

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

János Nagy¹

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.

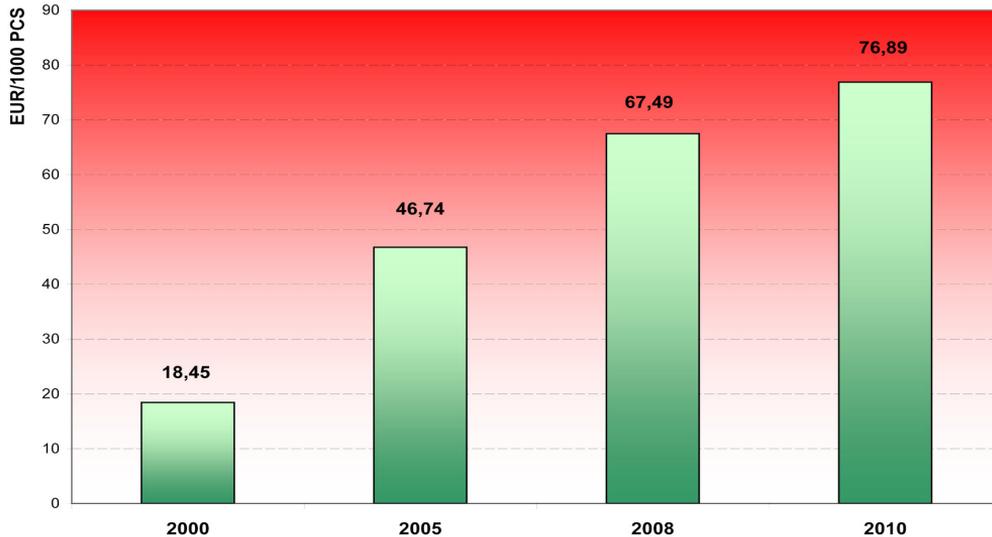
Romania is a special case (see also section 3, which deals specifically with the situation in Romania) as historically the level of cigarette excise duties was lower than the minimum EU rate between accession to the EU by neighbouring Hungary, Slovakia and Slovenia in 2004 and by Romania in 2007. It 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

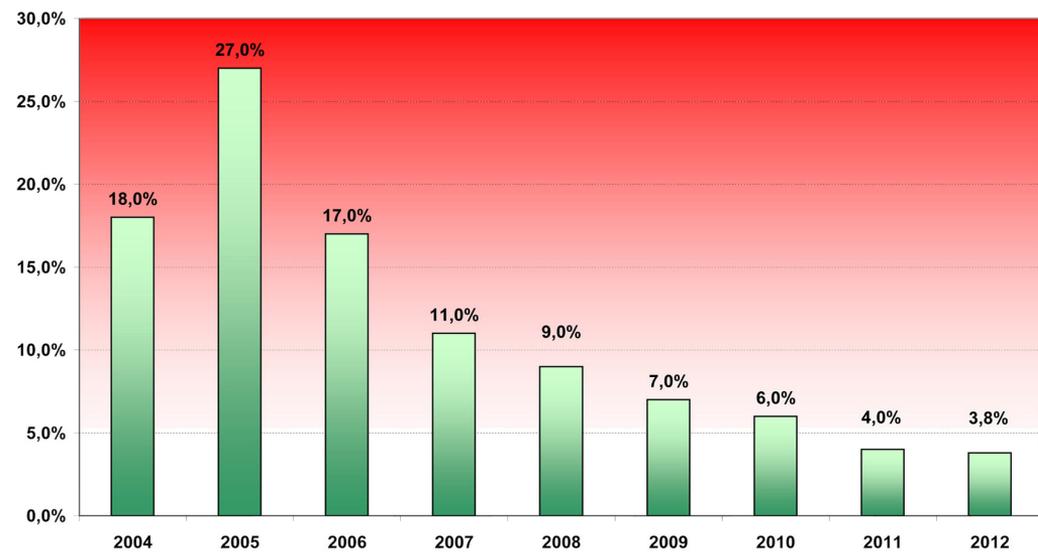
- more cooperation with the Hungarian tobacco industry in sharing information.

