

# Excise duties and smuggling

*The need of joint solutions to a global threat*

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**Abstract:** The founding fathers of the European Economic Community agreed that competition should be the mechanism for efficiently allocating economic resources in Europe. In order to achieve this goal, they prescribed the harmonisation of cumulative turnover taxes and excise duties, which could be used for protectionist purposes. The value-added tax (VAT) was adopted in 1977. Softer harmonisation proposals for the excise duties came later.

The failure of EU full harmonisation excise-duty regimes has resulted in tensions between transnational policies and national sovereignties and favours the emergence of criminal entrepreneurs willing to exploit these global market ambiguities. For that reason, illegal cross-border shopping, large-scale smuggling and the bulked-level counterfeiting of brand-named cigarettes have become a serious concern in several Member states because of the revenue loss produced, estimated to amount to more than €10 billion a year.

Being harmonized high taxes a necessity, the solution lies in better governance: countries should strengthen tax administration and customs enforcement capacity, exercising an appropriate internal control but also increasing controls both on internal consumption and on smuggling from their neighbours. The European Commission is firmly decided to tackle this problem and its action plan to fight against smuggling of cigarettes and alcohol is the way forward. It suggests a stronger tax harmonisation but also proposes a wide variety of measures.

**Key words:** Tobacco, excise duties, customs, smuggling, repressive measures

**Resumen:** Los padres fundadores de la Comunidad Económica Europea coincidieron en que la libre competencia debía ser el mecanismo que asegurara una asignación eficiente de los recursos económicos en Europa. Con el fin de lograr dicho objetivo, se armonizaron los impuestos sobre el consumo y los impuestos especiales, que podían ser utilizados con fines proteccionistas. El impuesto sobre el valor añadido (IVA) fue adoptado en 1977. Posteriormente se realizaron tímidas propuestas de armonización de los impuestos especiales.

El fracaso de la armonización completa de los impuestos especiales dio lugar a tensiones entre las políticas y soberanías nacionales y favoreció el surgimiento de criminales emprendedores dispuestos a aprovecharse de tales deficiencias del mercado mundial. Por esa razón, las compras transfronterizas ilegales, el contrabando a gran escala y la falsificación a gran escala de cigarrillos se convirtieron en una seria preocupación para varios Estados miembros, ya que la pérdida de ingresos producida suponía -y supone- más de 10.000 millones de euros al año.

Si el disponer de una alta presión fiscal armonizada es una necesidad, la solución radica en una mejor gobernanza: los países deben fortalecer la administración tributaria y la capacidad de sus aduanas, ejercer un control interno adecuado, así como aumentar los controles sobre el consumo interno y sobre el contrabando de los países vecinos. La Comisión Europea está firmemente decidida a hacer frente a este problema y su plan de acción de lucha contra el contrabando de cigarrillos y el alcohol es el camino a seguir. Dicho plan sugiere una armonización fiscal más fuerte, entre otras muchas medidas.

**Palabras clave:** Tabaco, accisas, aduanas, contrabando, medidas represivas.

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## I. Introduction

The origin of tobacco as a consumption good backs to the Mayan civilization, one thousand and five hundred years ago, although the first tobacco crops took place between five thousand and three thousand years before Christ. The Aztecs preserved the habit until the arrival of the Spanish in the early sixteenth century. Spanish sailors Rodrigo de Xerez and Luis de Torres were those who, exploring the island of Cuba under the command of Christopher Columbus, discovered and introduced tobacco in Spain.

Nowadays, tobacco farming is a sector with significant growth prospects: tobacco world production, according to FAO statistics, amounted to almost 7 million tons in 2008 and has an increasing trend. The European Union only farms 4.25% of that production, being a net importer of tobacco. Nevertheless, European tobacco has been historically one of the most subsidised crops. In 2000, farmers received an average of EUR 7.800 per hectare of plantation, with an annual cost of EUR 1.000 million. From 2009, the CAP reform (known as the health check) eliminated subsidies linked to production, keeping only (and temporarily) decoupled single payments. Currently, each Spanish farmer receives an average of EUR 4.000 per hectare. This system of subsidies has been a failure in terms of efficiency and effectiveness.

