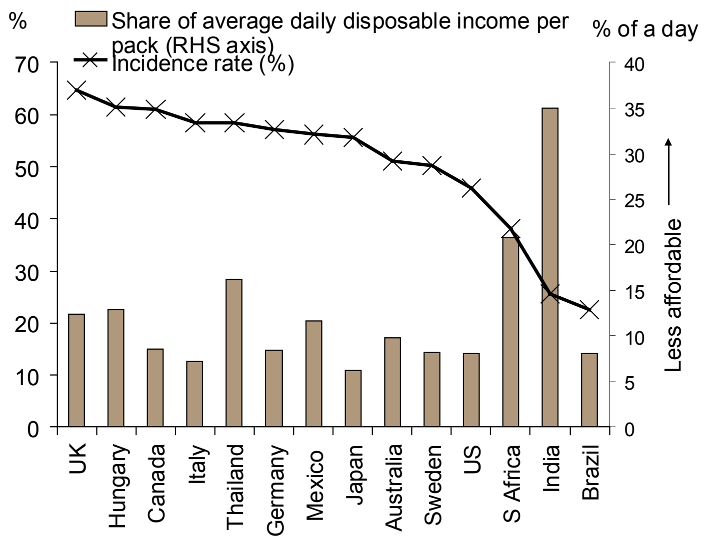
Figure 6: Excise tax incidence rate and retail price for comparable international brand cigarettes in 2011 Q1



Source: Industry data

It is also worth emphasising that there is no relationship either between excise incidence and the affordability of cigarettes. This is clear from Figure 7, which compares excise incidence and cigarette prices using data from the *Technical Manual*. It then combines these with Oxford Economics' data on daily disposable income per head to calculate a measure of the affordability of cigarettes based on share of daily disposable income required to purchase a pack of cigarettes. It shows that cigarettes are more affordable in, for example, Canada and Italy, which have very high levels of excise tax incidence, than they are in India and South Africa, where excise incidence is lower.

Figure 7: Relationship between excise incidence and affordability of international brand cigarettes in 2011Q1



Source: Industry data for excise incidence rate and Oxford Economics calculations for affordability

This analysis, therefore, again demonstrates that excise tax incidence is of no real value as a guide to the implications of tobacco tax policy. It also shows the inconsistency in the *Technical Manual's* analysis, since one of its recommendations is to increase tobacco taxes by enough to reduce the affordability of tobacco products, but there is no link between such an objective for affordability and the 70% excise incidence target it recommends.

4.3 Why 70% excise incidence?

So, excise tax incidence is not a sound basis for establishing tobacco tax policy. But what should we also make of the *Technical Manual's* proposal that excise tax incidence should be at least 70% of the retail prices for tobacco products?

The basic economic justification for the recommendation that excise tax incidence should be at least 70% – as opposed to any other figure – is not clearly set out in the *Technical Manual*. Research by Ross, Shariff and Gilmore (2008, 2009) is cited in support of the target. However, their analysis focuses on just two countries, Ukraine and Russia, which for a variety of reasons may be of limited relevance for the rest of the world. Moreover, Ross, Shariff and Gilmore (2009, p. 37) advocate an incidence target of 70% for total tax on cigarettes (excise + VAT), rather than a 70% target for excise incidence alone, as proposed in the *Technical Manual*. For example, the recommendation by Ross, Shariff and Gilmore for Ukraine would imply excise incidence of 53%, far below the minimum 70%.

The second justification in the *Technical Manual* is that 'A 70% benchmark does seem to be a feasible target given that it has already been reached by a few countries around the globe, including some developing countries' (WHO 2011a, p. 53).

The data the *Technical Manual* uses show that excise duty exceeded 70% of the MPPC price in nine countries out of 183 in 2008 – Bulgaria, Brunei Darussalam, Cuba, Fiji, Myanmar, Poland, Seychelles, Slovakia and Venezuela. This, of course, is a very weak and arbitrary basis for a recommendation for global tax policy.

First, it is important to note that the data used in the *Technical Manual* are not entirely reliable. In particular, for both Bulgaria and Poland, the data in *the Technical Manual* substantially overstate the level of excise incidence. Second, to base a global policy recommendation on so few countries is remarkably unscientific. Excluding the three EU countries, the remaining six are only 3% of the countries for which the WHO publishes data in its *Technical Manual* – the vast majority of countries have excise tax incidence well below 70%.

Even taken together, the six countries have a share of just 1.3% of world population.[6] Strikingly, three of them are very small, island economies. It is very difficult to understand the basis on which the *Technical Manual* extrapolates their experience to create a recommendation for a global tax policy.

In reality, what the data in the *Technical Manual* illustrate is that there is huge variability in excise tax incidence internationally. Indeed, it shows that the incidence level is not a reflection of the tax burden or retail price level. That variability reflects a number of factors, such as stage of economic development, geographical location, fiscal and social policies, the availability of substitute products and the extent of illicit trade. It is vital to reflect the different circumstances that countries face in their tobacco tax policy – which is the situation as they currently set their own policy. Countries would lose this freedom if they were to follow the *Technical Manual* recommendations.

What the *Technical Manual* fails to do, however, is recognise the scale of increases in taxes and prices it is seeking to impose and the destabilising impact such changes would have on the tobacco markets and government revenues in many countries.

Using the information provided in the *Technical Manual* on the price and tax rates of cigarettes in 183 countries in 2008, it is possible to calculate how much the price of a packet of cigarettes would have to rise if each country were to impose a tax to meet its current shortfall from the 70% excise incidence target. We find that:

- Overall, this 'one size fits all' approach will have a different impact in each country. However it would imply very marked declines in the affordability of cigarettes and a probable surge in illicit trade.
- While high-price markets would generally face a smaller proportionate increase in retail prices than low-price markets, the absolute size of the increases would in many cases be larger. That implies that price gaps between markets would widen in absolute terms, further fuelling cross-border purchasing and smuggling.
- In the six WHO 70%+ excise sample countries, it will have no impact, enabling Cuba, for example, to keep its USD0.30 pack price, one of the lowest in the world.

The experience of accession countries in the EU illustrates these risks. Excise taxes on cigarettes have been increased sharply in recent years without reaching a 70% excise incidence level but nevertheless with seriously adverse consequences. We examine that experience in the next section.

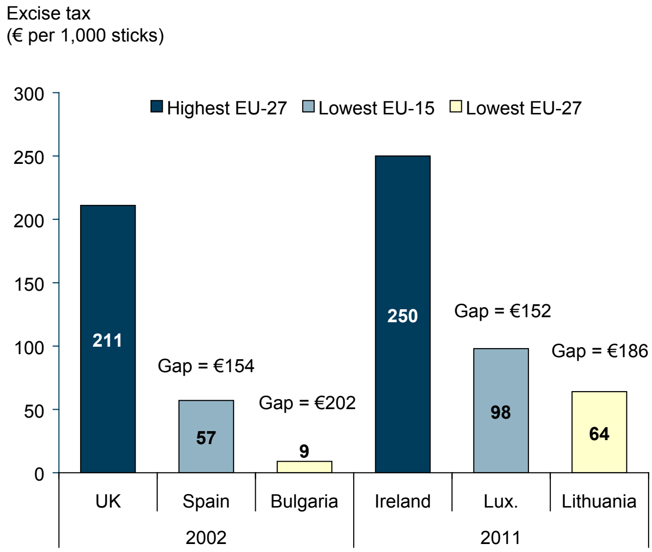
5. The 40-year EU region harmonisation experience

The notion of harmonised tobacco taxation was first legislated in the 1972 Council of European Communities Directive 72/464/EEC, agreed by the founding six members of the EEC. However, it was not until 1992 that the EU set requirements with regard to the minimum level of excise incidence on cigarettes and not until 2002 that it set minimum requirements with regard to excise yield. The current EU tax rules require excise duty should be at least EUR64 per 1,000 cigarettes applied to all cigarettes and that excise incidence should not be less than 57% of the weighted average retail selling price (unless excise yield exceeds EUR101 per 1,000 cigarettes) (European Union 2011). These EU-wide targets have been intended primarily to reduce the risk that a large scale cross-border trade in tobacco would undermine Member States' revenues in the context of the establishment of the single market.

Despite having Excise Directives for over 40 years, as the European Commission itself has acknowledged, these common targets have not led to a convergence in excise duty or price, within either the older EU-15[7] or the wider EU-27[8] Member States (Commission of the European Communities 2001). Indeed, since 2002 the excise differential per thousand cigarettes within the old 15 Member States has stayed at virtually the same level; the excise differential within the wider EU-27 decreased by only EUR16 per 1,000 cigarettes from EUR202 to EUR186 since the old Member States continued to increase excise levels despite their existing high base (Figure 8). Consequently, the regime has not achieved the convergence of retail selling prices for cigarettes. Moreover, since 2002 retail price spreads have actually widened across both the EU-15 and the EU-27 markets (from gaps per pack of EUR4.69 in the EU-15 and EUR6.14 in the EU-27 in 2002, to EUR6.09 and EUR6.45 in 2011 within the EU-15 and EU-27, respectively).

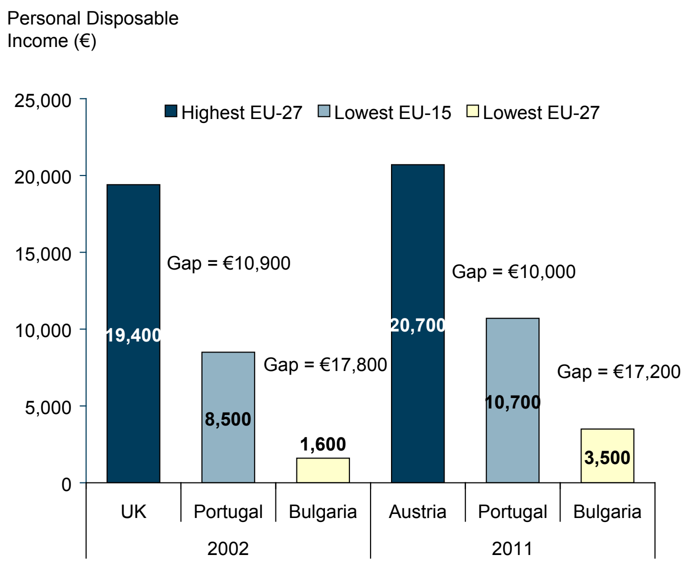
Although, the poorest EU countries have rapidly increased excise duties to EU minima, their incomes remain far below those in the rest of the EU (Figure 9). Consequently, consumers in these countries have experienced significant declines in the affordability of cigarettes, and have switched towards illicit sources of supply in large numbers.

Figure 8: Excise gap in the EU, 2002 and 2011 (Euro per 1,000 cigarettes)



Source: Oxford Economics; European Commission (2011a); Industry data

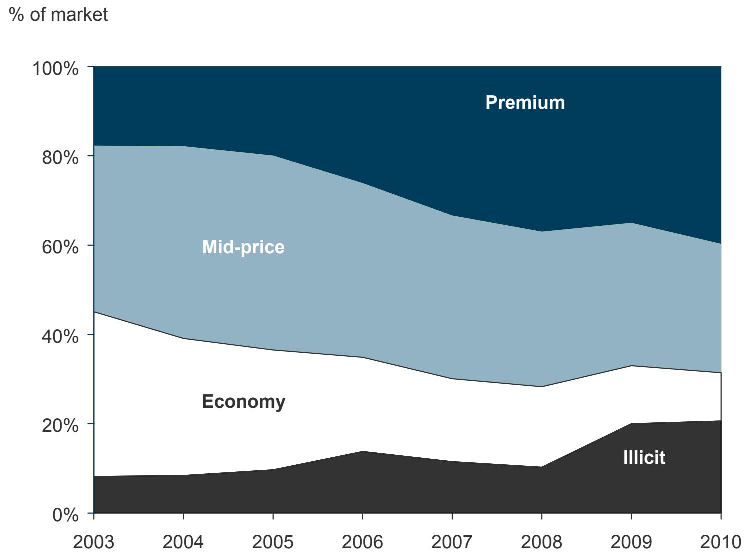
Figure 9: Disposable income gap in the EU, 2002 and 2011



Source: Oxford Economics; Industry data

In Romania, excise taxes on cigarettes have been increased by more than 800% in nine years – a very marked rise in a relatively short time period. Not surprisingly, the rapid transition in the excise duty rate has stimulated the illicit cigarette market (Figure 10). Between 2005 and 2010, KPMG (2011) estimates indicate the illicit cigarette market share more than tripled in size to almost 20%; at the same time, the excise incidence was 63% in 2010. The latest estimates indicate that the illicit trade may have fallen back to around 11% of total cigarette consumption in 2011, driven by lower inflows from Moldova, Serbia and Ukraine. However, despite this decline, the level of illicit activity is more than 50% larger than in 2007.

Figure 10: Composition of the Romanian duty-paid cigarette market



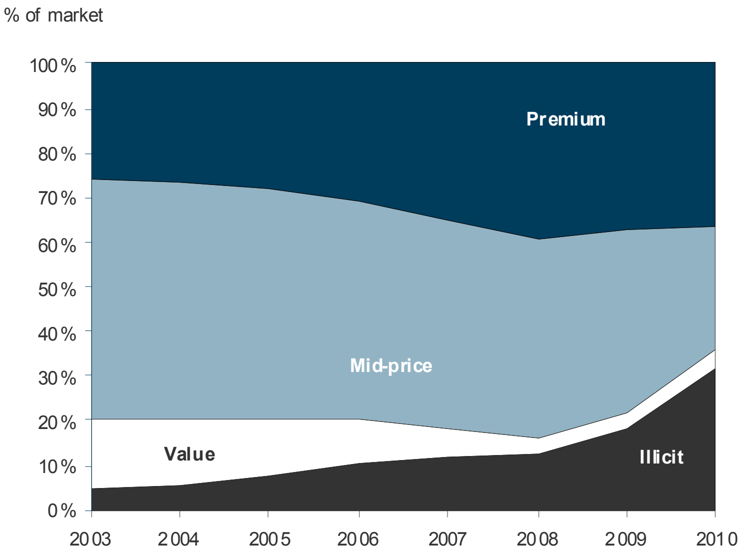
Source: Euromonitor; Goldman Sachs estimates (2010); KPMG (2010)

But Romania is not alone among the accession countries in experiencing such problems. So, for example, in Bulgaria, the excise duty on 1,000 cigarettes in 2003 was BGN26. By 2010, it had been increased by nearly 500% to BGN154. In response, the average price of cigarettes rose by 280%. This prompted a significant proportion of consumers to switch to the illicit market (Figure 11). KPMG Star Report (2012) suggests the illicit market share is now 20%, while the excise incidence is 67%. Although, the illicit market share has dropped dramatically since 2010 (reported to be 31%), it still remains almost double the level witnessed in 2007. Similarly, in Latvia, the authorities increased excise duty on 1,000 cigarettes from LVL19 in 2007 to LVL50 (or 165%) in 2010, causing excise incidence to rise from 54% to 63%. Over that time, the volume of duty-paid cigarettes consumed declined by 65%, with excise revenues increasing by just 24%. KPMG Star Report (2012) estimates the illicit market comprised 32% of consumption in 2011, up from 6.5% in 2006.

By not combating, and in some cases exacerbating, differences in affordability, EU policy has contributed to the growth in the non-duty-paid market within almost two-thirds of its members. Despite the aim of reducing the illicit market share, the period of excise approximation has seen a modest increase in the non-domestic duty-paid share of the EU market, from 12.8% in 2006 to 13.6% in 2010 – a level of activity estimated to cost EU governments over EUR10 billion per annum (Europol 2011). The failure of the system is highlighted by the fact that 35% of non-tax paid product originated within the EU itself (both legally and illegally), thus nullifying a primary objective of the Excise Directive. In 2010, the EU reported that, cigarettes were the second most valuable illicit product in the Union (European Commission 2011b).

The experience of the accession countries clearly illustrates the destabilising impact that sharp increases in excise taxes on cigarettes can have on the legitimate market, and how rapidly the illicit trade can expand once the incentives are created for smugglers and counterfeiters. In all these markets, excise incidence, while increased, still remained below 70%. If the governments had applied the *Technical Manual's* recommended 70% level of excise tax incidence, experience shows that the problems of illicit trade would have reached even more severe levels.

Figure 11: Composition of the Bulgarian duty-paid cigarette market



Source: Euromonitor; Goldman Sachs estimates (2010)

6. Conclusions

Over the past two decades, countries around the world have adopted an array of tobacco taxation policies. Some countries, such as Canada, the UK, France, Germany, Malaysia, and the EU Accession countries, have implemented rapid increases in duties. Others, such as Japan, Italy and the US, have adopted a more gradual approach with few (if any) sudden jumps in excise. Despite representing a range of markets with different underlying characteristics, a common lesson can be drawn from all of these experiences: increasing excise levels without regard for consumers' purchasing power is detrimental to the tobacco market, undermines the sustainability of government revenues, and is likely to result in the development of large, unregulated illicit markets. However, when cigarette affordability is taken into account, excise levels and revenues can be increased while consumption is reduced and the illicit trade is kept in check.

Recommendations for a global excise tax incidence target of 70%, as proposed by the WHO, would be very destabilising if implemented. Excise incidence is flawed as the basis for setting tax policy – the changes that the EU has made to its tobacco tax Directives directly reflect these problems. Moreover, the *Technical Manual's* recommendation that excise tax incidence should be at least 70% is based on incorrect data and extrapolates unreliable evidence from a very small number of relatively small economies – including a number of remote island states – to a global tax policy. International experience, including that of the EU accession countries, clearly shows that countries which have implemented the sort of substantial tax increases that the *Technical Manual's* proposals would imply have seen a sharp rise in illicit trade in cigarettes, which damages the long-term tax base and undermines public health objectives.

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Notes

1 Article 1 of the WHO FCTC.

2 Malaysian Prime Minister speaking on TV3, Sunday 9 October.

3 Data in Figures 5, 6 and 7 refer to 2011Q1 except for the US which is May 2010. US data uses an average of States' taxes rather than select a particular one.

4 Council Directive 92/79/EEC of 19 October 1992 on the approximation of taxes on cigarettes.

5 Council Directive 2011/64/EU of 21 June 2011 on the structure and rates of excise duty applied to manufactured tobacco.

6 Population data taken from United Nations Population Statistics available sourced from Haver Analytics.

7 The EU-15 consists of the 15 countries that were members of the EU prior to 2004. These were: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Spain, Sweden, and the UK.

8 The EU-27 consists of the EU-15 plus the 12 accession countries have joined the EU since 2004. Ten countries joined the EU in 2004: Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. Bulgaria and Romania both joined the EU in 2007.

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Excise taxation of non-alcoholic beverages in Thailand: products, approaches, rates and administration

Rob Preece

Abstract

The system of excise taxation for non-alcoholic beverages in the Kingdom of Thailand is structured in such a manner that its impact is discriminatory towards several sectors, or categories within the non-alcoholic beverage market. Certain aspects of the administration of this excise tax also appear to lack clarity and transparency, which are two important aspects of what would be considered 'accepted best practice' in modern tax administration. The taxation of certain beverages is also significantly impacted by external excise policies, particularly the price sensitivity lists which monitor retail pricing for certain beverage products and have the potential to reduce the profitability of those excisable beverages. This paper discusses these particular issues, and canvasses possible reform options based on international approaches to non-alcoholic beverage taxation applied to the Thai market context.

The current excise tariffs

The Excise Act BE 2527 of Thailand prescribes an excise on certain non-alcoholic beverages. Currently, these excise rates are expressed in such a way that we see two rates prescribed for each product – an ad valorem (value based) rate and a specific (volume based) with excise payers asked to select the rate which results in the greatest revenue payable. Product classifications and associated rates are summarised in Table 1,[1] where it should be noted that any non-alcoholic beverages not listed in Table 1 are not subject to excise taxation, although the tariff items do lack sufficient clarity to readily identify what beverages are actually within or outside the tariff.

Table 1: Summary of non-alcoholic beverage excise, Thailand

Item	Percentage value	By volume
1. Soda	25	0.77 baht/440 cc
2. Beverage - General	20	0.37 baht/440 cc
3. Juice		
- General juice	20	0.37 baht/440 cc
- Water, fruit juices with ingredients required by the Department	Exception	Exception

The lack of clarity in the 'beverage' items of the excise tariff does make analysis of the excise taxation arrangement a little difficult, as the actual full scope of products being taxed (or excluded from excise) is not readily understood. As part of this project, the non-alcoholic beverage market of Thailand will be divided into clear product categories, so that discussion, economic modelling, and the analysis of that modelling can be properly undertaken and conclusions more certain.