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

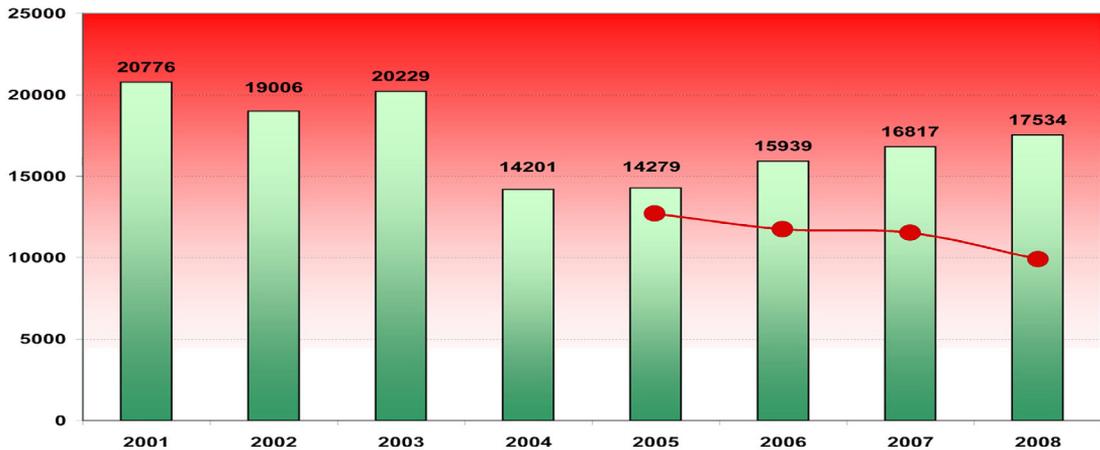


Source: Hungarian Customs & Finance Guard (HC&FG)

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

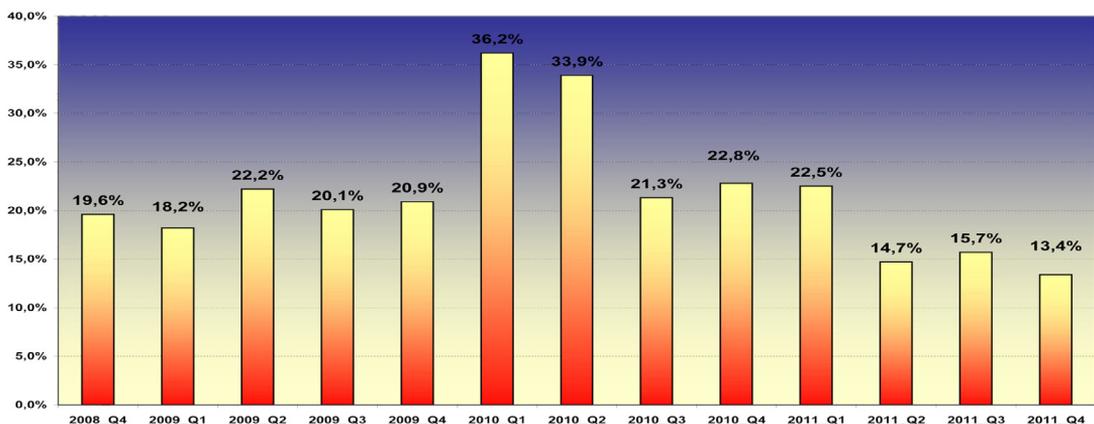
The study covered the years 2009 to 2011. The reason behind this is that Romania recorded the worst year of a growing black market of cigarettes in the first quarter of 2010 and a number of measures followed to solve the problem.