Tobacco industry is also a very profitable sector. The global market for elaborated tobacco, which includes cigarettes, cigars and cigarillos and pipe and rolling tobacco, has an estimated value of EUR 300.000 million per year<sup>1</sup>. Tobacco industry is a mixture of some of the most powerful transnational commercial companies in the world. State tobacco monopolies have been in decline since the 1980s, although the remaining monopolies represent a

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<sup>1</sup> DELOITTE, *Illicit trade of tobacco in Australia*. Sydney: 2011, pag. 7, [http://www.bata.com.au/group/sites/bat\\_7wykg8.nsf/vwPagesWebLive/DO7WYLJQ/\\$FILE/medMD8EHAM5.pdf?openelement](http://www.bata.com.au/group/sites/bat_7wykg8.nsf/vwPagesWebLive/DO7WYLJQ/$FILE/medMD8EHAM5.pdf?openelement), 28 October 2011, quoting DATAMONITOR, *Global Tobacco Market to 2014*. London: 2010.

combined consumption of 2 billion cigarettes or 40% of the world's total cigarette consumption. In the private sector, the five largest tobacco companies have a 42% of global market share<sup>2</sup> and that proportion exceeds 80% in many European countries.

With regard to the sector-related jobs, tobacco industry occupied in 2000 and in the European Union up to 126.070 full-time workers in tobacco farming; 12.372 in tobacco processing industry and 50.697 in tobacco industry, as well as 190.149 workers in indirect jobs. In total, they only represented 0.13% of total employment in the EU15.

Moreover, since the early 1990s, the cigarette companies have massively increased their manufacturing capacity in developing countries and Eastern Europe and it has supposed a threat especially for the European Union in so far as there is an incentive for cross-border purchases and customs and health controls become more difficult<sup>3</sup>.

## II. Taxing tobacco

### 1. Smoking costs and rationale of tobacco taxation

The traditional justification for the taxation of tobacco, and still the most common, is the great capacity to generate resources for the Treasury. Taxes on tobacco historically have represented between 3% and 5% of the total income of rich countries, although their importance has been declining over time. Only in middle-income countries represents a significant portion of government revenues, as in China, where in the late nineties tobacco taxation

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<sup>2</sup> MACKAY, J. Y ERIKSEN, M., *The Tobacco Atlas*. Geneva: 2002, <http://www.who.int/entity/tobacco/en/atlas18.pdf>, last visited 28 October 2011.

<sup>3</sup> The "cheap whites", produced by companies -often subsidiaries or controlled by tobacco multinationals- based in Russia, Moldova, the Balkans and China, are a serious menace to the EU. See EUROPEAN COMMISSION, *Contraband and counterfeit cigarettes: frequently asked questions*. Brussels: 2007, <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/07/584&type=HTML>, document MEMO/07/584, 14 December 2007. Last visited 3 December 2011.

represented 9% of total income. That figure contrasts with US or Spanish data, where tobacco collection only amounted to 0.5%<sup>4</sup> and 4.6%<sup>5</sup> of total revenue, respectively

In addition to this purely patrimonial justification, excise duties on certain harmful products to health, known in the literature with the term *sin taxes*, have been traditionally justified as a mean of correction of the external effects of non-healthy habits. Smoking is a deadly disease and, according to a report entitled *Tobacco or Health in the European Union*<sup>6</sup>, financed by and prepared for the European Commission, is the single largest cause of avoidable death in the world, killing over 7 million smokers each year, 625.000 of which in the European Union (one in seven of all deaths), and involving costs estimated at between 1.04% and 1.39% EU's GDP in 2000. Other studies, carried out in Australia, suggest that costs can range between 2.1% and 3.4% GDP.

Tobacco taxation respects the Pigouvian tax scheme, i.e., internalising health-affecting activities' actual costs (both external and internal) in the price. Problems appear when determining the total costs of smoking, which are very difficult to quantify accurately. Tobacco taxation is, moreover, economically efficient. A fundamental principle related to the taxation efficiency is that taxes with a great collection potential should minimize the welfare losses resulting from higher prices. The Ramsey rule sets for excise duties that the tax rate will be inversely proportional to the elasticity of demand, so goods with a relatively inelastic demand, like tobacco, must be highly taxed.