Excise tariffs are by their very nature 'discriminatory' in that they add an additional taxation burden to products which are deemed to have some negative externalities or classified as a 'luxury' good for which revenue is sought. However, the excise tariffs applying to non-alcoholic beverages in Thailand are levied in an inconsistent manner, and the discriminatory effect of the excise only falls effectively in two categories of the non-alcoholic beverage market, that is, carbonated soft drinks and energy drinks. Although an excise is prescribed for a 'juice' category, provision exists to exempt from excise a range of juices and waters that meet departmental criteria. In effect, many juices are indeed exempt from excise taxation which further adds to the uncertainty for excise payers and distorts the market in this category of beverage.

Generally, we would expect to see some clear policy intent as to why 'like' products are included or not included in a tariff, but in this case the policy is unclear as to intent – certainly there is no distinction in the excise tariff based on criteria such as sugar content, caffeine or value aspects, which could be expected to be part of an excise tax in a non-alcoholic beverage tax system.

Thus the overall tax policy intent for the non-alcoholic beverage is not entirely clear, and the effect of this is to discriminate against certain sectors of that market to the detriment of consumers, profitability of manufacturers, investment and, likely, to government revenues.

Current administration of the excise tariffs

The excise tariffs are administered by the Royal Thai Excise Department. As with many other excisable products in Thailand, the excise duties are levied according to what delivers a higher assessment from an ad valorem rate and a specific (or sometimes referred to as 'unitary') rate. We need to look at these two components – the ad valorem and specific components of the tariff in a little more detail to understand certain issues that will be analysed later in this paper.

The first component of the tariff is an ad valorem rate which is set as a percentage of an 'ex-factory' value and is 25% for soda waters and 20% for carbonated soft drinks and other non-alcoholic beverages. The term 'ex-factory' is not defined in the current excise laws but this is managed by way of 'internal guidance' issued by the Thai Excise Department which provides that ex-factory values include costs, profits, excise tax and local tax.[2] However, for certain commodities, the Thai Excise Department has prescribed applicable ex-factory prices for the purposes of assessing excise duties. This process of authoritative assessment is a little unclear, and the existing minimum ex-factory price list has remained unchanged since 1999, indicating it is a process that may be somewhat dated and in need of reform.[3] Indeed, it would also appear that the Thai Excise Department may itself be losing revenue in real terms by continuing to utilise this approach, as excisable values and calculations of excise payable on products today are applied to 1999 ex-factory values.

A review of the current prescribed 'ex-factory' prices used for excise calculation suggests that the Excise Department has applied a process of 'deeming' or 'determining' that ex-factory value, or costs, profits and taxes is some 75% of the products' retail selling price (RSP). Whilst consistent, the process suggests both a lack of recognition of the various commercial aspects of beverage production, and a lack of transparency in arriving at how ex-factory valuations are determined.

Where ex-factory prices have not been prescribed, generally new products coming into the market, manufacturers of those excisable beverages are required to submit ex-factory valuations to the Excise Department seven days prior to production. The Excise Department will only respond to the valuation should they have concerns, in these cases any submitted 'ex-factory' valuations less than 75% of retail price will likely raise such concerns, however, a non-response within the seven days generally means the beverage manufacturer can use the submitted valuation.

A proposal to amend the Excise Act BE 2527 to include a definition for 'ex-factory' valuation for all commodities has been circulated with Thai excise payers, but has not progressed beyond consultation in a public forum setting.[4] This definition is expected to be:

> Ex-factory price means the price actually sold or should be sold from the factory which is a normal business price with honesty and frankness.[5]

This proposal recognises an inherent risk in utilising ex-factory valuations for excise taxation purposes, in that manufacturers will look to minimise excise payable by reducing ex-factory valuations. One such method has traditionally been for the manufacturer to set up a distribution company to purchase or take ownership of the products so as to remove margins, distribution, marketing and licensing type costs out of the ex-factory price. The proposed definition for ex-factory price, whilst needed, still will not necessarily address the question of related party sales as it will be difficult for industry and the Excise Department to identify the difference (if any) in pricing between related and unrelated party transactions.

The second component of the excise tariff rate for non-alcoholic beverages is the specific or unitary rate which is based on the volume of product leaving the factory. This rate stands at THB0.77 for sodas and THB0.37 for other categories, for each 440cc unit. Any part 440cc units are rounded up. In effect, the calculation would result in a 500cc container being classified as 2 x 440cc units for multiplication with the THB0.77 or THB0.37 excise rate.[6]

Impact of non-alcoholic beverage excise on manufacturers

Despite a tariff which states that the excise payable is based on the higher of an ad valorem and a specific rate of duty, in effect we find that the ad valorem rate always prevails as the higher of the two assessments. Thus it is considered that non-alcoholic beverages in Thailand are taxed on an ad valorem basis based on their ex-factory value. The issue of this ex-factory value being set arbitrarily has already been raised above, as has the fact that these arbitrary values have remained unchanged since 1999, however, it is worth analysing some of the impacts on manufacturers.

This policy would appear quite unrealistic in that a value-based excise is no longer levied on true values, but on an assigned value (authoritative assessment) that today likely bears no resemblance to the actual value. As a result of this policy, there are certain impacts on manufacturers which need to be highlighted as part of analysing policy and administrative issues. Firstly, the policy as seen in the discussion above works on the principle that tax inclusive ex-factory values are at least 75% of RSP. Considering that RSP also needs to include any value-add between the factory and the sale such as transport and retailer costs and margins, plus the retailer's Value Added Tax (VAT) liability of 7%, the manufacturer's margins are reduced significantly on any product which is actually valued less than the 75% benchmark.

Further complicating the issue is that RSP is subject to government monitoring and in effect industry cannot raise the RSP without first having an 'informal approval' from the relevant authorities – a topic which will be further discussed below. However, the effect of an RSP 'cap' is that again 'ex-factory' valuations for excise cannot rise with increasing raw material and other costs as industry and the Excise Department are 'tied' to this guidance of ex-factory valuation being 75% of a static RSP.

In this context, despite the excise payable being stable with static RSP prices, rising raw material and production costs, inside a capped RSP does further erode, often significantly, the manufacturer's margins. In particular, pressure on the raw material input costs such as sugar (see Figure 1 below) cannot be passed on to consumers, and with excise 'set' raw material cost rises need to come out of the manufacturer's margins.

A review of the literature on non-alcoholic beverage taxation

This paper recognises a key principle in tax policy which is that the objective of an indirect tax should be neutrality, or that the tax rate, tax base and tax structure should not impact markedly on investment, production or consumption. Tax policy in certain circumstances will often include the need to levy 'special' taxes or discriminatory taxes such as an excise tax, in response to the externalities (or harm) associated with the consumption of certain goods and services. These products are usually alcohol, tobacco, fuels and gambling.

Therefore, a key question that arises in the literature is 'do we need to have a discriminatory tax on non-alcoholic beverages?' Or, what are the externalities behind the consumption of such beverages which need addressing through a discriminatory tax such as a non-alcoholic beverage excise?

If the policy intent is not in response to identified externalities but is simply to raise revenue, then we need to return to our first key principle of neutrality in tax policy, where taxes such as VAT are likely to conform. However, if raising revenue is not the prime objective of the tax, we need to assess those externalities and consumption issues and design an excise tax system accordingly.

In relation to Thailand, we see both VAT and excise duties being applied to non-alcoholic beverages. Thailand is not alone in levying excises on such products, but it is different to others in terms of levying excise on just a narrow range of products, rather than capturing all product categories.

Those countries levying an excise on non-alcoholic beverages can be divided into two groups. Firstly, those developing countries within Africa, the Middle East, and Asia where non-alcoholic beverages are seen as a 'luxury' good and as a source of revenue from the consumer, and as such, the excises have been structured on an ad valorem basis as a pure revenue raising measure.[7] Secondly, in the more advanced economies where excises on non-alcoholic beverages are levied, there have been certain externalities from consumption identified for redress, such as harm from sugar intake, or harm to the environment from disposal of packaging.[8]

Thailand is interesting in that its excise tariff contains both an ad valorem and specific tax rate, with manufacturers paying the rate which delivers the highest assessment, although effectively, with taxable values set by the Excise Department, the ad valorem rate is the one used for excise. In fact this taxation arrangement may be unique to Thailand in terms of taxing non-alcoholic beverages.[9] The ad valorem component of the rate which is set at 25% for soda waters and 20% for carbonated soft drinks is considered to be at the upper middle range of rates globally but regionally would be considered quite high.[10] This will impact on the competitiveness and future profitability of those taxable segments of the non-alcoholic beverage market.

Significantly, where externalities are behind the policy for implementing an excise tax, there is a move towards taxing non-alcoholic beverages on a specific or unitary rate of excise (that is, per unit of liquid). This approach better reflects the externalities of consumption by taxing the volume or amount of consumption which is believed to be related to or is actually causing the harm, rather than the value which taxes the quality of the product rather than the harm.

There has been some debate in recent times about introducing levies, like an excise tax, on non-alcoholic beverages to reflect the externalities of sugar content with its impact on health objectives. The proposals are to guide manufacturers and consumers to more healthy consumption through reduction in sugar intake. This type of discussion has recently commenced in Thailand, with the Director-General of the Excise Department making a statement that his Department was 'considering higher taxes on the amount of perceived harmful active ingredients in goods such as ... sugar products'.[11] However, this paper does not wish to evaluate the science of sugar and health but rather focus on tax design should a government wish to levy an excise type tax on non-alcoholic beverages. This paper does wish to highlight, however, that the literature review failed to locate any readily and publicly available policy debate on Thailand's position in relation to the potential externalities arising from non-alcoholic beverage consumption.

Likewise, there is no intention in this paper to commence a debate about the merits of using an excise or like tax for managing the environmental aspects of soft drink consumption through disposal of containers. Often, excise type taxes in this context can be operated with tax rebate, tax refund or deposit type arrangements to encourage return and recycling of containers; this creates many levels of complexity in excise policy design,[12] and in this paper we need to focus on particular reforms and best practice in the Thai excise system. However, what is important to note in the literature is that where government tax policy indicates an excise is being levied on the ground of externalising harm, then specific taxation is shown to be the preferred taxation approach.

Significantly, the application of specific taxation not only recognises the nature of excise taxes and externalities but has several other significant benefits over ad valorem taxation which are worthy of discussion. Specific taxes also provide several advantages over ad valorem taxation in terms of managing revenue income from excisable products. The advantages are therefore not only limited to taxing harm.

Specific taxation is becoming the preferred approach generally in excise taxation for all goods, and there are several reasons for this. Specific taxation is far simpler to administer from the perspective of both industry and revenue agencies. The requirement to simply measure physical volumes is far simpler than assessing the value of a product at a certain point in time. Values are subject to many changing factors, such as raw material inputs, labour, fuel prices, etc., which need constant surveillance and adjustment. Volumes are simply derived from product passing flow meters or scales and recorded for tax purposes.

Specific taxation provides stability in revenue, with tax receipts growing or moving in line with consumption. Values change constantly in line with market and economic conditions, and we can see factors such as cost cutting, price wars, and trading down by consumers, all impacting negatively on revenue, including periods where consumption is stable. Taxation by volume also challenges the ability of industry to aggressively plan pricing strategies as a way to reduce taxable values.

Specific taxation also prevents discrimination or distortion in the market. Goods are taxed for what they are or what they do, and not what their value is. This has the effect of not placing certain quality goods out of the reach of many consumers, nor is there a need to trade down to inferior quality products. This again helps maintain revenue levels, and also works against the incentives to counterfeit premium branded excisable goods.

The literature review looked at several excise systems which taxed non-alcoholic beverages on a specific rate basis and provides as examples the following structure and rates:

Table 2: Examples of specific taxes – non-alcoholic beverages (converted Thai baht equivalent at time of writing)

Country	Tax	Products	Rate THB equivalent
Netherlands[13]	Consumption Tax	Carbonated soft drinks	2.97 per litre
		Vegetable & fruit juice	2.23 per litre
		Mineral waters	2.23 per litre
Finland[14]	Excise	Soft drinks, juices and sodas	1.81 per litre
	Beverage Container Tax	All beverages with non returnable packaging	30.0 per litre
Croatia[15]	Excise	Refreshing non-alcoholic beverage	2.24 per litre
Washington (State) USA[16]	Soda Tax	Sugar sweetened beverages	1.80 per litre

There are clear arguments therefore for applying these concepts to Thailand and restructuring the existing excise 'greater of' ad valorem or specific rate system, with a single specific excise rate more comparable with the existing ad valorem component. The precise setting of such a rate will be an option tested with economic modelling later in the paper.

However, if Thailand was to retain an 'effective' ad valorem system, there is also certainly scope to review the existing tax base of 'ex factory authoritative assessment' with a new tax base such as self-assessed ex factory, wholesale, or retail selling price. Each of these approaches will be looked at in more detail below in terms of discussion of future potential tax bases, but there will continue to be analysis of ex-factory based valuations in this paper.

Wholesale selling price as excisable values are in use in other countries but for Thailand may have several issues which are similar to those raised in relation to ex-factory valuation in the areas of distribution structure and related tax avoidance issues. The Australian 'Wine Equalisation Tax' is an example of an excise type tax levied on a beverage and operates very closely with the local Goods and Services Tax (GST) law.[17] In the case of Thailand however, it would seem that the distribution of many beverages is directly from the manufacturer to retailer, and thus is effectively an ex-factory (plus delivery) value and is how the price is structured today and represents little change, and may therefore carry the same issues previously discussed.

Further, the ex-factory or wholesale value, where self-assessed, will be subject to constant fluctuation depending upon factors such as cost of inputs and prevailing market conditions. Whilst the authoritative assessment of ex-factory price removes this fluctuation, the process is not considered 'best practice' and as such it is very difficult to argue for retention of ex-factory valuation, or the introduction of wholesale pricing, as part of any reform of excise tariffs for non-alcoholic beverages.

The other value which can be used for excise purposes is the retail selling price (RSP), particularly where this price is consistent, regulated or set in some manner. RSP-based excises are not unique, and they are in use for the excise taxation of tobacco across the European Union (EU), but the literature review did not find RSP excises in use in the non-alcoholic beverage industry. There are however, several aspects required to be worked through – the main issue being that excise is a 'production' tax and levied on producers who may have no control or effective knowledge of the retail price. Further, retail pricing for the same goods can vary largely depending on point of sale for example, the price differential between a can of soda purchased at a supermarket and a restaurant can vary between four and five times. As such, for an RSP-based excise to be applied successfully there needs to be a means of setting that RSP which is equitable, simple and transparently fair across like products in the market.

The use of RSP in the EU excise taxation of tobacco is quite complex in terms of it being a 'mixed' ad valorem and specific system, in which an element of both applies to each member state's tobacco excise rate, with a minimum level of specific rate taxation applying. The ad valorem component is then based on RSP, but that RSP is in fact a derived value based on the Most Popular Price Category (MPPC) and reviewed each year.

Thus any consideration of the use of RSP in Thailand will need certain design rules to overcome these sorts of issues, for example, should RSP for excise be based on:

- the most popular price categories as with EU tobacco excises
- recommended retail prices as set by the manufacturers
- watch-list levels set by the Ministry of Commerce, or registered prices with the Ministry of Commerce
- price indicated/printed on packaging as 'suggested' retail price, or
- price registered with the Excise Department.

What is best practice tax policy and administration?

A major part of this research is to develop thinking around a number of different approaches to excise taxation of non-alcoholic beverages in Thailand which are more in line with 'best practice' principles. As such, the existing tax administration and current proposals to enhance administration of non-alcoholic beverages have been reviewed against what can be considered 'benchmark' or 'best practice' tax administration. In making this analysis, the principles of good tax administration have been drawn from the OECD's guidance materials, which themselves are based on extensive study and research across the developed world's tax systems.[18]

Critically, we will examine two key areas listed under the OECD's guidance note, which recommends that revenue authorities be encouraged to:

- apply tax laws in a fair, reliable and transparent manner
- ensure compliance costs are kept to a minimum level necessary to achieve compliance with the tax laws.

In relation to 'fair, reliable and transparent', this can be measured both on 'outcomes' and 'procedures': outcomes in terms of pricing and impact on the market, and procedural in terms of how the tax is administered, both of which have been found to be important factors in the effectiveness of the tax as even new taxes or undesirable taxes have more chance of being accepted by taxpayers and consumers if they are considered 'fair'.[19]

Looking at the Thai non-alcoholic beverage excise system, there are several observations that need to be made. At a 'fairness' level, there are certainly questions on fairness and equity in relation to the issue of differentiating between like products in the non-alcoholic beverage market for the purposes of excise.

In effect, out of 11 categories of non-alcoholic beverage, only two are taxed, and these two categories have rate differentials. In summary, the issue can be highlighted by the following table (Table 3) which looks at the components of the non-alcoholic beverage market and effective taxation rates:

Table 3: Effective rates of excise in the Thai non-alcoholic beverage market

Product category	Excise rate
Soda water	25% (or 0.77 Baht per 440ml)
Carbonated soft drink and energy drink	20% (or 0.37 Baht per 440ml)
Fruit/Vegetable juice	Ex (or 20% or 0.37 Baht per 440ml)
Packaged water	Ex
RTD Tea	Ex
RTD Coffee	Ex
Sports drinks	Ex
Still drinks	Ex
Syrups	Ex
Nectar	Ex
Fruit powder	Ex

At this point however, there is an argument to be made for the continued exemption from excise of bottled water. This argument would be mounted on the premise that there is a lack of certainty as to the potability of tap water for the population in Thailand.[20]

The inconsistent tax treatment of like products has the potential to distort the market, with pricing advantages able to be gained by certain products over others, and consumers selecting certain products over others. For the government, there also seems to be a 'missed opportunity' by excluding these non-taxed product categories, and this revenue opportunity can be further eroded if the market is not working properly and consumers switch to 'non-taxed' products. Thus, this question could be addressed by the addition of these untaxed categories into the excise system, unless there is a clear need to exclude that category.

Otherwise, the discriminatory taxation can also represent a missed opportunity for the growth of those categories of beverage taxed, and on this basis the government would look to repeal the non-alcoholic beverage excise from the Excise Act. See Table 4 below, where the excisable soft drink category is consistently and clearly unable to share the same volume growths of other non-excisable product categories.

Table 4: Growth in selected non-alcoholic beverage categories 2002 to 2008[21]

	2002	2003	2004	2005	2006	2007	2008	Average growth
Fruit juice	18.2%	18.6%	1.6%	18.5%	25.6%	14.5%	3.2%	14.3%
RTD Tea	81.9%	118.0%	151.0%	21.1%	-29.0%	13.2%	17.8%	53.4%
RTD Coffee	27.4%	24.9%	15.0%	5.3%	5.1%	16.4%	3.1%	13.9%
Soft drinks	4.6%	13.5%	1.6%	2.1%	3.3%	-0.9%	-3.7%	2.9%

Source: Nielsen Retail Audit

The question of whether future excise policy should be looking at extending non-alcoholic beverage excise to all products, or repeal all such excises has many considerations. The Irish Government looked at a similar question in the early 2000s in the context of a general move by the EU to remove excise-type taxation from non-alcoholic beverages in favour of VAT. In the Thai context, this would see the removal of excises from sodas and energy drinks and a reliance on VAT, for which revenues would likely increase as sales volumes in these categories grow at rates more consistent with other categories listed in Table 4 above.

Alternatively, a move to seek equity or fairness by extending non-alcoholic beverage excise to all categories would likely see impacts on the consumption of those beverages not currently subject to excise. The extent to which consumption would fall can be measured by understanding the price elasticity of these categories of beverage, or their price sensitivity upon any price change. Actual price elasticities will need to be derived from economic modelling of the non-alcoholic beverage market, but as a starting point, industry estimates suggest that price elasticity for the Thai market is around -1.2 to -1.3.[22] This figure suggests that consumers are quite responsive to price changes and that a 10% increase in the price of a beverage will lead to a 12–13% fall in consumption.

Another area to examine in terms of best practice is the tax base of those non-alcoholic products currently taxed. Prima facie, the current ex-factory arrangement valuations would fall well short of best practice administration, particularly in relation to fairness and transparency. These negative impacts fall, it seems, upon both industry and the Thai Excise Department.

The authoritative assessment arrangement places the valuation of products with the department as opposed to the actual costs of production. As stated, ex-factory prices have not been altered since 1998, due partly it is believed to the price cap policy – which itself has not allowed certain retail level prices to have moved since 2001. This price cap policy may in fact be a 'road block' to best practice administration as, generally, valuation best practice would move towards a self-assessed value determined by clearly stated rules and practices that apply equally to all non-alcoholic beverage manufacturers.