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:

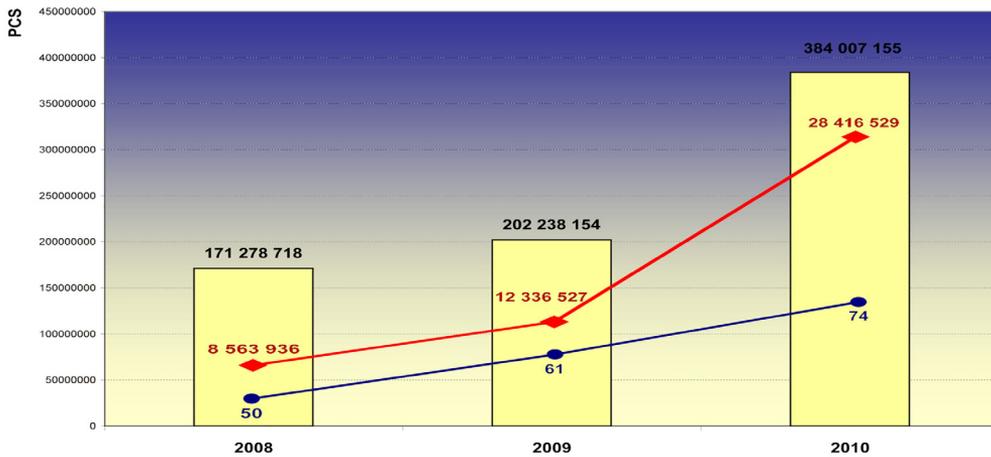
- changes in laws and regulations to allow the seizure of vehicles modified for smuggling purposes
- restrictions on duty free importation
- redefinition of the terms ‘smuggling’ and ‘excise fraud’ to allow more effective investigation and prosecution
- restrictions on the activities of tax free shops 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).

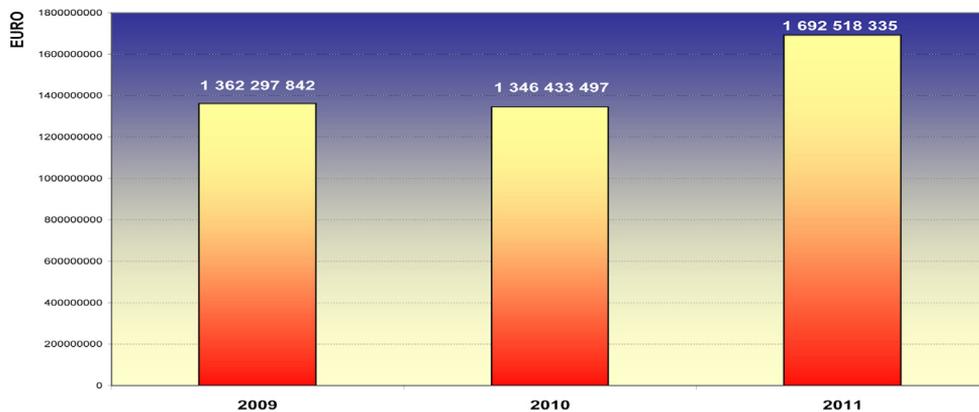
Table 5: Statistics on Romania



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.