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<sup>4</sup> US OFFICE OF MANAGEMENT AND BUDGET, Table 2.3—Receipts by Source as Percentages of GDP: 1934-2016, Washington DC: 2010, <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/hist02z3.xls>, last visited 28 October 2011.

<sup>5</sup> AGENCIA ESPAÑOLA DE ADMINISTRACIÓN TRIBUTARIA, *Informe Anual de Recaudación Tributaria 2010*. Madrid: 2011, Anexo, pag.6.

<sup>6</sup> EUROPEAN COMMISSION, *Tobacco or health in the European Union. Past, present and future*. Luxembourg: 2004, [http://ec.europa.eu/health/ph\\_determinants/life\\_style/Tobacco/Documents/tobacco\\_fr\\_en.pdf](http://ec.europa.eu/health/ph_determinants/life_style/Tobacco/Documents/tobacco_fr_en.pdf), last visited 28 October 2011.

Moreover, taxing tobacco is administratively simple. Tobacco is a relatively homogeneous product and the tax base is easy to determine (amount or price of tobacco). The fact that in many countries, like Spain, the offer has been in the hands of a state monopoly and retailing is still under license reduces the problems of fiscal control.

## 2. Principles and structure of a good excise duties system

As already mentioned above, excise taxes are levied on single commodities for revenue purposes or often additionally justified by health hazards (tobacco and alcohol) or ecological (gasoline tax and motor vehicle tax). In a closed economy, excise duties drive wedges between producer and consumer prices, create a substitution effect or deadweight loss (welfare loss), which besides the revenue aspect might also be politically justified to steer the demerit preferences of the consumers. In a cross-country perspective, different taxes cause international welfare losses or inefficiencies in production so, according with the standard neoclassical assumptions (the preferences are equal in all countries), harmonisation is positive<sup>7</sup>.

If the preferences are not equal, perhaps due to different cultural backgrounds, harmonisation would increase internal distortions and reduce welfare. As stated by De Bonis, “tax rate uniformity does not appear to be the right way to maximize welfare if integrating countries are different. Some flexibility should be maintained<sup>8</sup>”.

### A) *Fairness*

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<sup>7</sup> PETERSEN, H.G., *Tax Systems and Tax Harmonisation in the East African Community (EAC)*. Report for the GTZ and the General Secretariat of the EAC on Tax Harmonisation and Regional Integration. Potsdam: 2010, pag. 26, <http://www.econstor.eu/dspace/bitstream/10419/39673/1/630944601.pdf>, last visited 13 November 2011.

<sup>8</sup> DE BONIS, V., *Regional Integration and Commodity Tax Harmonisation*. Policy Research Working Paper 1848. Washington DC: 1997, pag. 2, [http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/1997/11/01/000178830\\_98101904061493/Rendered/PDF/multi0page.pdf](http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/1997/11/01/000178830_98101904061493/Rendered/PDF/multi0page.pdf), last visited 3 November 2011

The notion of fairness is a basic principle of tax policy. Fairness can be vertical equity or horizontal equity. Under vertical equity, the tax system should distribute the burden fairly across people with different abilities to pay. The idea implies that a person with higher income should pay more in taxes than one with less income. Horizontal equity requires that people in equal positions should pay the same amount of tax. That is to say people with equal income or wealth should pay the same amount of tax. Consumption taxes and, in particular, excise duties, do not respect the vertical equity, as in so far the non poor and the poor consuming the same quantity of cigarettes pay the same<sup>9</sup>. Apparently, it is a very discriminative and regressive tax, as noted by many authors<sup>10</sup>.

Regressivity should not be a problem if excise duties would transfer to cigarettes' prices the smoking-derived external and internal costs: the poor, like the rich should pay for the costs they impose on others (excise tax functions like a Pigouvian tax). But if the social cost argument is eclipsed by State tax collection's interest, then the regressivity itself should be taken into account<sup>11</sup>. Anyway, the issue of the progressivity or regressivity of the tax is not peaceful, since the most recent literature has found an inverse relationship between the elasticity of demand for cigarettes and socioeconomic status of its consumers<sup>12</sup>. Although tax burden is higher for low-income smokers, it is certain that tax increases can make the system more progressive, in so far as consumption will fall more in the population

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<sup>9</sup> OBWONA, M.; WASSWA, F. and NABWAAYO, V., *Taxation of the Tobacco Industry in Uganda the Case for Excise Duty on Cigarettes*, Research Series No. 44. Kampala: 2010, pag. 10, [http://www.eprc.or.ug/pdf\\_files/researchseries/series44.pdf](http://www.eprc.or.ug/pdf_files/researchseries/series44.pdf), 28 October 2011.