For industry however, the arbitrary setting of ex-factory values is not reflective of the industry which is subject to often significant fluctuations in pricing of key raw materials inputs, including inputs such as sugar. Whilst sugar is a product on the Ministry of Commerce Control List and price movements are carefully managed, Figure 1 below which includes the global price of sugar over the past 10 years in US dollars[23] indicates there has been continual pressure on the price of a major business input to the industry for the past few years. When the price changes do occur, such as the 30% increase in 2008, there was no adjustment to the prescribed ex-factory selling prices, indicating a substantial flaw in the policy approach to excise taxation and a loss of excise revenue for the government. Currently, the Ministry of Commerce is considering allowing manufacturers to increase pricing to take account of these sorts of factors,[24] and the concern for industry is how the Excise Department will respond in terms of its prescribed ex-factory pricing.

Figure 1: Ten-year sugar prices

Source: Preece 2012

Perhaps some rationale for this policy might come from this government policy which places non-alcoholic beverages on a 'Price Sensitive List' which requires the industry to alert the government should it wish to alter an RSP. Administered by the Department of Internal Trade at the Ministry of Commerce, this pricing watch-list issue becomes a potential excise policy issue as industry often finds it difficult to increase RSP with increases to raw material costs, and normally it could be reasonably expected that the Excise Department could increase prescribed ex-factory prices to reflect an increase in raw material inputs. The issue here becomes one of how can the industry maintain any sort of margins if, effectively, RSP is fixed but raw materials and excise taxes both increase.

In this context, the question of whether an ex-factory value is the most appropriate approach needs to be raised. Indeed if ex-factory valuations are to continue, there needs to be a better approach to assessing this value in the context of raw materials, excise tax levels, and retail price caps. Alternatively, if value-based taxation is preferred by government, then perhaps other valuations can be considered, such as retail pricing itself which in this case is a 'set' and 'known' value, which is critical as, being an excise, it would still be payable by the manufacturer.

However, these types of valuation based issues give rise to the question of whether this continues to be the most appropriate for assessing the excise on non-alcoholic beverages, or whether it would be more appropriate to now move to another approach such as specific taxation, or ad valorem taxation based on an RSP. The benefits and impacts of a specific tax have been discussed already in this paper, and must remain an option for reform given that specific taxation, or taxation by volume, can add a degree of certainty and consistency in taxation, and remove many of the value-based administrative issues raised above.

However, if the government was to continue with ad valorem or value-based taxation, then there are two further options we can also explore at this point, firstly, to remove the authoritative assessment and move to full self assessment. Full self-assessment, supported by clear rules, guidelines and anti-avoidance measures, is consistent with best practice administration but would be difficult for industry given the existing price cap policies.

Self-assessment or use of actual 'real' ex-factory values will fluctuate with market conditions and as such there will be occasions in which ex-factory costs with the excise tax will approach the price cap value leaving no room for profitability. Thus in the context of the Ministry of Commerce policy, this option is difficult to analyse or propose as a reform option. In addition, manufacturers will be looking for some consistency in excise liabilities over their products as they are likely to be involved with long-term contracts with their customers and based on set prices that cannot be altered delivery–by-delivery to reflect these differing excise liabilities.

Realistically, outside of a fully self-assessed ex-factory value, the only real alternative valuation point would be some form of a 'stable', 'set' or 'regulated' RSP. Normally, RSP would be a difficult issue to administer as the excise tax is required to be paid by a manufacturer who would not necessarily know the retail price at the taxing point (or point at which goods leave the licensed factory). RSP as seen above is further complicated by the place of purchase – primarily on or off premise, and we see large price variations between retail prices of beverages at the supermarket, at a street vendor, a restaurant or up-market hotel.

However, the same price cap policy existing in the Thai market does provide for a stable 'retail price' to be utilised by all manufacturers, being that price prescribed by the cap. As a result, excise rates would only change with a change to the price cap level – but again, this tax base would need to be reviewed if ever the government was to abandon the price cap policy for non-alcoholic beverages.

Thus the taxation scenario development proposals for future analysis and discussion need to focus on options that include pure specific taxation, building equity into the existing ex-factory ad valorem taxation, and RSP ad valorem taxation. As such, the following 'starting point' scenarios based on the discussion and findings above have been developed for further debate and testing:

1. Introduction of a single specific excise duty rate to existing excisable non-alcoholic beverages which is revenue neutral.
2. Introduction of a single specific excise duty rate to all excisable non-alcoholic beverages* which is revenue neutral.
3. Introduction of a single ad valorem excise duty rate based on ex-factory pricing for all non-alcoholic beverages* which is revenue neutral.
4. Extension of the existing 20% ad valorem ex-factory rate to all non-alcoholic beverages*.
5. Introduction of a single ad valorem excise duty rate based on RSP for all non-alcoholic beverages* which is revenue neutral.
   ** excluding bottled water*

In this case, the scenarios would look at several different RSP options but realistically, it would appear from the study that 'price cap' values would be the most relevant RSP.

Looking at the five scenarios identified above in more detail:

1. **Introduction of a single specific excise duty rate to existing excisable non-alcoholic beverages which is revenue neutral**

Specific taxation options are worthy of analysis for several reasons:

- they are transparently equitable across like beverages in the market, not discriminating against one or favouring another on the basis of characteristics such as value, origin, volume or contents
- they are simple to administer, requiring calculation of volumes for reference against a prescribed rate, rather than requiring the establishment of detailed rules around what and what is not included in the taxable value, and prevent price structuring to minimise excise payable
- excise payable by manufacturers (and collectable by government) is not subject to fluctuations based on movements in raw material input costs, packaging costs, salary costs, volume discounts, price competitions, etc.
- they better reflect externalities or costs of harm, where applicable, rather than cost of production.

2. **Introduction of a single specific excise duty rate to all excisable non-alcoholic beverages which is revenue neutral**

Building on scenario 1, scenario 2 introduces equity into the taxation of non-alcoholic beverages by extending the excise to those beverages currently not subject to excise (except bottled drinking water). This scenario also starts with the premise that the extension of excise to all non-alcoholic beverages needs to be revenue neutral so that the new taxes are not seen as ‘revenue grabs’, ensure that the initial excise tax on new products is not so large, and existing excisable products are given the opportunity to re-establish some of their margins that have been ‘cut’ over the preceding years from rising raw material costs and price caps.

3. **Introduction of a single ad valorem excise duty rate based on ex-factory prices for all non-alcoholic beverages which is revenue neutral**

This scenario analyses the continuation of the existing ad valorem ‘ex-factory’ based taxable valuation system for non-alcoholic beverages, but looks at introducing a degree of equity into the system by again extending the excise to all beverages (except bottled drinking water). If introduced, the revenue neutral excise rate was found to be 16% of ex-factory value, down from the existing 20% and 25% rates.

4. **Extend existing 20% ad valorem ex-factory rate to all non-alcoholic beverages**

In this scenario, the single ad valorem rate is retained at 20% of an ex-factory value, but is applied to all beverage categories except bottled drinking water, thus differs from scenario 3 by introducing equity immediately by applying the existing 20% excise rate to all non-alcoholic beverages (although this will represent a very small effective tax cut for soda water). Thus scenario 3 represents no tax changes for carbonates and functional drinks but implements the full rate for existing non-taxed beverage categories.

5. **Introduction of a single ad valorem excise duty rate based on RSP for all non-alcoholic beverages which is revenue neutral**

This final scenario introduces the concept of an excise based on an RSP valuation. It reflects the concept of equity by applying the excise tax to all beverage categories (except again to bottled water) and uses existing RSPs as subject to Ministry of Commerce price sensitive watch-lists. Thus the use of RSP does have a degree of transparency and simplicity as manufacturers link excise valuations to RSP valuations held by the Ministry of Commerce. The scenario will be revenue neutral in terms of setting an RSP excise rate.

Summary and conclusions

When examining the existing excise taxation systems for non-alcoholic beverages in Thailand there are clearly some areas in which reforms can be made when benchmarking the system against 'best practice'. When looking at policy and administration there needs to be consideration of equity in terms of what products are subject to excise and at what excise rate. There needs to be greater transparency in terms of both 'effectively' what beverages are subject to excise and at what rate. Further, if Thailand is to remain with an ad valorem excise systems for non-alcoholic beverages – this aspect of transparency needs to be extended to include consideration of what valuation approach is adopted and how this is administered.

As part of these considerations, this study would benefit from some form of economic modelling to better understand the potential impacts of any recommended reforms to the excise system for non-alcoholic beverages. This process also allows for policy development such as rate settings, in the context of limiting impacts on revenue, prices and sales to predetermined extents that are acceptable to the policymaker.

As a result, it has not been possible in this paper to quantify the potential impacts on the market with the introduction of possible reforms aimed at introducing such equity and transparency into the Thai non-alcoholic beverage excise system.

This paper could not locate definitive policy in terms of the Thai Government's position on the taxation of non-alcoholic beverages and so it is difficult to make a definitive recommendation as to which proposed taxation scenario is best placed for Thailand; however, some observations can be made.

For the concept of 'equity' in the taxation of like products, scenario 1 does not meet this criterion, rather it leaves the excise restricted to two main categories of poorly defined beverages, from which certain exemptions also exist. For the concept of 'transparency', it is difficult to see a continuation of the existing 'ex-factory' administrative arrangements as being best practice policy and administration given the methodology of calculation and opportunities to restructure such ex-factory costs. Thus, scenarios 3 and 4 do not meet these important criteria.

Scenarios 2 and 5 do start to meet these criteria that represent best practice, albeit an approach based on RSP requires significant consistency and certainty of the RSP to be used. Provided this certainty can be managed through some form of independently regulated or monitored pricing, scenario 5 does provide positive overall growth to the Thai non-alcoholic beverage market, whereas scenario 2's specific taxation impact is a small contraction in overall sales.

As stated in the paper, the use of specific taxation does relate to harm and various externalities and as such, is used to reduce consumption as we see with alcohol and tobacco, thus had the policy intent of managing consumption been a primary consideration of the study, scenario 2 would likely have been more of a focus. However, as a tax to raise revenue from a consumer item, the use of RSP-based ad valorem excise applied in a non-discriminatory manner to all beverages appears to grow the market volumes and will therefore in time be able to grow revenues accordingly.

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Notes

1 As adapted from the departmental website, www.excise.go.th/index.php?id=178.

2 These internal procedures were previously published by the Royal Thai Excise on their website but have since been removed.

3 Excise Department Notification 1/2542.

4 Industry Consultative Forum held at Renaissance Hotel, March 2010.

5 Unofficial translation of Industry Consultative Forum draft amendments to excise laws.

6 See Thai Excise Department website www.excise.go.th/index.php?id=179.

7 This study identified the following excise rates: Turkey 20%; Zambia, Egypt, Chad, Zimbabwe 25%; Uganda, Ethiopia, Ghana 50%; Laos, Cambodia 10%.

8 Bahl, Bird & Walker 2003, p. 511.

9 Turkey also uses a type of 'greater of' ad valorem or specific rate approach in excise products – but not for non-alcoholic beverages.

10 See also Note 9.

11 www.bangkokpost.com/business/economics/214021/excise-tax-on-goods-with-sugar-considered.

12 See, for example, 'Beverage Container Tax' 1037/2004 Finland, which is a tax on beverages classified to Chapter 22 of the HS, with deposit return arrangements, and applies from 2008.

13 www.minfin.nl/english/Subjects/Taxation/A_brief_outline_of_all_taxes_in_the_Netherlands/Indirect_taxes.

14 www.vero.fi/nc/doc/download.asp?id=4151;1035296.

15 www.ijf.hr/eng/taxguide/3-09/7.pdf.

16 Griffey, 20 March 2010.

17 The Australian GST is a value added tax on private consumption.

18 OECD 2001.

19 Cnossen 2005a, p. 235.

20 Whilst the Bangkok Metropolitan Authority claims the tap water in Bangkok is safe to drink, many international medical travel advisories are still recommending that tap water not be consumed.

21 Adapted from a presentation by Coca Cola to the 'Enhancing Tax Administration' workshop at the Pullman Hotel, 6 May 2010.

22 Oxford Economics & International Tax & Investment Centre 2009 (unpub.)

23 As mapped by the World Bank, Washington, DC.

24 Based on submissions by the industry to Commerce Ministry. *Financial Times,* 29 June 2010, International Trade Department may have to allow soft drink manufacturers to increase prices to account for these fluctuations (increases) in sugar prices. http://news.reportlinker.com/n03364073/Thailand-Internal-Trade-Dept-says-soft-drink-prices-may-go-up-on-sugar-price-hike.html#**.**

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The role of bilateral and regional trade agreements in the modernisation of taxation and revenue policy in developing economies

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Abstract

This paper investigates the impact of existing trade agreements on domestic revenue policy and assesses the potential impact of differing levels of economic integration of domestic policy objectives. The role of bilateral and regional trade agreements is increasingly important given the emergence of the comprehensive trade agreements, such as the current Trans-Pacific Partnership (TPP) negotiations, which seek to have a greater impact on the international trading environment than existing FTAs. In a changing world with rapidly integrating economies, governments are more frequently taking the initiative to reform their trading arrangements through direct negotiation. Given the protracted process of multilateral trade negotiations – as evidenced by the Doha Round – bilateral and regional trade agreements (such as Free Trade Agreements [FTA]) are setting the framework for trade liberalisation in the 21st century. The commencement of the ASEAN Economic Community (AEC) from 2015 demonstrates that emerging economies still see value in further enmeshing their economies into the development of neighbouring economies across the region.

1. Introduction

Over the past twenty years, countries around the world have increasingly embraced trade agreements at both the country-to-country (bilateral) level and amongst (often geographical) groupings of multiple countries (regional level). A Free Trade Agreement (FTA) is a formal undertaking between signatory countries to eliminate or reduce trade barriers, including tariffs and quotas/quantitative restrictions on goods and services traded within the signatory countries.

Developments at a regional level heavily define the present international trading environment. Whilst ongoing uncertainty over the future of Europe has highlighted structural features of the European Union (EU), the Asia-Pacific region continues to work towards enhanced regional integration. The commencement of the ASEAN Economic Community (AEC) from 2015 demonstrates that emerging economies still see value in further enmeshing their economies into the development of neighbouring economies across the region. The AEC continues to be underpinned by the four key characteristics of (1) a single market, (2) a competitive economic region, (3) equitable economic development, and (4) integration into the global economy (ASEAN Secretariat 2012). Additionally, the emergence of the comprehensive Trans-Pacific Partnership (TPP) agreement demonstrates that the current global economic downturn has not inhibited progress towards greater trade liberalisation at a broader Asia-Pacific level.

Bilateral and regional trade agreements (such as FTAs) are a potential avenue for signatory countries to develop and modernise their tax and revenue systems. The liberalisation of tariff barriers through the phasing down or removal of customs duties is the primary objective of a trade agreement. However, trade agreements also create an opportunity for associated reforms to domestic tax and revenue policies. Growing integration across the ASEAN region, and the goal of TPP negotiators to forge a ‘modern and comprehensive 21st century agreement’, demonstrate the potential role for regional agreements in driving reform.

The very nature of bilateral and regional trade agreements results in signature countries taking a greater role in shaping the direction of their trade policy. Sovereign nations join together, usually on a regional scale, to create free trade agreements. Member countries belonging to the free trade area trade freely with each other while maintaining trade barriers for non-member countries (Kirkwood 2011).

Trade liberalisation is widely credited for enhancing economic development amongst participating economies. By reducing barriers to trade, countries in the international trading system unlock their economic potential by empowering domestic industries to access foreign markets and strive for greater productivity. Reducing restrictions that are imposed at a government level has the beneficial effect of exposing businesses to international competition and compelling domestic industry to greater innovation and efficiency. Studies have determined that reductions in trade barriers result in benefits to the broader economy. In 2000, a study by the Centre for International Economics (CIE) in Australia found that opening up the Australian economy to greater trade has resulted in the average Australian household being better off by an estimated AUD3,900 per annum (CIE 2000).

Whilst the benefits of reducing the barriers to international trade a well documented, trade liberalisation in isolation is unlikely to deliver optimal economic benefit. Greater trade facilitation alone can only unlock a limited proportion of opportunity as economic wellbeing generated primarily within an economy. The Australian Government’s 2011 *Trade Policy Statement*, recently highlighted this point, arguing:

Trade policy and microeconomic policy are as one; the best trade policy is domestic economic reform – a productivity-raising, competitiveness-enhancing microeconomic reform program supported by responsible fiscal policy (DFAT 2011a).

With a growing proliferation of bilateral and regional FTAs, do trade agreements provide a modern and dynamic avenue for countries to undertake necessary economic reform, in parallel with the progressive raising of trade barriers?

2. The growing significance of trade to economic development

As modern commerce increasingly takes place at a global and regional level, businesses require greater certainty when operating within the international trading environment. Globalisation has increased the volume of capital, goods and services that transact across traditional state borders. As the Australian Government’s 2008 *Review of Export Policies and Programs* (the Mortimer Review) stated, direct foreign investment has led to an increase in the level of engagement between countries and their economies (Mortimer 2008).

There are considerable advantages resulting from opening up economies to world trade. Global markets offer vast commercial opportunities that in most circumstances far outweigh opportunities that exist within a domestic economy. According to a study conducted in Australia in 2000, it is evident that enhanced trade is directly attributable to higher levels of skills and wages within the domestic economy. As a consequence, Australians working in export industries on average are paid 60 per cent more than other Australian workers in non-trade exposed industries (Pink & Jamieson 2000).

Whilst the benefits of a liberalised trade environment are becoming more evident in developed economies such as Australia, it is important to consider the short and mid to long term impacts of trade liberalisation to developing economies, such as those neighbouring Australia in the Asia-Pacific region.

Following a recommendation from the 2008 Mortimer Review, the Australian Government directed its independent research and advisory body, the Productivity Commission, to undertake a study on the impact of bilateral and regional trade agreements on Australia's trade and investment performance. Amongst other areas, the Commission examined:

- the impact of bilateral and regional trade agreements on trade flows, unilateral reform, behind-the-border barriers, investment returns and productivity growth
- the scope for Australia's bilateral and regional trade agreements to reduce trade and investment barriers or to **promote structural reform and productivity growth in partner countries** (emphasis of this analysis)
- the scope of bilateral and regional trade agreements to evolve over time to deliver further benefits. (Productivity Commission 2010).

The above examination into the scope for trade agreements to promote internal structural reform is central to this analysis. *This research project offers two specific legal case studies in Thailand and Vietnam, as outlined in case studies 1 and 2 below.*

Bilateral and regional trade agreements have become more prevalent across the Asia-Pacific region due to a combination of global factors and factors within the region. In many ways, the 1980s and early 1990s represent the zenith of multilateral trade negotiations. This period saw the negotiation and completion of the heralded 'Uruguay Round' of global trade negotiations, which culminated in the 1994 Marrakesh Agreement which established the World Trade Organization (WTO).

From an international trade law perspective, the Marrakesh Agreement developed out of the *General Agreement on Tariffs and Trade (GATT) 1947*, which was incorporated as an annex into the *WTO Agreement 1994*. The WTO came into force on 1 January 1995, and oversees the international 'rules based' trading system. The WTO Agreement combined the GATT with several other agreements, on such issues as trade in services, sanitary and phytosanitary measures, trade-related aspects of intellectual property and technical barriers to trade. The new agreement also established a new, more efficient and legally binding means of dispute resolution (WTO 1994).

Several Asia-Pacific countries found common ground during multilateral trade negotiations during the 1980s and 1990s. In particular, Indonesia, Malaysia, the Philippines, Australia and New Zealand are all members of the 'Cairns Group' of agricultural producing nations. Established at the height of the Uruguay Round global trade negotiations, the Cairns Group took a common approach to the liberalisation of agricultural trade, and this was significant in developing the Agreement on Agriculture (Cairns Group 2010). This grouping continues to push for the liberalisation of trade in agricultural exports – largely driven by the mutual need to gain greater access to growing export markets.

Following the successful Uruguay Round multilateral negotiation period, global trade talks began to stall after the 1999 WTO Ministerial Meeting in Seattle, USA. The Seattle meeting, hosted by US President Bill Clinton, was marred by violent anti-government street protests and failed to deliver the ministerial declaration needed to get a new round of negotiations under way. Sadly, for proponents of further multilateral trade liberalisation, the Seattle meeting floundered following growing rifts between the United States (US) and the EU, and President Clinton championing the insertion of labour rights in the negotiations, which was the main demand of US trade unions as a mechanism to retain protectionism (Kelly 2009).