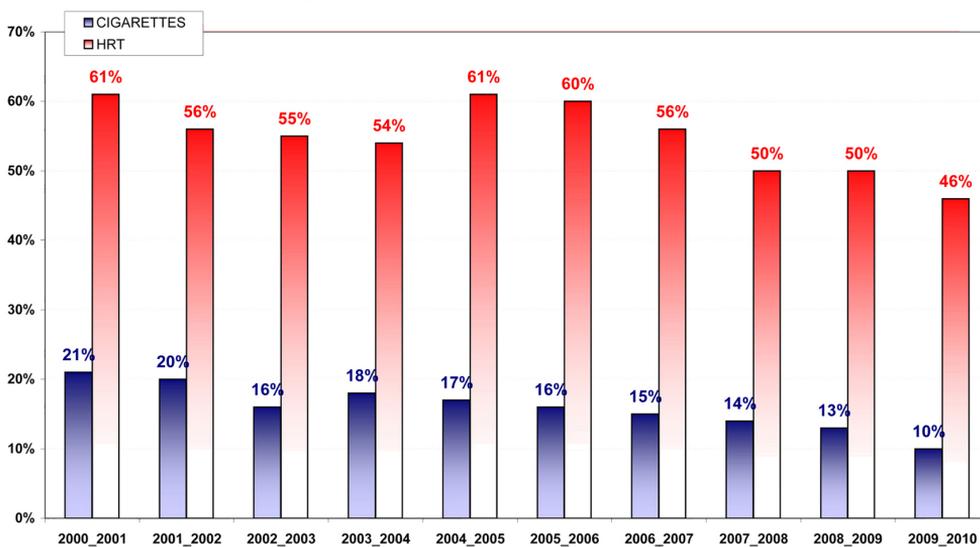
This factor does not affect only illegal imports from countries having very low rates of excise duties outside the EU. The relatively high difference in prices triggered both organised and small scale, but widespread (so-called ant trade) from across the Channel.

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.

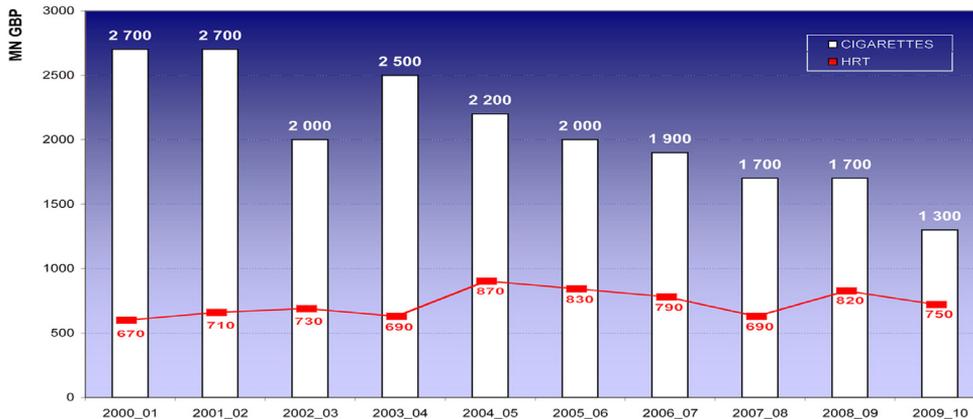
Finally, I have to emphasise that a strong publicity campaign to educate the general and the smoking public is a peculiarity of the UK cigarette anti-smuggling strategies.

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.

References

- HM Revenue & Customs (HMRC) 2000, 'Tackling tobacco smuggling', Strategy Paper issued by UK Customs & Excise, March, London.
- HM Revenue & Customs (HMRC) 2006, 'New responses to new challenges: reinforcing the tobacco smuggling strategy', issued by HM Treasury, London.
- International Tax and Investment Center (ITIC) 2012, 'WCO-ITIC global excise summit: 2-3 July 2012, Brussels', ITIC Bulletin, August, www.wcoomd.org/files/2.%20Event%20files/PDFs/Excise_Summit/Outcomes/wcogsb.pdf.

Note

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

János Nagy



Dr János Nagy, is a retired Lieutenant General, an economist and lawyer, and served in Hungarian Customs and Finance Guard in various positions from 1980 to 2010, including as Deputy Director General (1992-96) and Director General (2003-10). He was responsible for the Hungarian OLAF Coordination Bureau and the modernisation of the Hungarian Public Internal Financial Control system in the Hungarian Ministry of Finance (2002-03). János was Deputy Director at the World Customs Organization Secretariat (1997-2002), responsible for the management of training/technical assistance services to Members, the WCO Customs Reform and Modernisation, and Integrity Programmes. He was Vice-Chairman of the WCO Council (Europe Region) in 2005, re-elected in 2006. He is an Officer of the Oranje-Nassau Order of the Netherlands.