<sup>10</sup> CNOSSEN, S., *Tobacco Taxation in the European Union*. CESifo Working Paper No, 1718, 2006, pag. 11, [http://www.ifo-dresden.de/DocDL/cesifo1\\_wp1718.pdf](http://www.ifo-dresden.de/DocDL/cesifo1_wp1718.pdf), 28 October 2011 and CHALOUPKA, F.J.; HU, T.W.; WARNER K.E.; JACOBS, R. and YUREKLI, A., "The taxation of tobacco products", in JHA, P. and CHALOUPKA, F.J., *Tobacco Control in Developing Countries*. Oxford: 2000, pag. 258, <http://siteresources.worldbank.org/INTETC/Resources/375990-1089904539172/237TO272.PDF>, last visited 28 October 2011

<sup>11</sup> CNOSSEN, S., *Tobacco Taxation in the European Union...*, *op.cit.*, pag. 12.

<sup>12</sup> GRUBER J. y KŐSZEGLI, B., *A Modern Economic View of Tobacco Taxation*. Paris: 2008, pag. 15, <http://www.worldlungfoundation.org/ht/a/GetDocumentAction/i/6577>, last visited 9 November 2011.

groups with lower income. According to Chaloupka *et al.*, it seems that tobacco taxes are less regressive than previously thought<sup>13</sup>.

In any case, excise duties, in general, and tobacco taxation, in particular, represent a small portion of the tax system, which as a whole is progressive (or it would be desirable) and have appropriate mechanisms to offset tobacco taxes' regressivity. Some States, for example, affect revenue increases resulting from new tax increases to programs targeted to lower-income sectors of the population.

### B) Efficiency

As well as the addictive nature of consumers to cigarettes makes the price elasticity of demand of cigarettes low, the excess burden arising from a tax increase will be minimal, making high taxation so attractive. The latest scientific literature<sup>14</sup> finds that tobacco demand does respond to changes in prices and other factors: the elasticity of demand ranges between -0.25 and -0.50 for rich countries (taking -0.40 as the usual value) and between -0.50 and -1.00 for poor countries. An elasticity of -0.40 means that for each 10% increase in price, demand is reduced by 4%.

Determining the appropriate level of taxes is a complex policy issue and goes beyond just the revenue-maximizing tax rate (determined by the Laffer curve<sup>15</sup>). In that sense, there are three issues to consider. Firstly, substitution

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<sup>13</sup> CHALOUKKA, F.J.; HU, T.W.; WARNER K.E.; JACOBS, R. y YUREKLI, A., "The taxation of tobacco products", en JHA, P. and CHALOUKKA, F.J., *Tobacco Control in Developing Countries*. Washington DC: 2000, pag. 259, <http://siteresources.worldbank.org/INTETC/Resources/375990-1089904539172/237TO272.PDF>, last visited 28 October 2011. See also REMLER, D.K., "Poor Smokers, Poor Quitters, and Cigarette Tax Regressivity", in *American Journal of Public Health*, vol. 94, no. 2, 2004, pags. 225-229.

<sup>14</sup> VISCUSI, W.K., *Smoking: Making the Risky Decision*. New York: 1992 and VISCUSI, W.K., *Smoke Filled Rooms: A Post-Mortem on the Tobacco Deal*. Chicago: 2002.

<sup>15</sup> Higher taxes do not always imply more revenue. While this idea is strongly associated with the name of Arthur Laffer, the first explicit reference to this concept was made by Adam Smith: "High taxes, sometimes by diminishing the consumption of the taxed commodities, and sometimes by encouraging smuggling, frequently afford smaller revenue to government than what might be drawn from more moderate taxes". There are basically two reasons for which a rate increase may cause a drop in tax revenue. The first is that consumers' response from higher prices can produce that the higher price will not offset the lower quantity sold in the



to other products (like rolling tobacco or more dangerous products like heroin or similar drugs especially to those who are more addicted)<sup>16</sup>. Secondly, cross border shopping: if rates are set higher than those in neighbouring countries, cross border shopping will be inevitable. For that reason, harmonizing tax rates with neighbouring countries is more critical than maximizing the tax collection. And thirdly, tobacco smuggling.