The immediate post-Seattle period marked a turning point in regional trade liberalisation across the Asia-Pacific. The failure of the Seattle WTO Ministerial Meeting also had a lasting impact on other countries across the Asia-Pacific region. From late 1999 onwards, Singapore responded by actively seeking regional and bilateral free trade agreements. With a small, highly educated population and minimal agricultural and mining industries, Singapore stood to gain greatly from liberalised flows of trade and capital. Furthermore, Singapore sought to build on the twin aspects of the Seattle failure and its own preference for liberalised trade, to actively advocate enhancing bilateral and regional trade liberalisation though greater integration of existing trade deals such as the ASEAN Free Trade Area (AFTA) and the Australia-New Zealand Closer Economic Relations (CER) (Pitty 2003).

Since the early 2000s, countries across the Asia-Pacific region have concluded numerous bilateral and regional FTAs, establishing a framework of trade liberalisation that is increasing in its breadth and scope.

The growth in FTAs across the Asia Pacific built on existing trade agreements, including the AFTA concluded in 1992, and the Australia-New Zealand Closer Economic Relations Trade Agreement (ANCERTA) which came into effect in 1983. Key FTAs concluded since 1999 include those outlined in Table 1.

Table 1: Key Free Trade Agreements concluded since 1999

Free Trade Agreement (FTA)	Commencement year
Singapore-Australia FTA (SAFTA)	2003
Thailand-Australia FTA (TAFTA)	2005
Australia-United States FTA (AUSFTA)	2005
ASEAN-Australia-New Zealand FTA (AANZFTA)	2010
New Zealand-China FTA (NZCFTA)	2008
Japan-ASEAN FTA (JAFTA)	2008
ASEAN-China FTA (ACFTA)	2010
ASEAN-India FTA (AIFTA)	2010
EU-Korea FTA (EU-KFTA)	2011

Through the development of these and other FTAs over the past decade, trade barriers across the Asia-Pacific region have progressively fallen, whilst global trade negotiations through the WTO’s multilateral Doha Round have largely stalled.

The proliferation of trade agreements across the Asia-Pacific region mirrors the growth of bilateral and regional trade agreements across the world. Whilst the broad strategic objectives of FTAs around the world are often similar, agreements differ considerably in terms of their impact on domestic laws and regulatory frameworks.

3. Developing and implementing a trade agreement

The impact of regional and bilateral trade agreements enacted around the world over the last two decades differs on a case-by-case basis. Some less sophisticated agreements are simply FTAs which involve a reduction in current tariff and non-tariff import controls, so as to liberalise the trade in goods and services between countries. The more sophisticated trade agreements, particularly at the regional level, go beyond traditional trade policy mechanisms, to include regional rules on flows of investment, intellectual property rights, agreements on environmental policies and the free movement of labour (Boston House 2011).

By entering into a trade agreement, member countries choose to adopt a certain level of economic integration. From a minimal integration perspective, a simple FTA offers a loose form of integration, with member countries simply agreeing to remove tariff and non-tariff barriers between them to promote the free trade of goods and services. Many of the bilateral FTAs outlined in the above table are examples of this minimal approach.

Conventional FTAs concluded across the Asia-Pacific over the last decade have effectively taken place as a contract between the negotiating parties. In most circumstances, FTA measures do not require amendments to domestic legislation. Signatory parties generally implement key adjustments to the bilateral/regional trading arrangements, such as adjustments to tariff schedules, by direct gazettal. In some countries international agreements and treaties require the ratification of the national parliament/assembly before they can take effect. For example, in Australia, irrespective of whether proposed final trade deals require legislation, they are subjected to parliamentary scrutiny before the Parliament's Joint Standing Committee on Treaties (DFAT 2011a).

As trade agreements become more sophisticated, signatory countries take on board additional undertakings to reform and harmonise the application of domestic legislative and regulatory functions, including:

- the setting of common external tariffs
- the mobility of assets
- harmonised economic and monetary policy.

Table 2 outlines a scale of economic integration, ranging from a minimal free trade area through to a comprehensive economic union, which encompasses the comprehensive levels of integration outlined above. Regional groupings, such as ASEAN, which are moving towards greater economic integration through the AEC 2015 should note the opportunities and challenges posed by each stage.

Table 2: Level of economic integration by grouping/union type

Stage of Economic Integration	No Internal Trade Barriers	Common External Tariff	Factor & Asset Mobility	Common Currency	Common Economic Policy
1. Free Trade Area	X				
2. Customs Union	X	X			
3. Single Market	X	X	X		
4. Monetary Union	X	X	X	X	
5. Economic Union	X	X	X	X	X

Note: Table 2 draws on an analysis undertaken by Boston House (2011).

This table demonstrates the significance of progressing from phases one and two to phase three, where signatory states are required to make legislative or regulatory changes beyond simply adjusting tariff and other trade barriers. This analysis is particularly relevant when assessing the economic crises impacting the EU throughout 2011 and 2012. As a Monetary Union, but not a full Economic Union with common economic policies, Eurozone economies have the inflexibility of a common currency, without a common approach to policy to underpin the long term economic direction of the grouping.

As bilateral and regional trade agreements continue to proliferate, a more comprehensive analysis of what members seek to gain from greater trade integration is required. In particular, greater consideration of the role of trade agreements in the modernisation of taxation and revenue systems could add additional value to the integration process. As countries seek to enter into comprehensive regional trade agreements, such as the TPP Agreement, trade negotiators in partnership with their domestic stakeholders are contemplating how modern agreements can seek to address multiple policy aims. Formal consultation processes provide an opportunity for countries to consider non-tariff reforms within their domestic economy that can impact ongoing international trade with signatory parties.

4. The direct impacts of trade agreements in the Asia-Pacific region

Australia provides a useful case study of the importance of enhancing international trade arrangements. Australia has greatly increased its trade with neighbouring Asian countries over recent decades. Australia's trade with North-East Asia (including China, Hong Kong, Japan, the Republic of Korea and Taiwan) increased from 25 per cent of Australia's total exports in 1965, to 44.6 per cent of Australia's total exports by the time of the establishment of the WTO in 1995. Additionally, the proportion of Australia's total exports going into South-East Asia grew from 4.3 per cent to 15.9 per cent over this period (Smith 2001).

The slowing of multilateral trade negotiations since the conclusion of the Uruguay Round has shifted focus to direct trade agreements. Given the growing importance of regional trade, Australia sought to enhance its market access into the region with a broad FTA with the members of the Association of South East Asian Nations (ASEAN). In 2009 Australia, together with New Zealand, concluded the ASEAN-Australia-New Zealand FTA (AANZFTA). Coming into force in 2010, AANZFTA is the biggest FTA that Australia has concluded, with ASEAN and New Zealand together accounting for 20 per cent of Australia's total trade in goods and services. Worth AUD112 billion in 2008, this was larger than Australia's trade with any single country (DFAT 2011b).

An often overlooked aspect of many free trade agreements is that they require signatory countries to make only limited amendments to domestic legislation. Most of the changes resulting from the AANZFTA were enacted through simple changes to tariff schedules or other non-legislative means. Table 3 below maps the key chapters within the AANZFTA against requirements for legislative amendments.

Table 3: Impact of a Free Trade Agreement on domestic legislation

AANZTFA – Table of Contents		
FTA Chapter	**Issue**	**Change to domestic legislation?**
Chapter 1	Establishment of Free Trade Area, Objectives and General Definitions?	NO (Overview of definitions in the agreement)
Chapter 2	Trade in Goods	NO (Provision for schedule of tariff reduction commitments and reassertion of obligations under *WTO/GATT Agreement 1994*)
Chapter 3	Rules of Origin	NO (Overview of definitions and formulas used in the agreement)
Chapter 4	Customs procedures	NO (Provisions in the chapter are broad, with references to general obligations [e.g. encouraging parties to consult], but limited prescription for customs procedures)
Chapter 5	Sanitary and Phytosanitary Measures	NO (Text of this agreement affirms commitment to WTO SPS Agreement and trade facilitation measures between signatory parties.)
Chapter 6	Standards, Technical Regulations and Conformity Assessment Procedures	NO (However, this chapter commits signatory parties to consider accepting technical regulations of other parties. This may require some regulatory or legislative amendment.)
Chapter 7	Safeguard Measures	NO (Affirms signatory parties to global safeguard provisions under Article XIX of the GATT 1994 and definitions for enforcing safeguard measures.)

AANZTFA – Table of Contents		
FTA Chapter	**Issue**	**Change to domestic legislation?**
Chapter 8	Trade in Services • Financial services • Telecommunications	POSSIBLY (Depending on the internal prudential regulations, signatory parties may need to adjust foreign investment restrictions in the banking and financial services industry. Additionally, telecommunications industries are tightly regulated in many signatory markets, and individual domestic legislation is referenced in the text of the *Annex on Telecommunications*.)
Chapter 9	Movement of natural persons	NO (Affirms signatory parties to grant temporary Visa entry to natural persons of other parties to facilitate fee commerce amongst member borders.)
Chapter 10	Electronic Commerce	**YES POSSIBLY** **(Article 4 of Chapter 10 calls for each party to maintain, or adopt as soon as practicable, domestic laws and regulations governing electronic transactions taking into account the *UNCITRAL Model Law on Electronic Commerce 1996*. Legislative amendment is only required where this model law has not yet been adopted.)**
Chapter 11	Investment • Annex on Expropriation & Compensation	NO (Text of Chapter 11 takes into consideration domestic definitions of investment.)
Chapter 12	Economic Cooperation	NO (Acknowledges the need for further economic cooperation and sets broad framework for individual cooperation activities.)
Chapter 13	Intellectual Property	**YES** **(Article 6 of Chapter 13 requires signatory parties to 'maintain appropriate laws, regulations or policies that make provision for its central government agencies to continue to use only legitimate computer software in a manner authorised by law and consistent with this Chapter'.)** *NOTE: The Australia-United States Free Trade Agreement required domestic legislation in Australia regarding Effective Technical Measures for media copyright laws and the administration of Australia's Pharmaceutical Benefits Scheme* (DFAT 2011c; DoHA 2008).
Chapter 14	Competition	NO (Chapter 14 provides a framework for cooperation activities.)
Chapter 15	General Provisions and Exceptions	NO (Article 3 of Chapter 15 specifically states that the Agreement has only limited prescription to taxation measures – not including customs tariffs.)
Chapter 16	Institutional Provisions	NO (Provides framework for ongoing administration and review of the agreement.)
Chapter 17	Consultations and Dispute Settlement	NO (Sets the terms, scope and coverage of the dispute settlement process.)
Chapter 18	Final Provisions	NO

Source: AANZFTA 2010.

As Table 3 demonstrates, a 'minimalist' FTA such as the AANZFTA is essentially a contractual agreement between the signatory parties to reduce tariff-based and non-tariff-based barriers to trade. This FTA does not prescribe a considerable level of economic integration between the signatory parties beyond the removal of tariff barriers. As such, only limited amendments to domestic legislation are required to enact the agreement.

A key difference between a 'minimalist' trade agreement and a more comprehensive agreement, such as a single market or an economic union, is the requirement for signatory countries to adopt measures that require amendment to or modification of domestic laws. Keeping domestic legislative changes to a minimum removes potential obstacles to the adaptation of a trade agreement as legislative amendments often result in political resistance, particularly where the short-term interests of domestic industry and government revenues are involved.

5. Immediate costs and benefits from trade agreements

A potentially unforeseen consequence of trade liberalisation is the impact of customs tariff reductions on domestic tax bases, and therefore on domestic tax collections. Whilst trade is likely to stimulate further economic activity, government treasuries and finance ministries are nevertheless concerned about the impact to indirect tax revenues. This is particularly the case with narrow-based indirect taxes such as excises, also known as 'special consumption taxes' or similar titles.

The broad perception of free trade agreements across a broad regional grouping such as the AANZFTA signatory countries is likely to vary greatly depending on specific economic circumstances of the particular country. For more developed countries, such as Australia or New Zealand, trade agreements are broadly regarded as positive developments that will lead to greater prosperity as a result of a greater flow of trade across signatory countries. For example, the Australian Government publicly supports the benefits of bilateral and regional FTAs, despite the current government's strong statements that the Doha Round of multilateral trade negotiations remains Australia's number one trade reform priority.

In developing economies, there is likely to be a greater degree of debate regarding the overall costs and benefits of trade agreements. Whilst developed economies have broad, diverse and mature industries across a wide range of goods and services sectors, developing economies often have a narrower base of established industries. Furthermore, developing economies are often more likely to have higher levels of existing protection than developed economies, for example, higher Most Favoured Nation (MFN) Customs Duties (Ali 2011)

Table 4 below demonstrates the diverging MFN Customs Duties on one example of a good which is levied an excise once in the domestic market: alcohol beverages. The table demonstrates different rates in select AANZFTA member countries.

Table 4: Divergent domestic excise rates in different countries within the AANZFA

Country	MNF Customs Duty on alcohol beverages	
Australia	Beer	0%
	Wine	5%
	Spirits	5%
Thailand	Beer	60%
	Wine	54% or 60%
	Spirits	60%

Country	MNF Customs Duty on alcohol beverages	
Vietnam	Beer	35%
	Wine *(still and sparkling grape wine)*	50%
	Spirits *(whisky, gin, vodka)*	48%
Cambodia	Beer	35%
	Wine	35%
	Spirits	35%

Source: Customs Tariff Working Pages, current as of July 2012.

6. Impacts of FTAs on government indirect tax revenue

From an excise taxation perspective, this analysis highlights the impact of trade agreements on the internal tax treatment of alcohol beverages. Alcohol is an effective case study as it is a key excisable commodity, which is classified as a 'narrow based' indirect tax. Governments levy excise on alcohol. The Organisation for Economic Co-operation and Development (OECD) classifies excise taxes as: '... taxes levied on particular products or on a limited range of products', and qualifies this by stating that 'they may be imposed at any stage of production or distribution and are usually assessed by reference to the weight or strength or quantity of the product', but sometimes by reference to value (OECD 2004, 5121).

Governments levy excise on certain products for two main reasons. Firstly, governments seek to recover the negative external cost to the community of the consumption of certain commodities, such as alcohol, tobacco and petroleum. Secondly, excisable products often have a low price elasticity. As a result, in practice, most countries have enacted excises for revenue purposes, regardless of consumption concerns, as they represent a stable revenue base (Cnossen 2005).

This international definition of excise taxation is important as it demonstrates differing policy priorities between different governments regarding excise taxation. In developed economies, excise taxes account for less than 10 per cent of total government revenues. For example, in Australia revenue from alcohol, tobacco and petroleum products accounted for 7.5 per cent of total taxation revenues in the 2008-09 financial year (Australian Government, Department of the Treasury 2010). In contrast, this proportion is far greater in developing economies, for example, in Thailand excise revenues generally account for approximately 25 per cent of total government revenue (Chandevwit & Dahlby 2007). In considerably under-developed economies, such as Cambodia, excise revenues account for approximately 46.3 per cent of total government revenues (Cnossen 2011).

Table 5: Government revenue from customs and excise taxes

Level of economic development	Country	Proportion of government revenue from customs and excise taxes, 2008
Developed economy	Singapore	17.3%
Developing economy	Thailand	33.9%
Under-developed economy	Cambodia	46.3%

Source: IMF 2008 data; Cnossen 2011.

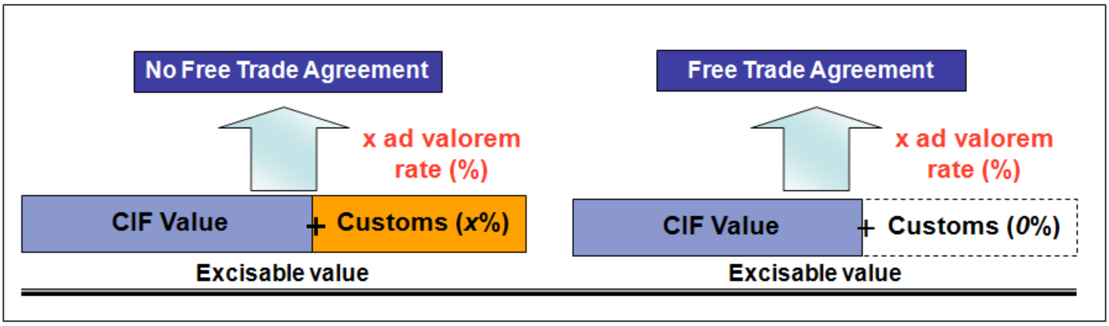
As Table 5 demonstrates, developing countries have a greater reliance on narrow-based excise taxes. Excise taxation is an internal taxation measure levied on both domestically produced and imported products.

Linkage between customs duties and excise revenue

However, in many developing countries, including Thailand and Cambodia, alcohol excise is levied through an ad valorem (or value-based) method, in which customs duty paid forms a component of the excisable base of the product. As a result, falling customs duty rates through tariff reduction commitments directly impact excise tax bases. Presently, FTAs across the Asia-Pacific region do not prescribe reforms to internal taxes such as excise; rather the focus is on the reduction or removal of customs duties.

With FTAs progressively decreasing and then eliminating applied customs duties on alcohol beverages, signatory countries are faced with the dual impact of falling customs revenues and excise revenues with the shrinking of taxable base values used for calculating ad valorem excise liabilities. The graphic below demonstrates the impact of a reduction in customs duties on an excisable base value.

Box 1: The impact of reduced customs duties on ad valorem excise base values



Source: Obradovic 2012.

Addressing falling customs and excise duties is an increasingly relevant issue across the Asia-Pacific. In particular, 2010 saw applied customs duties in Thailand under three key FTAs – the AFTA, the China-ASEAN Free Trade Agreement (CAFTA) and the Thailand-Australia Free Trade Agreement (TAFTA) make their final phased reduction down to 0 per cent.

Whilst governments, in particular their customs agencies, factor in the impact of falling customs duty revenues when negotiating trade agreements, this is not necessarily the case with other revenue agencies.

The following case studies in Thailand and Vietnam are two contemporary examples where developing economies have proposed amendments to domestic laws or regulations to offset the short-term impacts of trade liberalisation.

7. Case study 1: Thailand 2009 – the impact of free trade on internal excise taxation

2010 represented a watershed for trade liberalisation in the Asia-Pacific, with many commodities subject to phased tariff reductions undergoing their final transition phase down to 0 per cent. In the case of alcohol beverages in Thailand, beverages originating from signatory countries to the AFTA, CAFTA) and TAFTA reduced from 5 per cent to 0 per cent on 1 January 2010.

Beer products in Thailand are predominantly levied an ad valorem alcohol excise (known as the ‘Liquor Tax’). As 2010 approached, some policymakers in Thailand were concerned about the impact of shrinking excise base values for imported alcohol products that had traditionally been levied a customs duty. Furthermore, the looming removal of the final 5 per cent of customs duties aroused some local concern regarding the potential impact of a 'flood' of cheap imports, especially beer, from less developed countries within ASEAN and China.

In an effort to offset the impact of the removal of the final customs tariff amount, several reform proposals emerged to amend Thailand's *Liquor Act B.E 2493 (1950)* (the Liquor Act). Of particular significance was a proposal to roll back the FTA reductions in customs duties, and reinstitute MFN tariff rates for the purposes of calculating ad valorem tax bases.

Below is an unofficial translation of the key section of one proposed amendment to the Liquor Act. In bold is a contentious proposal on the application of customs duties in ad valorem excise bases, as well as a proposal to grant arbitrary powers for the determination of the excisable base value in the event of a disputed Cost + Insurance + Freight (CIF) price.

> <u>Section 8 quarter</u> *Ad valorem liquor tax shall be imposed according to the value of liquor set out under (1) (2) and (3) which shall include payable liquor tax as follows:*
>
> *(1) In respect of liquor made in the Kingdom, the tax shall be based on ex-factory price.*
>
> *(2) In respect of imported liquor, the CIF price of the liquor plus import duty, special fees under the law governing investment promotion and other taxes and fees to be determined by a royal decree shall apply, but excluding the value added tax as prescribed under Chapter IV, Division 2 of the Revenue Code.*
>
> *CIF price under the first paragraph is the price of liquor plus insurance and freight at the customs house in the Kingdom unless, where the customs officials re-assess the price for imposition of import duty under the law governing customs, such price shall be the liquor price for the purpose of calculation of CIF.*
>
> ***Where the import duty is waived or discounted under the law governing investment promotion or is waived or discounted to the rates which are lower than the normal rates applicable in general with other countries, such waived or discounted import duty shall be included as a basis for calculation of the value under the first paragraph.***
>
> *(3) In respect of liquor produced in Customs Free Zone or Export Processing Zone, the tax shall be based on the ex-factory price if being used for other purposes than export.*
>
> ***In the case there is no price under paragraph 1 (1) (2) and (3) or there are multiple prices or the selling prices applied are not the selling prices of the [unrelated] parties, the Director-General, by an approval of the Minister, shall have the power to announce the liquor price for tax calculation basis****, provided that the calculation methods applied are those that have been certified internally and shall be made in pursuant to the rules, procedures and conditions as stipulated in the Ministerial Regulation (Proposed amendment to the Liquor Act B.E 2493 (1950), unofficial English translation 2009).*

In application, the proposal to reinstate MFN customs duty amounts into the excise tax base would result in a scenario where reduced customs duty rates would not flow through the supply chain to apply to ad valorem internal taxes, such as excises.