### *C) Structure of tobacco taxes*

As with other commodity taxes, cigarette taxes can take three forms: specific taxes, ad valorem taxes or a combination of the two. Tobacco taxation schemes often have both components, in order to take advantage of the benefits of each one. In other EU countries (18 of 27) there is also a minimum tax when the sum of the two components does not reach a certain threshold, aimed at avoiding the existence of excessively cheap tobacco brands.

Choosing the most appropriate tax form is controversial and the solution may differ depending on the details of implementation of the chosen method. Each approach has its merits and problems, and the best trade-off between the two may differ from country to country and even from item to item. The theoretical and practical experience shows that there is no single, definitive solution. Thus, there are optimal taxing schemes only ad valorem and only specific. In any case, the choice of the right balance is very important in regard to the interests of consumers, producers and governments.

In a perfectly competitive market, the choice would be irrelevant: any specific tax could be replaced by an equivalent percentage without implying any effect on consumer and producer prices as well as State revenue. In an imperfectly competitive market, however, the quality of products with the same tax burden, such as cigarettes, differs substantially. Thus, a specific tax

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market. The second reason concerns the existence of a parallel market for the same good but without paying taxes (illegal market for example). See SMITH, A, *An inquiry into the nature and causes of the wealth of Nations*. Lawrence: 2009, pag. 527. (original version of 1776)

<sup>16</sup> OBWONA, M.; WASSWA, F. and NABWAAYO, V., *Taxation of the Tobacco Industry...*, *op.cit.*, pag. 11.

reduces the relative price differences between low and high quality brands, and it does not occur with an ad valorem tax, in which case relative price differences remain.

The advantage of an ad valorem taxation scheme is that maintains prices updated to inflation: cigarette prices and tax collection are automatically indexed to inflation. The main disadvantage is that this system is vulnerable to industry pricing strategies. Cigarette manufacturers can reduce their tax contribution lowering the price of their products (reducing its quality, reducing retail margins or using other marketing techniques) and it affects revenue in an adverse way. It also creates a disincentive to invest in quality (for example, the cost of the filters that purify the tobacco of tar and other substances is subjected to the multiplier effect of the tax), advertising, promotion or other fixed costs demand-improving.

The advantage of a specific tax is that it is much more difficult to circumvent compared with an ad valorem tax<sup>17</sup>. Tax collection will be less dependent on the tobacco industry decisions. Specific tax applied to cheap and expensive brands will induce consumers to consume expensive brands because their relative price is lower. A disadvantage is that revenues are not sensitive to price increases or inflation, so it will be necessary to update them periodically according to consumer price index.

Tobacco tax structure can also have a significant impact on smuggling. According to Delipalla<sup>18</sup>, in a non-competitive environment, tax increases lead to a higher fraction of sales smuggled under pure *ad valorem* taxation, but the effect is ambiguous under a purely specific tax. Under a mixed tax regime, tax rises increase the fraction of sales smuggled when the balance of the two types of taxes leans towards the *ad valorem* component. In any case, shifting

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<sup>17</sup> It is easier to measure the turnover than the sales value. See AGOSTINI, C.A., *Tributación a los cigarrillos: análisis y propuestas*, ILADES-Georgetown University Working Papers. Santiago de Chile: 2010, pag. 41, <http://fen.uahurtado.cl/wp/wp-content/uploads/2010/07/inv246.pdf>, 28 October 2011.

<sup>18</sup> DELIPALLA, S., "Tobacco Tax Structure and Smuggling", in *FinanzArchiv/Public Finance Analysis*, vol. 65, no. 1, 2009, pag. 93. See also STEHR, M., "Cigarette tax avoidance and evasion", in *Journal of Health Economics*, vol. 24, 2005, pags. 277-297.

the balance towards the predominant tax component reduces smuggling. The results are very relevant to global tobacco control policies and, in particular, to the smoking intervention and tax harmonisation policies in the European Union.

Overall, ad valorem taxes appear to be more attractive (in terms of consumer welfare and collection) for monopoly markets with little product heterogeneity. Specific taxation, by contrast, seems more appropriate when seeking to maintain product quality and/or when one of its negative externalities can be directly associated with one of its measurable characteristics (such as quality: a low-quality tobacco will be more harmful than a higher-quality one). However, as already mentioned, there is no single solution to that issue. In Europe, manufacturer countries prefer specific taxation because of its greater effectiveness in securing tax revenue. The situation is reversed in the farming countries, which prefer ad valorem schemes protecting their low-quality tobacco crops<sup>19</sup>. This difference of opinion over Europe produces large price differences.

### III. Tobacco taxation in the European Union

#### 3. Legal framework

The manufactured tobacco tax has the honour of being the first excise duty and, for a long time, the only tax harmonized within the European Union. The problems arising from using protectionist taxation of manufactured tobacco and especially of cigarettes by Member States led to the then European Community, in the mid-sixties, to consider the harmonisation of this taxation. After long and difficult negotiations, the Community illuminated the Council Directive 72/464/EEC of 19 December on taxes other than turnover taxes

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<sup>19</sup> CNOSEN, S., *How should tobacco be taxed in EU-Accession countries?*, CESifo Working Paper No. 539, august 2001, pag. 15, [http://www.cesifo-group.de/portal/page/portal/DocBase\\_Content/WP/WP-CESifo\\_Working\\_Papers/wp-cesifo-2001/wp-cesifo-2001-08/cesifo\\_wp539.pdf](http://www.cesifo-group.de/portal/page/portal/DocBase_Content/WP/WP-CESifo_Working_Papers/wp-cesifo-2001/wp-cesifo-2001-08/cesifo_wp539.pdf), last visited 28 October 2011.

which affect the consumption of manufactured tobacco<sup>20</sup>. The main achievement of this directive, whose content (although highly modified) is still in force, was to find an intermediate system to avoid distortions in competition and other difficulties arising from the exclusive use of specific or proportional taxes on cigarettes.

The wide variety of tobacco taxation schemes within the European Union forced the European Commission to establish a mixed tax rate. According to Article 8, the specific component might not be lower than 5% or higher than 75% of the total tax burden (VAT included). These upper and lower limits were conceived to be approximated gradually until total harmonisation. The second stage of harmonisation, in July 1978, set out the well-known 5-55% rule, the only significant requirement for many years, in force until 1 January. Now, the rule is 5-76.5%<sup>21</sup>, in my opinion, a step back in this harmonisation process.

On the occasion of the implementation of the Internal Market as from 1 January 1993, the European Economic Community set out through the Council Directive 92/79/EEC<sup>22</sup>, an overall minimum excise duty (specific duty plus ad valorem duty excluding VAT) whose incidence was set at 57% of the retail selling price (inclusive of all taxes) for cigarettes of the price category most in demand (MPPC). The establishment of a purely proportional requirement was certainly surprising, because high-tax countries in absolute terms faced serious troubles to meet that requirement, having to increase still more their tax burden.

That “proportionalist” victory was neutralised by Directive 2002/10/CE’s escape clause: high-tax countries (States which levy an overall minimum excise duty of at least EUR95 per 1000 cigarettes) did not need to comply with

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<sup>20</sup> OJ L 303, 31.12.1972, pags. 1-3.

<sup>21</sup> Article 3 Council Directive 2010/12/EU of 16 February 2010, amending Directives 92/79/EEC, 92/80/EEC and 95/59/EC on the structure and rates of excise duty applied on manufactured tobacco and Directive 2008/118/EC. That Article also sets out a new range between 7.5-76.5% as from 1 January 2014. See also document COM(2008) 460 final, of 16.7.2008.

<sup>22</sup> Council Directive 92/79/EEC of 19 October 1992, on the approximation of taxes on cigarettes, OJ L 316, 31.10.1992, pags. 8-9.

the 57% minimum incidence requirement. That amount was updated to EUR 101 as from 1 July 2006 and will be set out in EUR 115 as from 1 January 2014. Moreover, the 2002 reform set out a specific overall minimum excise duty of EUR 60 per 1000 cigarettes<sup>23</sup>, EUR 64 per 1000 cigarettes as from 1 July 2006 and EUR 90 as from 1 January 2014.