Additionally, paragraph 3 of the draft liquor amendment proposed granting additional discretion to the Excise Department (through its Director-General) to unilaterally set disputed CIF prices when determining the excise base value of the product. Thailand had previously faced the threat of a formal trade dispute in 2008 and 2009 regarding the discretionary setting of import values, including alternative customs valuation methods for imported goods including distilled spirits beverages (United States Trade Representative 2010).

Since this dispute, the Philippines have successfully challenged Thailand's arbitrary customs valuation practices, with the WTO Dispute Settlement Panel in *DS371: Thailand – Customs and Fiscal Measures on Cigarettes from the Philippines* finding that Thailand's Customs Valuation Procedures are inconsistent with Thailand's obligations under the WTO Customs Valuation Agreement (WTO DS371 2011).

Thailand's Liquor Act proposal met firm resistance from industry and representatives of the international community, including the EU. At the time of writing this paper, Thailand was yet to enact any of the aforementioned reforms to the Liquor Act, and there do not appear to be public indications that such a reform is currently under consideration.

A possible role of bilateral and regional trade agreements?

This proposal demonstrates a disconnect between bilateral and regional trade agreements and domestic taxes that are directly impacted by the reduction in ad valorem tax bases. Through preparing this draft Liquor Act amendment, the Excise Department, in effect, argued a case to recoup revenues lost due to its shrinking taxable base values.

This amendment highlights the fact that a minimalist FTA does not prescribe reform options to modernise the excise taxation system in Thailand. The impact of the tariff reductions on Excise Department revenue demonstrates the inherent instability of Thailand's narrow-based indirect tax systems, in particular the reliance on ad valorem excise systems that require the establishment of import prices, and result in price inter-dependencies running through the supply chain.

Many key stakeholders within industry, government and the health lobby advocate 'volumetric' excise methodologies, where the rate is determined according to the volume or certain characteristics of the excisable product. Many within the alcohol industry support volumetric taxation as it creates certainty regarding excise tax liabilities, as alcohol strength and product classification – not price – are the determining factors. Health and social policy advocates support volumetric tax due to its fundamental link between the tax levied and the volume of the product of which the tax seeks to discourage or regulate consumption (Due 1994).

The EU has, since 1992, required its signatory members to adhere to a series of criteria regarding the structure and rates of their internal alcohol excise systems. These measures, which are outlined in Directive 92/84/EEC and Directive 92/83/EEC, prescribe a volumetric alcohol excise regime as a condition of EU membership. EU members retain the flexibility in how each party sets their actual volumetric excise rate, and/or delivers rebates for consumption within that member's borders (EU 1992).

Aside from the health and social policy elements of volumetric excises on alcohol beverages, the EU's prescribed alcohol excise regime ensures that there is a complete de-coupling of the customs and excise taxation systems. This is important from a tax policy planning perspective, as it enables a more modern approach where each system can focus on their primary policy objectives.

8. Case study 2: Vietnam 2011 – proposed changes to import regulations

The second (minor) case study in this analysis concerns a series of non-tariff proposals put forward by two Vietnam Government departments: the Ministry of Finance (MoF) and the Ministry of Industry and Trade (MoIT). These proposals have imposed additional restrictions on the trade of certain goods into Vietnam. In contrast to the main case study in Thailand, the proposals from the MoF and the MoIT are not directly related to the implementation of a bilateral or regional trade agreement, rather they are in response to general concerns regarding Vietnam's trade position.

The MoIT and MoF suite of proposals were announced in April 2011 in response to a commitment by Vietnam's Prime Minister to keep the country's trade deficit below 15 per cent in 2011. The MoIT initiated the series of measures by identifying 100 different imported commodities for special import restrictions to temporarily restrict the trade deficit. One of the products nominated for this list is distilled spirits beverages. The MoF proceeded to assist the MoIT proposals by developing proposal number *4629/BTC-TCHQ*.

This document proposed the following measures to enact a temporary restriction on imports of the selected commodities:

1. restricting the importation of alcohol products to only three ports in Vietnam
2. increasing the customs duties rate to the maximum MFN rate permitted under Vietnam's WTO commitments
3. longer import processing timeframes
4. movement of goods restrictions
5. pre-export labelling
6. tightened import, wholesale and retail regulation
7. investigating increases to alcohol excise rates (Vietnam MoF 2011).

Whilst the MoF/MoIT proposals were not made in the direct context of Vietnam's commitments under its various bilateral and regional trade agreements, it is important that the proposals are taken into consideration when assessing Vietnam's commitment to trade liberalisation. The seven measures outlined above propose six non-tariff barriers to trade, and one additional tariff barrier (measure number 2). As a result, Vietnam's trading partners were notified of the measures under the terms of the WTO's Agreement on Technical Barriers to Trade (TBT) and the TBT Committee process.

The proposal in measure 2 to increase customs duties to the maximum allowable MFN rate runs the risk of Vietnam rescinding its tariff reduction commitments under its existing FTAs, including AFTA, AANZFTA, CAFTA and the ASEAN-India FTA. Whilst other measures within the MoF/MoIT proposals are broadly covered in the text of minimalist FTAs, such FTAs only provide for a contractual arrangement between signatory parties and do not offer international best practice guidelines as an alternative to reactionary policymaking.

The Vietnam MoF/MoIT proposals raise several international trade law issues. While this article does not provide a detailed critique of individual policy measures against international trade law principles, it is worth briefly highlighting where policymaking in emerging economies can run the risk of breaching international trade law if there is a potential lack in best-practice policy. Initial analysis of these measures indicates that, if challenged, Vietnam could be in breach of several WTO obligations, including the Agreement on Sanitary and Phytosanitary Measures (the SPS Agreement) and Articles of the GATT 1994.

A possible role of bilateral and regional trade agreements?

As outlined with respect to the proposals in Thailand, bilateral and regional trade agreements provide an opportunity to prescribe international best practice policy to assist emerging economies in their modernisation process.

In particular, incorporating best practice regulation into bilateral and regional trade agreements can help to steer emerging economies away from policy proposals that risk breaching their international trade law commitments, as well as their direct obligations under the trade agreement itself. With the development of modern trade agreements, such as the current TPP negotiations, trade negotiators and stakeholders are looking for ways to enhance their country's trade interests. The text of modern agreements provides a potential avenue for an era of expanded trade policy enhancements, with trade negotiators considering the inclusion of specific annexes that deal with specific tariff or non-tariff issues that impact the trade of goods under the terms of the agreement.

9. Developing a revenue modernisation 'framework'

The very fact that a bilateral or regional FTA constitutes a contract between the signatory countries summarises the dynamic of the argument around modernising tax and revenue policies. From one perspective, if a trade agreement is a contract, rather than a comprehensive review of policies, direct trade agreements are primarily focused on streamlining current systems and are not designed to be overtly prescriptive in their policy intent. However, an alternative view could argue that by entering into a direct trade agreement, signatory countries are taking a proactive step, ahead of global pace, to modernise their trade environment.

Trade agreements can bring forth unintended consequences, with government indirect tax revenue bases along the supply chain for imported goods dependent on customs duties. Modern, comprehensive trade agreements afford the opportunity for signatory parties to consider legislative or regulatory reforms that can further-modernise domestic tax and revenue policies.

The AANZFTA stipulates that signatory countries should maintain, or adopt as soon as practicable, domestic laws and regulations governing electronic transactions taking into account the *UNCITRAL Model Law on Electronic Commerce 1996*. This provides a tangible example of how a trade agreement can provide a contractual avenue for the development and implementation of international best practice law or guidelines. In particular, this represents an area of policy, or a default option in which countries can amend domestic legislative requirements to ensure that complementary legislation is in place to ensure that the trade liberalisation process meets its objectives.

Another initiative open to modern trade agreements is the potential to enshrine international best practice, as it has been developed and is enshrined within either the WTO Agreement 1994, its annexes, and other international trade and customs conventions. In terms of tax and revenue policy however, the link between internationally recognised 'model laws' or guidelines and international trade agreements is not as explicit. In developing and implementing 'model laws' or guidelines for implementation into bilateral or regional trade agreements, negotiating parties can consider precedents that exist from two distinct categories:

1. measures or directives for existing comprehensive groupings (for example, Single Market or Monetary Union), or
2. model laws or guidelines developed by authoritative international agencies (for example, IMF, World Bank or OECD).

Measures such as those in the example below, EU directives could be applicable to bilateral trade agreements, however they could be particularly relevant for regional trade groupings where geographical and geopolitical interests additionally define membership (Chandra 2005). This includes the ASEAN grouping of countries, and to a lesser degree the Asia-Pacific Economic Cooperation (APEC). In contrast to the EU, other regional groupings of developing economies, such as the Southern Africa Development Community and the East Africa Community do not mandate excise taxation structures. However, these groupings have committed to some degree of excise and VAT harmonisation or coordination amongst member countries.

Box 2: Example: EU and alcohol excise taxation

As outlined earlier in this article, EU member countries are required to ensure that their domestic laws adhere to the requirement that they are levied under a volumetric alcohol excise system. Whilst individual EU member countries retain the right to set different excise rates to one another, including rebates on domestic consumption, EU membership carries with it a requirement to adopt the volumetric alcohol tax methodology.

Whilst this in itself may be a controversial case study, given the health, social, religious and domestic industry sensitivities to imported alcohol beverages, the principles underpinned by a common taxation methodology are features of a modern and transparent tax and revenue system. The principles underpinned by Directives 92/84/EEC and 92/83/EEC and similar requirements for the tax treatment of other commodities across the EU could help to assist with the drafting of more comprehensive trade agreements into the future.

In addition to comprehensive international groupings, recognised international agencies, in particular the International Monetary Fund (IMF), the World Bank and the OECD are a good source of thought-leadership regarding drafting tax and revenue policies. At the macroeconomic level, many economic theorists and practitioners agree that fiscal transparency has large and positive effects on the fiscal performance of governments. In 1998, economists Kopits and Craig observed that:

> Transparency in government operations is an important precondition for macroeconomic fiscal sustainability, good governance, and overall fiscal rectitude (Kopits & Craig 1998).

By entrenching transparency into the drafting of internal tax and revenue laws, governments ensure that they open their legislative processes to the scrutiny of key stakeholders within the economy.

For the purpose of this analysis, below are two examples. One is a relevant IMF guideline and the other is a relevant set of OECD principles.

Box 3: Example: IMF suggested guidelines on tax law design and drafting

In 1996 the IMF published its suggested guidelines on the drafting of tax and revenue laws. The IMF released this publication based on the IMF Legal Department's experience in assisting many developing and transition countries with the drafting of tax legislation.

The guidelines distil from the IMF's experience into a set of practical guidelines for officials and their advisers. The guidelines cover international best practice in key areas including:

- the tax legislative process
- the legal framework for taxation
- drafting tax legislation
- law of tax administration and procedure.

One useful example where an OECD guideline is recognised as international best practice is in the area of transfer pricing. Transfer pricing is an intercompany pricing methodology used by multinational companies to determine prices for related party transactions, with this methodology providing guidance for tax administrations in determining tax liabilities when related parties transact with each other across customs borders.

Box 4: Example: OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

According to the OECD, the transfer pricing principles set clear and transparent rules regarding international commerce and cross-border transactions:

> In a global economy where multinational enterprises (MNEs) play a prominent role, governments need to ensure that the taxable profits of MNEs are not artificially shifted out of their jurisdiction and that the tax base reported by MNEs in their country reflects the economic activity undertaken therein. For taxpayers, it is essential to limit the risks of economic double taxation that may result from a dispute between two countries on the determination of the arm's length remuneration for their cross-border transactions with associated enterprises (OECD 2010).

A considerable amount of thinking has gone into whether the OECD guidelines can provide a framework for customs authorities to determine the import cost of a good in the case of a dispute over the declared transaction value.

The actual applicability of international best practice, such as the IMF Guidelines or the OECD Principles, require detailed analysis and are sure to engender considerable debate. Studies such as a recent *Asia-Pacific Tax Forum* research project on the relationship between transfer pricing, customs valuation and excise tax bases encourage international dialogue on the possible role of international best practice principles to trade liberalisation. The contractual nature of trade agreements, and the level of negotiation involved in developing a bilateral or regional trade agreement provides an avenue for the consideration of international best practice principles for ensuring a quality and sustainable outcome for signatory parties.

10. Conclusions

The current international trade and economic climate could create the environment for a range of enhanced bilateral and regional trade agreements. Whilst EU member countries seeking methods in which to move forward from current problems relating to the complex and comprehensive EU common market, ASEAN member countries are looking for ways to further enhance regional integration in the lead up to the AEC in 2015.

AEC integration will be an ongoing process between ASEAN parties, however in parallel to this process, modern bilateral and regional trade agreements across the Asia-Pacific, such as the TPP, develop trade policy reform frameworks that can assist countries across the region with the reform process. The contractual nature of trade agreements and the level of negotiation and consultation involved in developing a bilateral or regional trade agreement provides an avenue for the consideration of international best practice principles for ensuring a quality and sustainable outcome for signatory parties.

As the trade liberalisation paradigm shifts from the multilateral trade negotiation arena to a growing network of bilateral and regional trade agreements, new trade agreements offer an avenue to assist emerging economies modernise their tax and revenue systems. As the Thailand case study demonstrates, the immediate impact of falling tariff barriers can cause revenue authorities to take short-term focused measures that are contrary to developing a more open and transparent system that creates certainty for foreign investment.

Parties to contemporary trade agreements state the importance of the agreement being as comprehensive and as high quality as possible. As the recent Australian Policy Statement highlighted, 'low-quality free trade agreements are free in name only; they lock in and legitimise the protection of each country's market from competition from the others' (DFAT 2011a).

The AEC 2015 is intended to be bold and comprehensive, and as a result it will stand to gain a great deal more through similarities with modern and comprehensive regional trade agreements, as is the intention of the TPP, than from basic, low quality agreements that seek limited commitments from their signatories.

Trade agreements afford the opportunity to encourage further reform and transparency within domestic tax and revenue systems. Given the growing proliferation of trade agreements, it is important that new agreements unlock their potential to achieve greater commitments from signatory parties to enact positive and constructive reform.

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Note

1 The views and opinions expressed in this paper are those of the author and do not necessarily represent the views and opinions of KPMG, an Australian partnership, part of the KPMG International network.

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Section 2

Practitioner Contributions

Rethinking Customs' procurement practices to deliver improved business outcomes

Tom Doyle

Abstract

This paper draws attention to the need to rethink the traditional procurement practices used in the public sector and, in particular, by customs agencies. It poses three questions: Are customs agencies today getting optimal value in procuring goods and services from the private sector? Can collaboration be improved between the private sector and the customs agencies and amongst customs agencies themselves with respect to procurement? What can be learned from the private sector – what fundamental innovations exist and how can they be applied to the way Customs approaches procurement? After examining current procurement practices and identifying their inadequacy, the paper proposes that a comprehensive review be carried out to evaluate the efficacy of current Customs' procurement practices, with a view to developing best practice recommendations and designing a new practice for consideration by the World Customs Organization (WCO) and its Members as operating guidelines.

Purpose

The purpose of this paper is to challenge the way that customs agencies currently carry out procurement practices within the constraints of general public procurement rules and regulations with a view to creating a basis for dialogue on the specific nature of the challenge and need for change with customs agencies taking the lead in a wider public sector debate. It is suggested that the World Customs Organization (WC) is best placed to create the forum and opportunity for this dialogue which should also include the private sector suppliers of systems and services as we move forward towards new levels of operational efficiency, trust and collaboration.

Why should customs agencies examine current procurement practices?

In today's difficult fiscal environment, where customs agencies must balance financial constraints with effective operations, Customs needs to ensure that maximum value is derived from purchases it makes. It has been suggested that the global customs community is spending significantly more time, effort and cost on procurements, especially information technology (IT) procurements, than it needs to as a result of outmoded and rigid procurement practices.[1] In this respect, some serious questions need to be asked:

- Are customs agencies today getting optimal value in procuring goods and services from the private sector?
- Can collaboration be improved between the private sector and the customs agencies and amongst customs agencies themselves with respect to procurement?
- What can be learned from the private sector – what fundamental innovations exist and how can they be applied to the way Customs approaches procurement?

The historical approach to public sector procurement, which has more to do with transparency of spend rather than effective competition or return on investment (RoI), should be examined to establish whether it remains a valid approach for current and future spending within Customs.While many private sector organisations embrace a similar set of procurement fundamentals as the public sector, there is generally one fundamental difference: their purchasing is more focused on maximising the RoI. Shareholders have little patience for failed programs and poorly spent resources and those responsible (corporate leadership and vendors) normally pay the price. These 'market controls' are not nearly as robust in the public sector, leading to the first major challenge with public procurement – it is normally more focused on the control process rather than the outcome achieved.What may be even more worrying is the very distinct prospect that although almost all customs agencies will know the amount of money they spend on procurement, few may actually be in a position to know how much of that spend relates to programs and projects directly attributable to the achievement of specific business outcomes.

In general, customs agencies strive to design and deliver solutions to address the challenges posed by the ever-changing global regulatoryenvironment. Today, this invariably leads to IT which is simply not the core competency of the public sector. Thus, Customs look to procurement in order to obtain that which is required in support of the agencies' mandate. Common objectives of IT-related procurement initiatives include:

- improved service speed and quality
- access to new skill sets, tools and methods
- cost reduction and revenue enhancement
- organisational change/business transformation
- compensation for the inability to hire specialist staff directly
- improved management discipline, measurement and transparency
- capital investment rather than expense spending.

Despite complicated and bureaucratic public procurement rules and related tenders, competitive bidding by vendors, multi-dimensional scoring methodologies and countless other procurement practices, today's procurements rarely live up to expectations. Lengthy procurement processes, cost overruns, implementation delays and dissatisfied customers and vendors is all too often the result. Perhaps it is time to address 'how' customs agencies go about securing the goods and services required from the international vendor community with a focus on measurable results. After all, at the end of the day, Customs must determine if spending on procurements has delivered results in the operational environment and to its multiple stakeholder groups, including government, the trading community and society at large.

By focusing the procurement on outcomes, and contracting the private sector to achieve outcomes, the customs agencies are able to (a) share the risk of achieving the outcomes with the private sector, (b) align the incentives with its private sector provider, (c) improve its business outcomes based on private sector experience, and (d) optimise the incentive of the private sector to 'put its skin in the game'.

How do customs agencies take advantage of their collaborative environment?

The customs environment is, on the one hand, highly collaborative with institutions such as the WCO and agreements, instruments, policies and procedures designed to harmonise that environment. One need only look as far as the shared instruments that underpin modern customs operations (for example, ACV, HS, Kyoto) to find countless examples. On the other hand, in the area of procurement this collaboration is limited if existent at all. Customs agencies do not share their procurement practices, there is no pooling of the collective learning to improve the overall approach to procurement, and rarely do customs agencies share systems, despite the fact that they are based upon enforcing essentially the same rules and policies. Consequently, the standards and approaches to procurement taken by individual customs agencies vary as greatly as the respective results achieved by each. This hampers modernisation efforts and limits the ability to harmonise delivery and take advantage of market innovations such as emerging technologies and solutions.

A prime example of this dilemma is the functioning of the European Union (EU) Customs Union which has developed to a point where the cost of the IT spend centrally and nationally is now at questionably unsustainable levels. The EU's Minimum Common Core (MCC) implementation alone has been estimated to cost in excess of €1.5 billion, much of which will be IT spend. At the heart of the modernisation efforts in the MCC and individually within MS administrations is IT development; using smarter systems with more capabilities to help make EU Customs more effective. Nevertheless, the EU Customs Union continues to be burdened with the legacy of 27 different national and disparate systems with the European Commission's Customs Service (DGTAXUD) providing the central reference data facilities.

What are the current challenges and shortcomings of procurement in customs agencies?

Procurements tend to be lengthy, bureaucratically driven, focused upon detail and very difficult for purchasers and providers to navigate. The traditional contracting paradigm for a large-scale program involves the customs agency defining its requirements in significant detail over an extensive period (for example, 6-12 months); the private sector responding to the requirements in one or more stages (for example, 2-6 months); the customs agency evaluation of detailed responses (for example, 3-6 months) and formal contract negotiations (for example, 3-6 months). Hence the duration between the decision to buy and the contract award is rarely less than 14-24 months. In short, the traditional procurement paradigm allows Customs to purchase – but not yet implement – what was specified two years prior, not what it needs now.

This contracting paradigm is fraught with issues which include inbuilt obsolescence, insufficient flexibility, restriction of innovation, ambiguous communication and higher than necessary cost. Common shortcomings of today's procurements include:

- led by technical, not business experts
- clear on purchase intent but not on strategic intent
- often isolate the procurement from business and organisational strategy
- rely heavily on internal design and specification
- separate the design and build elements
- do not engage suppliers in effective upfront dialogue
- ineffectively apply cost-effectiveness
- initial purchases which rarely reflect what will eventually be delivered.

Unrealised business benefits. Technology itself normally does not disappoint. Rather it is how the technology is designed and configured to operate and interact with human resources that so often makes it unfit for purpose or simply fails. Design is often undertaken by technical teams within the organisation often with limited dialogue with other internal and external stakeholders. This is often done as Terms of Reference (TOR) that serve to define the procurement/tender. The public sector is not known for its expertise in the systems design space and should always seek outside assistance in this area.Without the right design expertise the risk is that the solution being sought may not reflect the business needs or the delivery realities involved. If this is implemented as a final product, it may not be suited to the way frontline staff operate nor reflect the organisation's required business outcomes. All too often IT systems come to reflect and institutionalise outdated processes and approaches rather than be an enabler of process optimisation, performance improvement and fundamental change to the way Customs does business. Typically, the procurement process excludes commercial providers (that is, vendors) from constructive dialogue – they often get presented with a worked-up specification without sufficient involvement to help design the best solution to fit the business needs. Within the context of procurement TOR, vendors are reluctant to submit a 'non-compliant' bid and respond to the TOR as set out, despite any inherent design flaws. The effect is obvious – the customs agency does not gain access to market innovations.

Cost vs value. The approach to procuring the 'economically most advantageous solution', (usually meaning lowest-priced tender wins), is laudable but in reality leads to a 'race to the bottom' in which providers compete to offer the lowest price. The commercial reality of this is that the scope of vendors' offers is reduced, additional services are removed and the initiative is stripped down to the minimum quality level acceptable to meet the specifications. The process is also greatly affected by the fact that customs agencies tend to set out detailed specifications and direct suppliers to tender for delivering a defined product and not the business outcomes sought. Open-ended tenders specifying outcomes and not technical requirements s would lead to a greater focus on the end product and not the price.

Systems vs capability. All too often, procurements are focused on purchasing a new system with the assumption that a new piece of software 'inserted' into the organisation will address all of the agency's problems, deliver efficiencies and be the answer to all that ails Customs. Customs should instead be focused on purchasing the capability, and procurements should merely be a mechanism to obtain those capabilities they do not possess internally or where they are deficient. This literally translates into skilled people that can, inter alia, develop strategy, conduct business analysis, document and redesign processes, provide training and effectively become the organisation's engine for future innovations. Vendors are world class in this area but the problem is when the project is over they leave and take this capability with them. Procurements should be structured so that these skills and knowledge are transferred to the customs agency.

Lack of innovation. Innovation is at best hampered and at worst lost in the current procurement paradigm. As noted previously, customs agencies operating and procuring in isolation from each other and from the eco-system of the suppliers' ring, fence innovations within individual projects. Lessons learned and innovations from one program are not transferred to others as each individual customs agency 'invents its own wheel'. This lack of collaboration inhibits the ability to influence the market to spark innovation as customs agencies acting in isolation have a markedly lower impact upon suppliers than the global or even regional customs community acting in concert. Were the customs community to rethink its approach to procurement and work more collaboratively, the commercial market would likely react more dynamically.

Implementation problems and delays. Often the initial purchase by customs agencies does not come close to reflecting the final implementation. This is a direct result of the rigidity of the initial tender and preconceived design elements. Actual detailed solution design should be a part of implementation not precede contract award. After the customs agency agrees a winning bid, the process of design and development begins again with a supplier who may have little influence on the design, and who is likely to cut their bid down to its bare bones to win the tender, now having to work to determine how to build a system that will meet its needs. This involves rework of design, the realisation in many cases that the design may not actually meet the business needs, and then development processes that are slowed due to the agreed bid having removed, for cost reasons, elements which soon turn out to be critical. In many cases significant problems occur when the first test elements are built and it becomes clear that the system does not work with frontline processes. The consequence of all of this is that implementation is repeatedly delayed, cost creeps up and the scope of the work expands.

Conclusions

It is time to take a hard look at the current procurement practices of customs agencies to examine the extent to which it is fit for purpose given the innovations that exist in the marketplace today. There is no definitive, one-size-fits-all solution to the challenges and shortcomings in the procurement environment, however it is time to begin focusing on more innovative and less costly possible solutions.

A comprehensive review is needed to evaluate the efficacy of current Customs' procurement practices with a view to developing best practice recommendations. This would involve examination of current practices in procurement and the design of a new practice for consideration by the WCO and its Members as operating guidelines. The study should also determine the constraints and limitations of the current practices, include an impact assessment and cost benefit analysis for each of the models proposed. This study should engage extensively with customs agencies, and product/service providers inside and outside of the customs community, to seek out, understand and evaluate best practices. Outcomes of this endeavour could include (a) a single coding standard for classifying Customs' spend, (b) a model for collaborative purchasing, (c) a tool for product/solution assessment and reporting, and (d) the creation of a collaboration portal where customs agencies can share design artefacts and other procurement-related assets. This would allow customs agencies to learn from each other's experience, standardise their procurement processes and ultimately take the lead in driving innovation collaboratively with suppliers in the industry. The WCO itself is best positioned to initiate this program and should seriously consider doing so.

Note

1 'Present approaches to procurement within the global Customs Community are outmoded, costly, time consuming and do not take into account innovations that already exist in the marketplace', *Border Management Modernization Handbook* 2011, World Bank, Washington, DC, Chapter 9.

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Trade risk management: a global approach

Lorraine Trapani

Abstract

This article discusses IBM's global approach to managing risk associated with importing product into more than 170 countries: why we focus on risk management, our approach to assessing and managing risk, and how we translate risk management into a competitive advantage for our business. Finally, we discuss our plans to develop new insights in the future.

Introduction

The IBM Corporation is a globally integrated enterprise which operates in more than 170 countries. In 2011, with annual revenue of approximately USD107 billion[1] we imported about USD20 billion worldwide. Our business mix is continually changing, moving toward higher value technologies and new market opportunities. Global integration, change, growth market expansion, acquisitions: each of these factors requires that we take a global approach to customs risk management. Global integration of all our major enterprise functions allows us to more quickly implement effective controls throughout our supply chain to mitigate any potential risk to compliance and supply chain security, but it also requires process and system flexibility to adapt to country-unique requirements as we manage country-unique risk.

Regulatory compliance is a given in IBM and the standards to which IBM operates are exacting. The risk we manage is related to achieving our objective of compliance with the laws and regulations governing imports in every country we operate. Each country is important to us, and although progress has been made, not all trade regulations are harmonised. Risk management in this environment is the practice of understanding and identifying those events and circumstances within the realm of our business operations which have the greatest potential of non-compliance. We then ensure that appropriate controls are implemented and resources allocated to prevent the risk of noncompliance and disruption to our supply chain. Within IBM, the Import Compliance Office (ICO) has global oversight responsibility to ensure that IBM's import processes are effectively implemented throughout our enterprise.

When considering stresses in the global economy along with the complexity of our operations, dynamic changes, divestitures and acquisitions, a laser-like focus is required to ensure continued compliance. As customs authorities seek to maintain revenue targets despite a turbulent global economy, risk of customs enforcement increases. Increased physical inspections upon import pose potential delays to our supply chain, and while post-entry audits do not delay our supply chain they do divert resource. In addition, a political desire to protect national economies means that Customs are sometimes enforcing new trade barriers even while countries are implementing new trade arrangements to attract investment and hopefully growth, increasing our need to adapt controls to ensure compliance with new requirements.

We view compliance not only as mandatory but also as strategic. Built on a foundation of strong and sustained regulatory compliance, we are not only protecting IBM's brand image and reputation – IBM's reputation and performance enable us to avoid disruptions to IBM's supply chain and to earn the privilege of using simplified customs procedures which in turn allow us to quickly get goods to market, contributing to growth, improving profitability, and reducing the cost of compliance. In what continues to be a turbulent economy, importing compliantly and securely demands more from us as we dynamically manage risk.

Understanding risk and properly managing it allows us, as a compliance-focused organisation, to add greater value and provides IBM freedom of action as we grow our business – a real competitive advantage.

Risk assessment and management

In our assessment of risk we look at specific environments, circumstances, events, business operations and imports, assessing which of these, alone or in combination, have the greatest potential to cause noncompliance and disrupt IBM's supply chain. This process forms a basis for deciding how we should manage the risk and for ensuring that controls are in place to mitigate the risk of noncompliance and disruption.

The process of assessing risk also provides the benefit of an opportunity for our global compliance team to assess the potential for issues affecting one country, region, geography, or process to affect another. Although we strive for 100 per cent accuracy, no importer is perfect. Mistakes can happen. The process of analysing risk and ensuring controls are in place to mitigate this, gives us another opportunity to identify gaps at the earliest possible opportunity in our supply chain.

Assessing risk, performing an impact analysis of our exposure, and implementing controls to mitigate our risk are critical components of our 'reasonable care' to ensure the accuracy of the information we declare to Customs.

While risk management occurs continuously, we have implemented a formal structure to periodically identify and analyse risk and processes which allows discussion of controls with the relevant process owners who execute them, and an overview with our extended network of approximately one hundred Import Requirements Executives (IREs) worldwide. These IREs are placed within line organisations such as Sales and Distribution, Manufacturing, Procurement, Finance, Customer Fulfilment, and Global Logistics. They represent the ICO either at a country level or within one of the globally integrated support processes which contribute to compliance. They are usually senior-level management with a broad view of the business and an ability to influence the actions of multiple organisations supporting their mission. Our regular collaboration with the IREs provides a mechanism by which we identify changes to business models, and consider information from their organisation's forecasting or strategic planning activities that could potentially affect our ability to achieve our mission, goals, and objectives related to customs activities. This open channel of communication allows us to proactively manage risk and prevent noncompliance and disruption to our supply chain.

Our assessment captures potential risk from both internal and external sources. In addition to the basic elements we capture which allow us to understand the environment, we identify, consider, and manage risks presented by change – whether new or changing regulations, change posed by rulings and court decisions, or in the economy; in operations; in resource; in the political environment; in major suppliers, contracts, agents, and brokers; by emerging matters of national interest or matters related to protection of domestic industries – all conditions which could affect customs compliance. We also identify risk through consideration of findings from external and internal audits, evaluations, and other assessments – not only in the import process but in complementary and related audits such as overview audits in smaller countries, tax, manufacturing, procurement, logistics audits, and others.

Internal changes affecting operations, resource, operating processes, sourcing, our move to higher value technologies, restructuring, rapid growth and expansion, and imports to new geographical areas all represent challenges to compliance and we must assess our risk and ensure appropriate controls are in place before the change to ensure continued compliance and prevent delays to our supply chain.

Our sources of information regarding risk are layered and include customs websites, the World Customs Organization (WCO), the World Trade Organization (WTO), publications by the World Bank, trade industry associations, advisory committees to which we belong, external consultants, logistics service providers, customs brokers, and other agents operating on our behalf, as well as indices such as the Corruption Perception Index published by Transparency International, and others.

Assessing risk exposure

Through practising risk management our primary objective is to ensure that IBM's internal control is adequate to ensure compliance with the laws and regulations in every country where we import. As we do that we must assess our exposure to risk associated with custom's activities from both a quantitative and qualitative perspective. When considering quantitative risk, we of course evaluate volumes, for example, volume of activity at a country level, perhaps related to a specific trade agreement or simplified procedure, or volume subject to high duty. However, with operations in more than 170 countries and given our continued global expansion, our risk of noncompliance may be greatest where our volumes are relatively low. Therefore, assessing qualitative risk is equally important and perhaps more challenging. While our policy is consistent globally, we must consider unique country customs requirements. Differences also exist in staff with varying levels of experience, training, and knowledge; customs activities, volumes, suppliers, agents, business partners and customers. Manufacturing locations have a specific opportunity to affect compliance in countries receiving goods from them. Because of all the above variables and many more, each location represents a different challenge when we assess customs risk related to IBM's imports and we work very hard to familiarise ourselves with operations at a local level. Often, this knowledge tempers the initial risk analysis. The actual risk exposure may be far less than the initial risk assessment based on controls which have been implemented.

So, although our approach is definitely global, it is also local.

When assessing our risk exposure we consider significance – or importance, and sensitivity – more difficult to assess but critical when protecting your brand image. We can assess significance usually by looking at the value of product to which the risk applies, but in some cases a more subjective judgment is required. For example, an incorrect statement of country of origin in a single instance may be considered of limited significance, but failing to perform a seven-point security inspection when loading a dedicated container at an IBM manufacturing location is of great significance since a failure, in the worst circumstances, could lead to a catastrophe. Determining sensitivity requires judgment based on the circumstances in each case. Some issues likely to be judged as sensitive include issues that have received media coverage, or have been the subject of political interest causing restrictive trade barriers, such as issues leading to antidumping or countervailing duties, controls over the import of used goods, or products containing encryption. Some issues may be both significant and sensitive. Of course, even related to issues of large significance, we also consider the inherent nature of the import to determine how susceptible the circumstances are to noncompliance, for example, automated controls would lower susceptibility.

Once we have identified risk, and analysed the potential impact, we use our assessment to ensure appropriate controls are in place, and resources allocated to mitigate areas of risk. We also use our assessment to develop an annual proactive review plan. Our proactive assurance reviews are one method we use to monitor controls. Designed to provide a reliable and independent assessment of IBM's internal control posture related to import compliance and supply chain security, the primary purpose of our reviews is to determine that internal controls related to cross-border movement of goods and supply chain security are effectively implemented and executed to ensure compliance with customs and other government agency requirements.

The entities for which we assess risk are dynamic and will continue to change as IBM's business changes. There is inherent risk associated with import compliance and supply chain security in any country, for example, impact to IBM's image through negative publicity or potential impact to business results through the loss or suspension of import privileges. This year we assessed more than 60 elements of risk for more than 280 entities (for example, in Hungary IBM Vacs – our manufacturing site – was separately assessed from our Sales and Distribution location in Budapest). Each entity was assessed for its relative risk to the business in six key areas:

1. **Customs environment**. We assess over 20 elements related to the customs environment to help us determine our risk in terms of transparency, predictability and security. We consider participation in organisations and agreements intended to introduce harmonisation and simplification and facilitate trade, such as the WCO,[2] WTO[3] agreements, Information Technology Agreement (ITA),[4] Revised Kyoto Convention[5] and many others. Political and economic changes can have a dramatic effect on the agencies that are involved in regulating goods which are imported so we consider the challenges. Also considered are multiple indices such as the Corruption Perception Index (CPI)[6] and the Bribe Payer's Index[7] published by Transparency International, and the Vulnerability to Political Revolt Index[8] compiled by the Economist Intelligence Unit and published by ViewsWire. We look at clarity of regulations, consistent interpretation, and changes presented by new legislation, and we also look at rulings and court decisions affecting our industry. We consider free trade agreements and participation in customs unions as these may provide some consistency and additional transparency in the application of customs laws. Customs clearance cycle time, measured in some countries, provides an indication of the level of automation and assessing changes may indicate the frequency with which our goods are delayed for inspection. We look at the percentage of national revenue represented by customs duties, the WCO Duty Survey,[9] and duty rates applicable to our products, and try to determine whether customs revenue targets have changed in that country. These categories help us assess the relative stability of Customs and the transparency and predictability with which they operate.
2. The **IBM customs environment.** We consider the unique customs risk associated with specific operations at each entity. For example, manufacturing at an IBM facility and whether manufacturing assists are provided to suppliers, manufacturing or assembly in a customs-free trade zone, trading centres, logistics hubs, parts hubs, products shipped on consignment, Global Asset Recovery Services, participation in free trade agreements or special trade programs, trusted partnerships; market – major, or growth.. These help us assess the level of stability within our operations related to customs – the extent to which business changes have an impact on the stability of the location or process. We consider significant changes in tools, systems, operations, and process controls; organisation (anticipated growth/decline), and technology. We also consider changes to external suppliers, contractors, agents, and brokers. We look at acquisitions and divestitures and determine our confidence in risk management through our involvement in the due diligence and integration process. We consider risk across all legal entities authorised to import into any given country.
3. **Size metrics – values**. We consider the value declared to Customs for both imported and exported goods (since the shipping location must ensure goods arrive compliant with the receiving country's requirements and ready to import). We consider duty paid as some risks associated with proper classification may be greater where duties are paid. Within the European Union (EU), we also consider risk associated with proper declaration of intra-EU shipments to ensure accurate information is declared for statistical (balance of trade) purposes.
4. **Control program**. The implementation, effectiveness and stability of our control program is assessed from the perspective of the five elements of internal control; control environment, risk assessment, control activities, information and communication, and monitoring. We assess the involvement, stability, and experience of the IRE who represents the ICO locally and also the completion of internal tools which help us assess and manage risk such as the Import Internal Control Program (IICP), import and export profiles, valuation profiles, and supply chain security assessments.

5. **Performance**. We include an analysis of the results of external and internal audits and reviews, and self-assessment and testing results. We also consider any publicly available information regarding customs concerns affecting other companies.
6. A sixth category, **Manager Influenced Criteria**, allows the person making the assessment to apply their intimate knowledge of operations at that location and assess areas we may not have included in one of the other categories. Their assessment carries equal weight as these are the individuals most familiar with IBM's execution in the local environment.

Scoring

Each entity for which IBM is the importer of record is assigned a risk score as a result of our assessment. A score of one to ten is assigned to each element of risk within the five categories (customs environment, IBM environment, values, control program, performance), with one being the lowest risk, and ten being the greatest. The minimum score is six and the highest score is 60.

This scoring provides us with an opportunity to compare and contrast risk across geographies and we compile a list of those entities which received the top ten scores which is used in the communication discussed below. Our assessment also helps determine the suggested frequency of our proactive assurance reviews. Locations or processes considered very high risk might have a review every year, while the lowest-risk locations could be selected for review less frequently. In some countries, review schedules are determined by agreements with Customs based on trusted partnership self-assessment requirements and are executed on a defined schedule to ensure continued eligibility for participation in specific programs.

Communicating risk

We summarise our identification of risks to customs compliance, and analysis for possible effects – our final assessment – into an executive summary which we communicate to those who need the information. This includes our executives, our practitioners, our internal audit organisation, and the business controls groups supporting the globally integrated enterprise. We include in our summary identification of key comparisons and contrasts, our 'top ten' scoring risk entities with a clear, concise articulation of the risk and potential effects, mitigation actions, a 'watch list', and our outlook for the remainder of the year. This information helps us ensure that our objectives relating to compliance are clear and consistent, enterprise-wide, and that the clarity of our assessment ensures we have relevant, reliable information for decision-making; that our resources are allocated appropriately, and that we maintain an environment and organisational structure which supports compliance.

Conclusions and future challenges

The sustained turbulence of the global economy dictates continued changes in the customs environment. Maintaining regulatory compliance in this environment requires dynamic assessment and management of risk and, as stated earlier, a laser-like focus. As a globally integrated enterprise doing business in more than 170 countries, our approach must be both global and local. Trust and personal responsibility in all relationships are core values expected from every IBMer. IBM's value system integrates a strict set of ethics and standards which guide us as we strive to establish and maintain trust with customs and other agencies governing our imports. With regulatory compliance a given, IBM continues to improve and refine our understanding of risk so that we can maintain our reputation as a compliant importer, a trusted partner, and deliver a real competitive advantage to the business through freedom of action. We are not only protecting IBM's brand image and reputation – IBM's reputation and performance enable us to provide business certainty through avoiding disruptions to IBM's supply chain. Our trusted partnerships with Customs afford us the privilege of taking advantage of simplified customs procedures which in turn allow us to quickly get our goods to market, contributing to growth, improving profitability, and reducing the cost of compliance.