The European Commission intended that a minimum tax can ensure a minimum price level and not the fixation of a minimum retail selling price, as some Member States did. That provision infringes Community law according to the European Court of Justice. This minimum duty was targeted, therefore, to avoid low tobacco prices: low-cost brands became a problem in countries like Spain, where it was possible to buy tobacco from EUR 1.10 per pack, posing a serious threat to tobacco control policies, especially those aimed at younger people. Nevertheless, it arises some issues in the field of market competition because the measure penalizes those who are able to sell cheaper. It is the revenge of “specifist” countries: in countries where the MPPC is located in the “Premium” segment (most expensive), the minimum tax may become de facto a single specific tax, posing the effective demise of the proportional element.

However, under their Acts of Accession, a number of new Member States were granted derogations to postpone the application of the minimum excise duties for periods ranging from 31 December 2006 to 31 December 2017, according also to Council Directive 2010/12/EU.

The last tobacco taxation Directive reform has been undertaken by the above mentioned Council Directive 2010/12/EU, codified and repealed by Council Directive 2011/64/EU<sup>24</sup>. The major development is, with a view to more transparency of the arrangements and in order to create a level playing field across the tobacco sector, the replacement of the MPPC (the most popular price category) by weighted average prices (WAP) as a reference for EU minimum requirements. Moreover, the Directive increases the minimum

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<sup>23</sup> This measure was taken thinking of the new acceding countries, because all EU15 countries, except Spain and Greece met this requirement.

<sup>24</sup> Council Directive 2011/64/EU of 21 June 2011 on the structure and rates of excise duty applied to manufactured tobacco, OJ L 176, 5.7.2011, pags. 24-36.

duties. It also no longer restricts the level of the minimum tax to the excise due on the MPPC and widens the specific component band from 5-55% to 5-76.5%. This is to say another victory of “specifist” countries, but also of the tobacco industry, which prefer a specific taxation scheme in so far it makes cheap brands less competitive (cheap brands are relatively more expensive) and increase market concentration and industry profits<sup>25</sup>.

To sum up, excise duties levied on cigarettes must fulfil the following conditions:

- They must include a proportional component, calculated on the basis of the maximum retail selling price, and a specific component, levied on each unit of the product.
- They must account for at least 57% of the retail selling price, inclusive of all taxes, and be at least EUR 64 per 1000 cigarettes for the cigarettes belonging to the weighted average price (WAP). As from 1 January 2014, 60% and EUR 90 per 1000 cigarettes.
- The specific component of excise duty must not represent less than 5% or more than 76.5% of the amount of the total tax burden on cigarettes falling in the WAP. As from 1 January 2014, 7.5-76.5%.

With regard to other manufactured tobacco (excluding cigarettes), i.e., cigars, cigarillos and other smoking tobacco (mainly pipe-tobacco), its market is less than 8% of the total market for manufactured tobacco. However, fine-cut tobacco consumption has increased over by 50% in the EU27, but over by 300% in countries like Spain or Poland, 400% in Latvia, 1.300% in Estonia or 11.000% in Bulgaria, due to the tax increases<sup>26</sup>. Fine cut tobacco is becoming cigarettes’ most relevant substitute and the big tobacco industry, although

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<sup>25</sup> WHO, *WHO technical manual on tobacco tax administration*. Geneva: 2011, pag. 46, [http://whqlibdoc.who.int/publications/2010/9789241563994\\_eng.pdf](http://whqlibdoc.who.int/publications/2010/9789241563994_eng.pdf), 03 November 2011. See also SOBEL, R.S. and GARRETT, T.A., “Taxation and product quality: New evidence from generic cigarettes”, *Journal of Political Economy*, vol. 105, 1997, no. 4, pags. 880-87.