What does the future hold?

We are working to find a smarter way to perform risk analysis through making it more instrumented, interconnected, and intelligent. IBM Business Analytics has capabilities related to governance and risk and compliance. If we can compare risk indicators to actual shipment data we believe we can predict which shipments, events, and circumstances have the greatest potential for non-compliance. We believe we could develop new insights based on statistical methods and analysis applied to our data, leading to better and more informed decisions. We would be better able to spot trends, patterns and anomalies, compare 'what if' scenarios, predict potential threats and opportunities, better identify and manage key risk and plan resource. With these deeper analytic capabilities we could better understand, anticipate and shape business outcomes, perhaps managing global risk in a smarter way.

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Notes

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Changes to the role of US Customs and Border Protection and the impact of the 100% container scanning law

Trang Nguyen[1]

Abstract

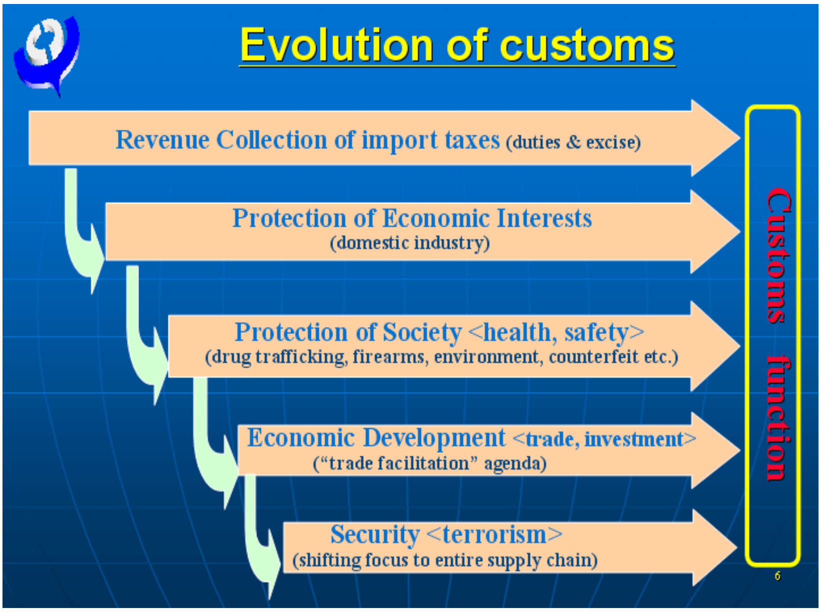
This paper considers the advantages and disadvantages of the introduction of 100% container scanning law according to Section 1701, Container Scanning and Seals, under Title XVII, Maritime Cargo of Public Law 110–53—AUG. 3, 2007 issued by the 110th Congress of the United States (US) on *Implementing Recommendations of the 9/11 Commission Act of 2007*. Scenarios are discussed which would impact significantly on customs administrations around the world and, in particular, on the additional costs involved in implementing the law as it stands. Options to address the requirements of the law are outlined, leading to the conclusion that streamlined Customs-to-Customs exchange of advanced information for risk management would meet both the priority objectives and the roles of Customs, that is, to enhance security and at the same time, facilitate global trade.

1. Introduction

The strategic event on 11 September 2001 (9/11) awakened serious concerns about United States (US) national security. The merging of US Customs and Border Protection (CBP) into the United State Department of Homeland Security on 1 March 2003 was one among many reactions by the US government to improve national security post 9/11 (Borner 2003). This change in organisational structure led to a change in the role of CBP.

Traditionally, customs administrations around the world in general and CBP in particular, function as public entities to collect taxes and duties, and supervise and control export and import activities. This traditional function of Customs explains why customs administrations are normally placed under a ministry of finance (and revenue) in many countries (Widdowson 2007, p. 31). Initially, the US Customs Service was part of the Department of Treasury (CBP website). With the dramatic increase in international trade in both volume and value, it is vital for customs administrations to facilitate trading activities. Only after the 9/11 event, for the first time in Customs' history, have security and terrorist fighting been incorporated into the missions of customs administrations and considered priority roles (Ireland 2009, p. 3). The so-called 'ideological shift' (Carluer, Alix & Joly 2008, p. 5) and evolving changes in the role of Customs were identified by Kunio Mikuriya, Secretary General of the World Customs Organization (WCO) as shown in Figure 1.

Figure 1: Evolution of Customs



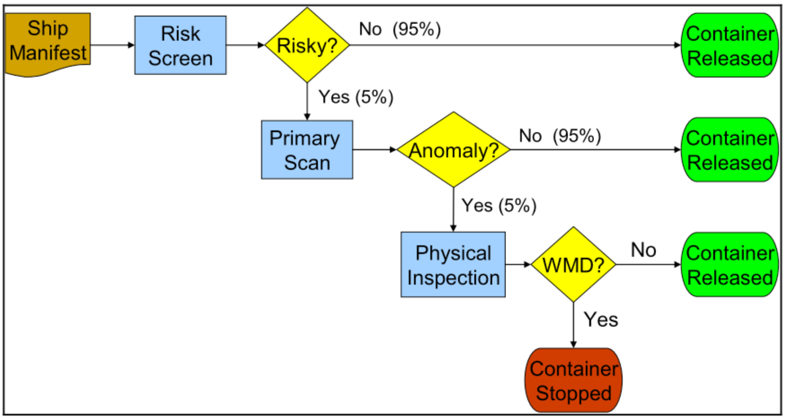
Source: Mikuriya 2007b

Shortly after the tragedy of 9/11, various programs were introduced by CBP to address potential threats of terrorist attacks. These programs included the Container Security Initiative, Customs-Trade Partnership Against Terrorism,[2] Free and Secure Trade Program, and the 24-Hour Rule (Ireland 2009, p. 2). Among these actions, the *9/11 Commission Act* came into force on 3 August 2007. According to Section 1701, Container Scanning and Seals, under the Title XVII, Maritime Cargo of Public Law 110–53—AUG. 3, 2007 issued by the 110th Congress of the US on *Implementing Recommendations of the 9/11 Commission Act of 2007*, 'A container that was loaded on a vessel in a foreign port shall not enter the United States (either directly or via a foreign port) unless the container was scanned by nonintrusive imaging equipment[3] and radiation detection equipment ***at a foreign port*** before it was loaded on a vessel ...' ***by 1 July 2012*** (emphasis added).

The regulation, which is known as the 100% container scanning law, targets the goal of detecting and neutralising nuclear weapons threats to the US (Bakshi, Flynn & Gans 2010, p. 4). Furthermore, supporters of the policy believe it would contribute to promptly returning the global supply chain to a steady state and minimise the costs arising from delays due to congestion at ports in the case of terrorist attack along the nodes of the global supply chain (Cirincione, Cosmas, Low, Peck & Wilds 2007; Bakshi, Flynn & Gans 2010, p. 4). It is estimated that if a port is attacked, there would be up to a three-month closure and backlog at US ports resulting in considerable losses. Due to the influence of the US in the world economy, an incident such as this may even cause economic recession (Allen 2006, p. 1). From a day-to-day benefits perspective, the law would help Customs to collect accurate amounts of tariffs (Cirincione et al. 2007, p. 25).

The immediate response to the aftermath of 9/11 was that US airport security was significantly tightened. Every passenger and the checked-in luggage and belongings of passengers are scanned. However, there have not been significant changes in security at seaports. 'Five years after 9/11, only 5% of the six million cargo containers that arrive at US seaports are scanned for threats' (Cirincione et al. 2007, p. 9).[4] This low percentage of random scanning represents a cautious approach to national security and personal safety at seaports.

Figure 2: Cargo security procedures



Source: Cirincione, Cosmas, Low, Peck & Wilds 2007, p. 13

Customs plays an increasingly important role in the area of free trade, that is, to facilitate legitimate trade and travel and protect the geographic and economic borders of a nation. In the changing nature of border management, the role of Customs is no longer apparent and simple (Lobdell 2009, p. 1). Customs administrations are in 'the unique position' to facilitate and secure global trade. The WCO supports customs administrations around the world to better perform these two functions, emphasising their security role, through the *WCO Framework of Standards to Secure and Facilitate Global Trade*[5] (the SAFE Framework) (WCO 2005). So far, 162 of the 177 WCO Members have committed to the SAFE Framework (WCO 2011), which indicates that their security mission is widely and actively accepted by customs administrations.

However, the 100% container scanning law of the US has been very controversial and has faced criticism by port authorities, maritime stakeholders, consignors and transporters, customs administrations, and even the WCO because 100% scanning is unlikely to ensure 100% security (McNeill 2010, p. 5). There is 'widespread concern that the resulting congestion would hinder trade significantly' and cause congestion at ports throughout the supply chain (Bakshi, Flynn & Gans 2010, p. 1), financial burdens and technology issues for outbound ports, which would be barriers to legitimate trade (Bennett & Yi 2008, p. 12). These concerns are further discussed below. Moreover, the law goes against the principles of trade facilitation reforms carried out by customs administrations and recommended by the WCO in the SAFE Framework.

2. Implications resulting from the implementation of the 100% container scanning law

Several implications would result from the implementation of the 100% container scanning law, an 'excessive security policy' (Ireland 2009).

2.1 Costs and time constraints

Martonosi, Ortiz and Willis (2005) conducted a study to examine the implementation of 100% scanning with the application of different levels of scanning technology, shown in Table 1.

Table 1: A comparison of 100% scanning using alternative technologies

Parameter	Base policy	100% scanning same technology	100% scanning slightly improved technology	100% scanning greatly improved technology
Fraction containers screened	0.05	1.00	1.00	1.00
Targeting method	Random	N/A	N/A	N/A
Detection rate	0.95	0.95	0.95	0.95
Scanning rat (TEU/hr)	20	20	30	30
False positive rate	0.05	0.05	0.05	0.01
Equipment unit cost ($M)	$4.5	$4.5	$1.0	$1.0
Annual maintenance costs ($)	$200 000	$200 000	$90 000	$90 000
Operators per scanner	4	4	4	4
Hand searching rate (containers per day)	1	1	4.8	4.8
Number of inspectors per team	5	5	5	5
Annual operator/inspector salary ($)	$50 000	$50 000	$50 000	$50 000

Source: Martonosi, Ortiz & Willis 2005, p. 223

As can be seen from Table 1, any option would significantly increase CBP's operational costs. The conclusions reached from a detailed cost-benefit analysis of the three options were that 100% scanning with the same technology may be cost effective for attacks with direct (labour and technology) and indirect (delay, intervention, ruination) consequences of more than USD 10 billion, but were still not viable due to the infeasibility of land and human resources (Martonosi, Ortiz & Willis 2005, pp. 228-37). The study's assumptions about the cost of an attack account only for material loss, not human loss.

Moreover, normally 5% of the scanned cargo will be physically inspected (Cirincione et al. 2007, p. 5). So, if the scanning percentage is 100%, Customs would have to spend considerably more resources (human and financial) on physical inspection. It takes 15 to 20 customs officers four hours to conduct a physical inspection of a container (Cirincione et al. 2007, p. 14).

Indirect costs and time constraints may be incurred from scanning procedures (Cirincione et al. 2007, p. 4), especially for perishable goods and fresh foods. Several authors view cost as the main implication of the law, including Dallimore (2008), Bennett and Yi (2008), and McNeill (2010).

2.2 Requirements for advanced technologies

In order to scan a container, Customs need to use an x-ray or gamma scanner. The kind of technology would have to be clearly defined (Cirincione et al. 2007, p. 16) or standardised (Bennett & Yi 2008, p. 155) otherwise the effort would be worthless. Apart from the expense of purchasing scanners, their usage, maintenance, daily operation, and the training of customs officers would add significantly to the overall cost of 100% scanning. Keeping in mind that many outbound ports are in developing countries (Carluer, Alix & Joly 2008), the technology available in outbound ports to the US is not sufficiently advanced to conduct 100% scanning of all cargo using non-intrusive inspection scanners (Cirincione et al. 2007, p. 17).

Also, these types of scanners emit radiation that requires a large exclusion zone to prevent harm to customs personnel. Thus, port facilities would need to be re-arranged and possibly re-structured to ensure a safe working environment (Ireland 2009, p. 12).

2.3 Collaboration with foreign customs administrations and sharing information

Shipping one container may involve up to 25 different parties and require 30 to 40 documents (Allen 2006, p. 2) and that shipment may move from country to country. While the current security procedures highlight cooperation with domestic carriers, for advanced information on cargo, the new law calls for close collaboration and cooperation with foreign customs administrations (Dallimore 2008, p. 104). Therefore, outbound customs administrations would most influence the success of US 100% container scanning law. Table 2 shows the reasons why the law requires containers to be scanned at foreign ports before loading.

Table 2: Reasons for scanning

Location of Scan	Consequence of Attack	Risk of Tamper	Trustworthiness of Scan	Technology Cost to U.S.
Prior to arriving at foreign port (exporter supply chain)	Low	High	Low	$
At Foreign Port	Low	Medium	Low to High	$
At U.S. Port	High	Low	High	$$
Beyond U.S. port (within importer supply chain)	High	Medium	Medium	$$

Source: Cirincione, Cosmas, Low, Peck & Wilds 2007, p. 30

Foreseen and heavy burdens (on cost, technologies and human resources) on foreign ports may prevent them agreeing to implement the law. Before 9/11 customs administrations were mostly concerned with imported cargo and had little to do with export cargo. In the event the law is implemented, additional resources would need to be allocated for export cargo (Mikuriya 2007a, p. 51). Even if the shortage of resources is resolved, the sharing of business information, the effectiveness of scanning and the mutual recognition of scanning results by CBP and foreign ports are difficult and sensitive issues to be dealt with – and these issues may affect the independence and sovereignty of nations.

2.4 Hindrance to national and international trade facilitation

At a national level, customs administrations make great efforts to harmonise and simplify customs procedures to streamline trade. At an international level, the WCO's recommendations and conventions encourage trade facilitation, and at the same time strive to ensure security. Instruments and guidance suggested by the WCO are compatible with the World Trade Organization's (WTO) trade facilitation agenda (Widdowson 2007, p. 34). Meanwhile, 100% container scanning law may cause restrictions to free trade and infringe Articles I, V, VIII, X and XI of GATT (Dallimore 2008, pp. 215-9). The WCO even lobbies the US Congress against 100% scanning (Ireland 2009, p. 11).

Customs administrations, in this case, have to consider the trade-off between human lives, national security and defence issues and trade facilitation requirements. Many authors contend that a fair choice would be unlikely (Carluer, Alix & Joly 2008, pp. 2, 19). Comparing the cost of an attack and the benefit of a prevention solution, such as 100% container scanning, is not meaningful because security (human lives) and economic benefits are not in the same cost-benefit units (Mankiw 2010, p. 231).

3. Possible alternative solutions

3.1 Defer the implementation of the 100% container scanning law

Despite the implications mentioned above that would result from 100% container scanning law, 'the question as to whether trade security initiatives have a positive or negative impact on trade facilitation at this time remains unanswered, as most companies continue to struggle with various stages of implementation, and nations wrestle with what is the perfect balance between facilitation and security' (Lobdell 2009, p. 1). The necessity of such a law remains vital, especially if there is an increase in terrorism attacks and organised crime. Thus, it would seem reasonable to defer the implementation of the law until the technology is more developed and available (especially in developing countries), and the CBP obtains additional political support to facilitate collaboration with customs administrations (because trade facilitation for economic growth is currently the first priority – not security – in developing countries). Screening at the originating ports would lead to US ports being the 'last line of defence, not the first' and put the US in more danger if less screening at US ports is required (Allen 2006, p. 6).

On the other hand, with the implementation of the law, security along the supply chain would improve significantly, creating much less opportunity for terrorism activities; threats would be prevented and stopped at the originating ports; faster recovery of the supply chain in the case of terrorist attack would be ensured and avoid serial closure of ports for lengthy periods leading to massive economic losses.

Furthermore, tariff collection would increase and corruption would be diminished because of the added transparency arising from the use of the non-intrusive imaging devices (Allen 2006, p. 6).

3.2 Further improve Customs-to-Customs exchange of advanced information for risk management

This option requires the following activities:

- To enhance the effectiveness of risk management, information about a shipment, including the number of containers, to be sent (preferably electronically) to outbound customs administrations prior to loading.
- Information to be processed by outbound Customs, and at the same time, transmitted to CBP for their risk assessment.
- High-risk information to be further examined or a physical examination made of the goods by outbound Customs, if necessary.
- Results of the examination and risk assessment to be sent to CBP prior to the ship's departure.
- CBP then to determine whether the shipment is eligible to enter US ports. This would not ensure there would be no additional information required or that the shipment is exempt from physical examination at US ports.

The advantage of this option is that it is economically feasible. The estimated budget for the Buenos Aires port authority to have four non-intrusive inspection devices was USD 33 million, including the expense of upgrading infrastructure. A container scanner may cost millions of dollars while 'investments in IT and existing infrastructure only often triple the compliance costs' (Allen 2006, p. 3). Moreover, this option would ensure customs administrations are well informed about real-time export and import activities (De Wulf & Sokol 2005, p. 285) and are able to take the initiative in decision making (ASEAN 2005).This is a risk-based approach committed to by several customs administrations (Carmody 2011, p. 7; McNeill 2010, p.1; ESCAP 2002).

Challenges to the success of this option are the agreement by customs administrations about the sharing of information, examination and risk assessment results; the level of information technology development; trustworthiness and mutual recognition of customs clearance results; and the secure transmission of data and information. In addition to Customs, the option requires cooperation and high compliance by the business sector to provide advanced information (Lobdell 2009**,** p. 2). In some cases, further incentives should be offered to the business sector, for example, the provision of free e-customs software and training so that companies can transmit the necessary information (Ministry of Finance of Viet Nam 2005).

4. The preferred solution

Each of the options has its advantages and disadvantages. However, in the short term, the use of advanced information for risk management is likely to be more feasible.

Despite the infinite value of human life, 'in both public and private decisions, we are at times willing to risk our lives to save some money' (Mankiw 2010, p. 232). Examples given are that people still decide to buy a small car, even one without air bags, or that traffic lights are not installed at every crossroad. Other opinions are that 'real security means choosing policies that not only keep Americans safe, but also keep them free and prosperous. The 100 percent scanning mandate does none of these well' (McNeill 2010, p. 1).

According to McNeill (2010), 'It is impossible to screen 11.6 million containers every year without bringing the global economy to its knees'. The US economy would face the loss of USD 500 billion in profit and more than five hours of delays per container if 100% containers are scanned (McNeill 2010, p. 1). The regulation would place heavy burdens on foreign customs administrations (Allen 2006, p. 9).

Customs-to-Customs exchange of advanced information for risk management would meet both the priority objectives and the roles of Customs, that is, to enhance security and at the same time, facilitate global trade.

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Notes

1 This paper stems from personal, independent research by the author and does not reflect the views of Vietnam Customs on the issue.

2 'The Customs-Trade Partnership Against Terrorism [C-TPAT] is a voluntary program that grants members expedited cargo processing if they submit to and meet CBP review of their supply chain security procedures. In practical terms, importers that are members of C-TPAT receive various benefits that reduce the level of scrutiny applied to their cargo shipments' (Cirincione et al. 2007, p. 11).

3 '… scanning technologies that can effectively scan the cargo without ever needing to open the container' (Cirincione et al. 2007, p. 17).

4 ‘While all cargo containers entering the U.S. are screened for security risk, currently only about one in twenty are physically scanned with technology that can detect WMD [Weapons of Mass Destruction]. Of this small fraction, only 5% then undergo secondary scans by means of physical inspection.2 Cargo containers therefore might be attractive vessels for smuggling conventional, chemical, biological, or nuclear weapons into the United States’ (Cirincione et al. 2007, p. 8).

5 A non-binding instrument by the WCO comprised of technical customs standards aimed at securing without impeding international trade (Ireland 2009).

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Editor’s note

In a letter dated 2 May 2012, US Department of Homeland Security (DHS) Secretary Janet Napolitano advised the House Committee on Homeland Security, US House of Representatives, of a decision to extend the statutorily imposed deadline for ‘the 100 percent scanning mandate’ for an additional two years, that is, until 1 July 2014.

In doing so, Secretary Napolitano identified ‘… two critical conditions which necessitate an extension of the July 1, 2012 deadline:

- ***Use of systems that are available to scan containers will have a significant and negative impact on trade capacity and the flow of cargo.***
  DHS has provided seven reports to Congress that detail the significant diplomatic, financial, technological, and operational barriers encountered throughout the deployment of integrated scanning systems to six foreign ports between 2007-2010, as part of the SFI pilots.[7] Based on our own operational experiences, and on substantial input from many industry partners and foreign government stakeholders, we conclude that utilization of current available, state of the art, integrated radiation detection systems and imaging equipment would be cost prohibitive and significantly impact trade capacity and the flow of cargo at this time.

- ***Systems to scan containers cannot be purchased, deployed, or operated at ports overseas because ports do not have the physical characteristics to install such a system.***
  The space within the confines of most ports is exceedingly scarce and expensive, complicating the installation of scanning technologies. Additionally, integrated systems to scan transshipped cargo efficiently have yet to be developed. No integrated solution exists that can be seamlessly incorporated into the precise operations of moving cargo from barges-to-ships, from ships-to-ships, and from rail-to-ships without adversely impacting port operations and creating delays. While scanning systems for outbound cargo can be and have been integrated into busy port environments on a case-by-case basis, this has to-date, proven to be the exception rather than the rule and is often the result of complex and protracted negotiations.

7 *Update on Integrated Scanning System Operations,* (May 29, 2008; June 12, 2008; January 4, 2010; July 15, 2010; January 24, 2011; May 20, 2011; and February 29, 2012). These challenges include: 1) operational costs associated with equipment, construction, communications and information technology, personnel, and resolution of alarms that occur; 2) diplomatic challenges related to obtaining critical host nation support; 3) severe space constraints within ports where land is limited and costly; 4) logistical and operational obstacles associated with deploying multiple systems or re-routing containers through the systems without causing bottlenecks that would trigger delays; 4) [*sic*] limitations on currently available technologies to adequately handle transshipped cargo and provide adequate automated alarm capabilities; 6) perceptions of health and safety concerns; and 7) varying degrees of terminal operator cooperation.’

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Section 3

An Excise Resource Summary

The Illicit Trade in Tobacco Products and How to Tackle it

Published by the International Tax and Development Center (ITIC)

Elizabeth Allen

The following is an overview of the content of a booklet published in 2011 by the International Tax and Investment Center (ITIC), a non-profit research and education foundation that provides information on best practices in taxation and investment policy.

The booklet is intended to inform policy makers and administrators in tax and enforcement organisations in less developed countries and help them improve efforts to combat the illicit trade in tobacco products. It brings together facts and views from respected academics, private sector consultants, journalists, international enforcement organisations, government revenue authorities and industry. It analyses the nature of the problem, its causes and consequences, and offers authorities best practice guidance on implementing anti-illicit trade strategies. Case studies are used to provide evidence of good practice and global efforts to tackle this serious problem.

The booklet was written by a former tax administrator in a style intended to make it accessible to those for whom English is not their first language.

The booklet includes a foreword by Kunio Mikuriya, the Secretary General of the World Customs Organization (WCO), and photographs and illustrations courtesy of the WCO, revenue and customs authorities and the industry. As a result of growing interest in the subject, the booklet has already been reprinted and translated into French, Arabic and Russian.

1. Definition and context

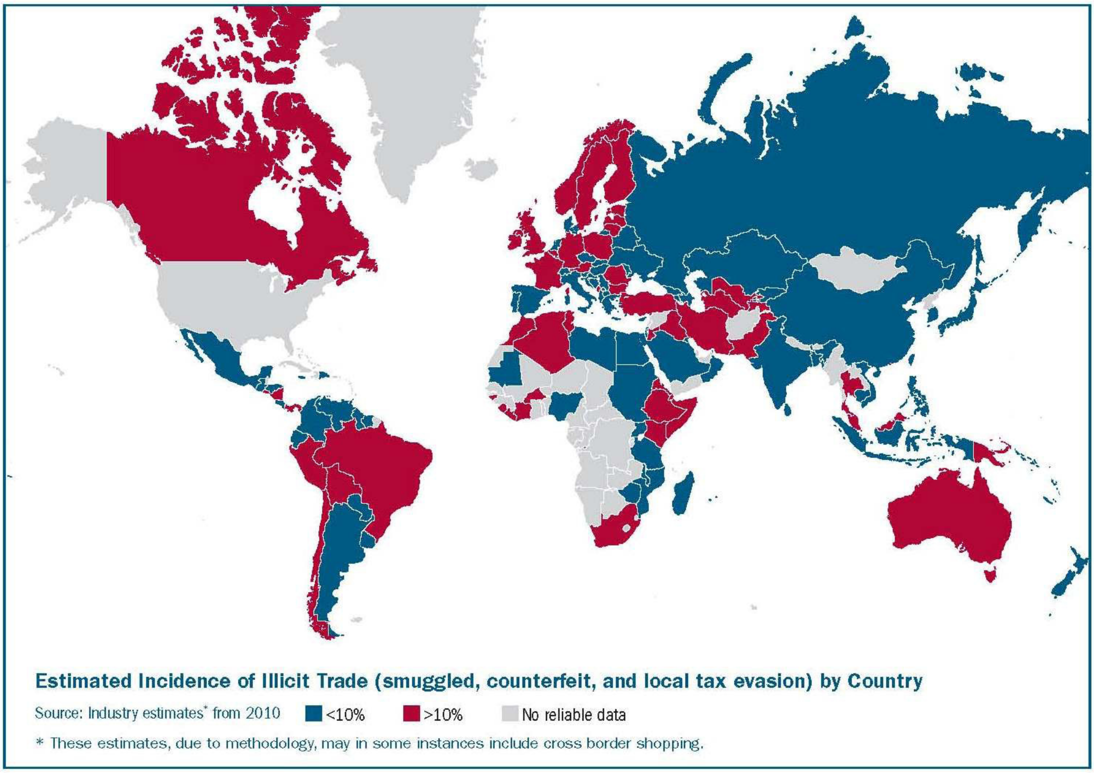
The illicit trade in tobacco products is defined in Article 1 of the World Health Organization's (WHO) Framework Convention on Tobacco Control (2003, p. 4) as 'any practice or conduct prohibited by law and which relates to production, shipment, receipt, possession, distribution, sale or purchase including any practice or conduct intended to facilitate such activity'.

Illicit trade manifests itself in three major and interrelated ways: smuggled, counterfeit and local tax evaded products. It is a global phenomenon, covering all continents and high and low income countries alike. Cigarettes, being highly taxed, easy to transport, and possessing a lucrative risk to reward ratio, are among the world's most illegally trafficked goods.

2. Size and nature of the trade

Despite the lack of robust global data, the overall consensus is that this worldwide illicit trade is unacceptably large and changes rapidly. Figure 1 shows the estimated global incidence of illicit trade in 2010.

Figure 1: Estimated global incidence of illicit trade in 2010



Source: Allen 2011, p. 6.

As countries, such as the United Kingdom (UK), have taken steps to tackle illicit trade in legitimate products there has been an explosive growth in 'illicit white' cigarettes made specifically for smuggling and in counterfeit cigarettes. Internet sites selling and shipping cigarettes worldwide in small quantities by post to evade taxation have proliferated. Shelley (2009, pp. 1-10) demonstrates that this trade has become a major security challenge around the world and is used increasingly to fund terrorism.

3. The impact of illicit trade in tobacco products

In addition to significant amounts of lost revenue in excise and value added or general sales tax, this illicit trade has a huge impact on the economic and social fabric of society. It obstructs economic development by legitimate manufacturers, suppliers and distributors. The Royal Canadian Mounted Police (2008, p. 17) report that this illicit trade in Canada resulted in a 30% revenue loss to convenience stores.

Illicitly traded tobacco products are outside the regulatory framework for strict health warnings, maximum tar/nicotine levels, and sales prohibition to minors. Campbell (2010) reports in The Guardian newspaper that 'Counterfeit tobacco has also been found to contain arsenic, rat droppings and far more tar and carbon monoxide than legal products'. Sincovich (2009) says that the World Customs Organization (WCO) receives reports of counterfeit cigarettes seizures containing mites and unprecedented methods of concealment posing serious health risks for law enforcement officers, for example, in barrels of titanium sponge containing toxic chlorine gas. Illicit cigarette sales focus on minors who cannot buy products legally and on those on low incomes. Illicit distributors also often supply other illicit products such as alcohol, drugs and firearms. Where there is a good distribution chain and a ready market for illicit products, the rule of law is undermined and corrupt practices thrive.

4. Drivers for this illicit trade

Illicit trade is demand and supply driven. Consumers want to buy cheap products and save money (demand); criminals want to take advantage of high taxes which they do not pay to make high profits with low risk of being caught and penalised. Contributory factors include unbalanced fiscal policies, disparities in tax-driven prices between neighbouring jurisdictions, protectionist policies, corruption, weak enforcement, porous borders, lack of official controls in free zones, poor transit controls, inadequate or out-of-date legislation and sanctions, growth in illegal distribution networks, and public tolerance.

5. How big is the threat? Is it really worth focusing on?

There is no robust estimate of global consumption of illicit tobacco products. Philip Morris International (2011), report the KPMG estimate that the counterfeit and contraband share of cigarette consumption in the European Union (EU) in 2010 reached almost 10% based on identical research methodology applied to each Member State. This estimate is accepted by the European Anti-Fraud Office (OLAF). The estimate of annual losses to national and EU revenues in 2010 amounts to about 10 billion Euros a year.

In the UK, HM Revenue and Customs (HMRC) (2011, pp. 25-6) estimates the size of illicit consumption of cigarettes as between 4% and 16% and of Hand Rolling Tobacco as between 41% and 50% of total UK consumption in 2009-10. According to the Tobacco Institute of South Africa (TISA), the incidence of illicit cigarettes in South Africa has almost doubled over the past three years and, in 2012, accounts for about 25% of the total cigarette market.

6. Measuring the trade

Several methodologies are in use. According to Cartwright and Stephens (2009), KPMG use the most sophisticated and expensive methodology in arriving at their annual estimates for the EU. This involves three primary sources of data: empty pack surveys; legal domestic sales; and consumer interviews with subsequent refinements to account for product flows between EU countries and into and out of the EU as a whole.

Data is cross referenced with all available alternative data sources, together with anecdotal observations of trends and developments by Customs and other experts involved in countering illicit trade. Seizure data may also provide good corroboration of results and is particularly useful to monitor trends and identify new routes, methods and players.

7. Combating the threat

All too often, the response of revenue, customs and other enforcement agencies is reactive, serving only to eliminate a small number of 'foot soldiers'. For tobacco smuggling, legal or counterfeit, organised by criminal or terrorist gangs, the response is to recruit replacements and, possibly, to change the method, route or means of transport. Criminals do not have to worry about legislative compliance, seeking departmental expenditure approval or behaving in accordance with the requirements of publicly accountable bodies.

But, all is not lost. Some countries, for example, UK (HM Revenue and Customs and UK Border Agency 2011) and Hungary (ITIC, Nagy 2012) have reduced levels of illicit trade by adopting a strategic and comprehensive approach. Such an approach requires acknowledgment and understanding of the nature and extent of illicit trade combined with strong political will to tackle the multi-faceted threat. Then, adequate financial resources need to be made available, joint outcome-based targets set, and progress monitored and reported.

8. Key components of a comprehensive strategic response

As in any war, 'know your enemy'. This means understanding the size and changing nature of this trade, of which the main indicators are:

- unexplained fall in legal market sales – usually noticed first by manufacturers and retailers
- reduction in the government revenue flow
- increase in illegal product seizures – either in frequency or quantity
- emergence of brands not displaying correct markings or not legally distributed and sold in the country
- changes in anti-illicit trade survey results.

Results from robust sizing methodologies can raise awareness of authorities and public alike about the seriousness of the threat, influencing allocation of resources.

Next, identify and evaluate illicit trade facilitators. This means examining and addressing weaknesses in:

- tax and administration policies and processes
- import/export and transit policies and processes
- relevant health, labelling and contents requirements that increase opportunities for fraud
- enforcement capabilities and tools
- penalties and the use of compounded settlements
- public awareness/acceptance of the illicit trade.

9. A balanced tax policy and effective tax collection

Governments setting tax rates should take into account levels of economic development, the average consumer's purchasing power and tax rates in neighbouring countries. Experience shows that sudden tax hikes are likely to lead to emergence or growth of illicit trade (for example, in Ireland from 2001 to 2003 and 2006 to 2009).

Tobacco products can be addictive. Research for the Health Education Council by the National Network on Tobacco Prevention and Poverty (2004, p. 1) indicates that cigarette smoking among adults is associated with social disadvantage as defined by educational attainment, income and occupational class, that is, people most likely to have a low income. Tax or price increases or disposable income reduction can make the legal product unaffordable or inaccessible to addicted consumers, thus creating a market for illicit products.

10. Necessary revenue control techniques

Modern excise administrative systems are based on licensing/registration of all excise operators and their premises. Controls combine audit and physical techniques.

Audits examine overall credibility of declared business operations in comparison with components purchased, machinery usage, declared losses and financial transactions. Audit controls should include customs and VAT/sales tax declarations and, for complex multinational businesses, can include tracing financial transactions between related companies across continents. Physical controls provide essential checks that operations are conducted in line with legislation and accurate records kept of inputs, stocks and outputs. Physical inspections should be unpredictable and made 24/7 to detect any undeclared ‘nightshift’ production.

11. Supply chain controls

The challenge is to secure the legitimate supply chain, to detect illicit trade more easily. Some countries require paper tax stamps, others covert fiscal markers to help enforcement officials detect tax unpaid goods. However, even the most sophisticated paper tax stamps and markers are not secure against the threat of illicit product providing officials with a false sense of security and counterfeiters with another money-making opportunity. And, revenue officials have to control the paper tax stamps as well as the product. Paper stamps are vulnerable to theft and re-use by criminals.

A more robust approach to supply chain security is digital tax verification using advanced unique digital coding technology printed directly onto packs. It is cheaper to implement than paper tax stamps and the codes are easily readable by officials and consumers. This technology:

- serves as an authentication tool
- provides governments with secure real-time information about cigarettes produced in and for their country
- provides the most cost effective system
- is in line with e-government and e-customs initiatives.

But, it does require sufficient interventions at all stages of the supply chain to detect duplicate ‘unique’ numbers. Technology cannot solve illicit trade on its own. There will always need to be robust controls and sufficient interventions to check the validity of the codes. Otherwise, what will detect or deter criminals from copying a valid (but already used) code? Digital coding technology makes it easier and quicker for enforcement officials to detect copied codes.

There are a number of digital coding systems in development and in use in different industries to secure the supply chain of their products. There is a prospect of a multiplicity of systems with different formats and access facilities being put in place for the same product in different countries. This will make the work of customs officials and cooperation across borders more difficult. It will also add costs for industry and, thus, for consumers as well as, potentially, discriminating in favour of domestic products. Perhaps it is time for the development of agreed global standards for track and trace systems to facilitate the work of Customs, discourage protectionist policies and minimise additional costs for industry.

Controlling the supply chain should include retail sales. This responsibility often lies outside the revenue authority. It calls for a cross-government approach involving those who issue retail sales licences, control product labelling and enforce restrictions on sales to minors.

12. What about legislation?

To be effective, legislation must be clear, simple and easy for industry to understand and implement as well as cost-effective for revenue authorities. It must provide law enforcement with sufficient authority to act. In addition to administrative requirements (for example, registration of excise operators, their premises and operations and security needed), it must cover:

- clear offences and appropriate penalties
- systematic destruction of all seized illicit tobacco products, raw materials, manufacturing equipment and components
- means to recover tax revenue losses and costs for destruction of seized goods, for example, through asset confiscation
- effective authentication, tax payment validation and supply chain controls (that is, including manufacturing, wholesale and retail licensing and security markings)
- information exchange about ‘suspect’ movements with other appropriate national and international authorities
- strong protection measures for brand owners against International Property Rights violations.

Legislation should stop governments from selling seized items related directly to the manufacture or sale of tobacco products including counterfeit and contraband cigarettes, manufacturing equipment, tobacco and non-tobacco raw materials.

13. The judicial process

This must deal with cases quickly, effectively and cheaply. If there is to be any real preventive effect, penalties must deter.

14. Is effective enforcement the real answer?

Although a key weapon, an effective multi-faceted targeted enforcement strategy is not the total solution.

Effective enforcement requires skilled resources and tools, with officials:

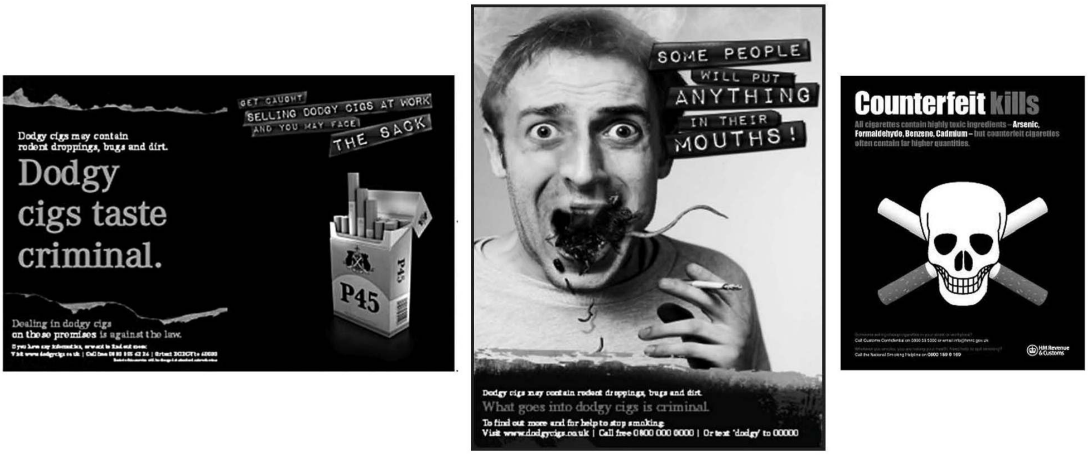
- skilled in audit and investigative techniques
- able to use IT tools and analyse data sources
- able to adopt a credibility approach to declarations.

Leadership, management, appropriate remuneration, ethics training and robust enforcement of an anti-corruption policy can help to counter a culture of corruption.

15. Tackle demand as well as supply

As long as there are willing customers for illicit products, criminals will continue their trade. Revenue, enforcement, health and trade authorities must deliver joined-up, consistent and continuing education and awareness targeting areas of low income. Examples of public awareness advertisements in the UK are shown in Figure 2.

Figure 2: Examples of public awareness advertisements in the UK



Source: Allen 2011, p. 24.

16. Legitimate industry can and do help

The EU has legally binding cooperation agreements with the four major tobacco companies. Details of these are available on www.europa.eu.

Several countries have voluntary Memoranda of Understanding (MOUs) with the Tobacco Industry. Key elements covered are information sharing and assistance in:

- assessing and measuring levels and sources of illicit trade
- exchange of data
- proactively responding
- monitoring movements of (suspected) ingredients, equipment and finished illicit tobacco products
- analysis and destruction of seized goods.

Some revenue authorities, for example, in South Africa, now work with legitimate trade to counter illicit trade providing channels for communication of intelligence and making use of industry resources for counterfeit product awareness training.

17. International cooperation

Highly sophisticated international criminal networks use complex routes and ingenious methods to move illicit goods, making international cooperation in the investigation, arrest and prosecution of offenders essential. Some international and regional organisations (for example, WCO, OLAF and Interpol) and customs authorities (for example, UK and USA) have liaison resources across the world. These work with local enforcement authorities and tobacco manufacturers to detect criminal activities.

18. The World Health Organization (WHO) Framework Convention on Tobacco Control

The World Health Organization (WHO) Framework Convention on Tobacco Control (FCTC) was adopted by the WHO in 2003, entered into force in 2005, and has now been signed by 174 governments. Subsequently, a Protocol has been in development aimed at curbing illicit trade in tobacco products.

This will be binding on signatories only when enabled into national law. The three main elements of the Protocol are supply chain security, offences and enforcement, and international cooperation.

The supply chain security envisaged requires a tracking and tracing regime for all legitimate products. ‘Tracking’ is the ability to monitor the forward movement of finished goods through the supply chain; ‘tracing’ is the ability to determine where the product was diverted into illegal channels.

The FCTC has important implications for revenue and enforcement authorities in signatory countries. Health departments have led negotiations in many countries and it is vital that those who must administer and control the new requirements are involved in determining how and when they are introduced.

19. Conclusions

However stringent the requirements on legitimate trade may be, one thing remains certain. As long as the illicit trade in tobacco products provides high profits at low risk and there is a ready market of consumers, criminals will find a way to continue their trade.

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Section 4

Reference Material

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