<sup>26</sup> EUROPEAN COMMISSION, *Releases for consumption of fine cut tobacco 2020-2010 (in kg)*. Brussels: 2011, [http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/excise\\_duties/tobacco\\_products/rates/tobacco\\_releases\\_consumption.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/excise_duties/tobacco_products/rates/tobacco_releases_consumption.pdf), last visited 3 November 2011.

also controls this market sector, wants to increase its taxation. Because of this, and for health reasons, the European Union also raised its tax burden, being still lower than cigarette's taxation. The European Union set out a partial (up to two thirds) alignment of the minimum rate for fine-cut tobacco to the minimum excise for cigarettes (40% of WAP) and also a compulsory monetary minimum of EUR 40 per kilogram, increasing by 2020 to EUR 60 per kilogram and 50% of WAP.

#### 4. Current situation

European Commission's position regarding tobacco is controversial: on the one hand there is a strong political commitment to reduce the health impact of smoking. But on the other hand, EU continues subsidising European low-quality tobacco farming, therefore more harmful for health. Moreover, EU tobacco control policy has abandoned the economic view (social costs and distributional issues) to adopt a health-based approach, more paternalistic from consumers' point of view. As taxation is one of the best ways to reduce tobacco consumption, the European Commission claims for further increases of tobacco taxes, notwithstanding the tax burden over cigarettes (300% of retail selling price before taxes) is greater than for any other product in the world.

However, it is easy to understand the state of harmonisation of tobacco excise duties with some charts. It is more; we will be able to discuss and even question the degree of harmonisation reached.

#### Figure 1. Cigarettes. Specific and Ad Valorem Excise

Source: DG TAXUD. European Commission

**Cigarettes. Specific and Ad Valorem Excise**

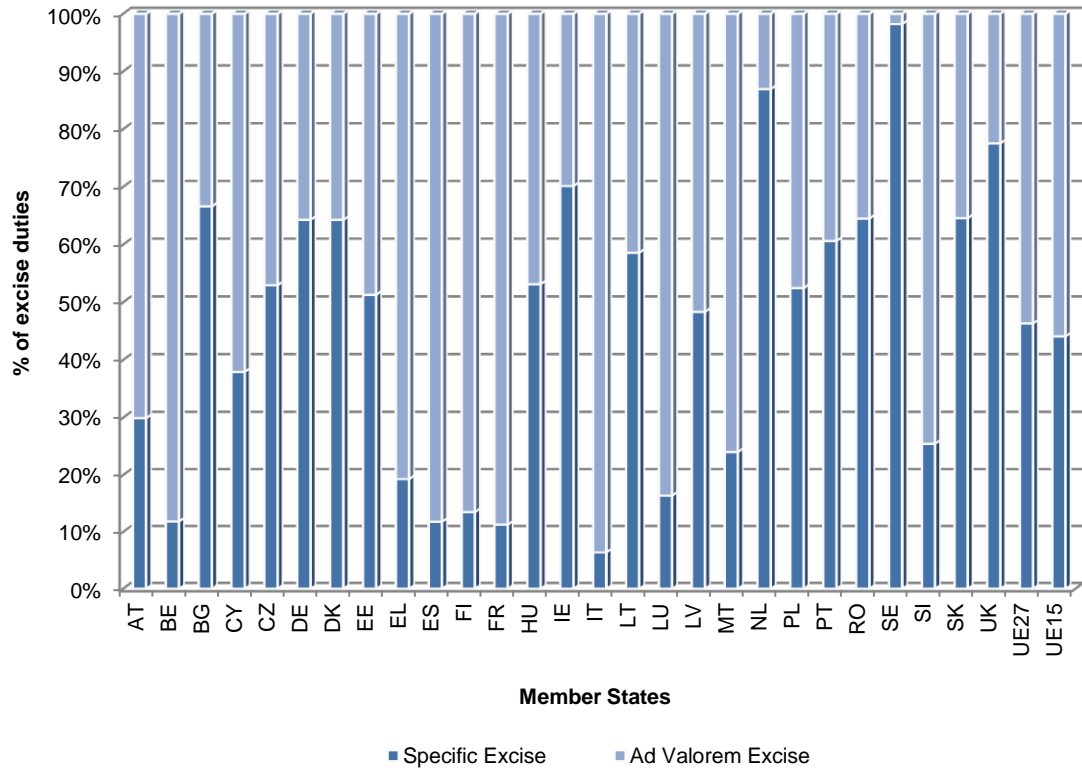
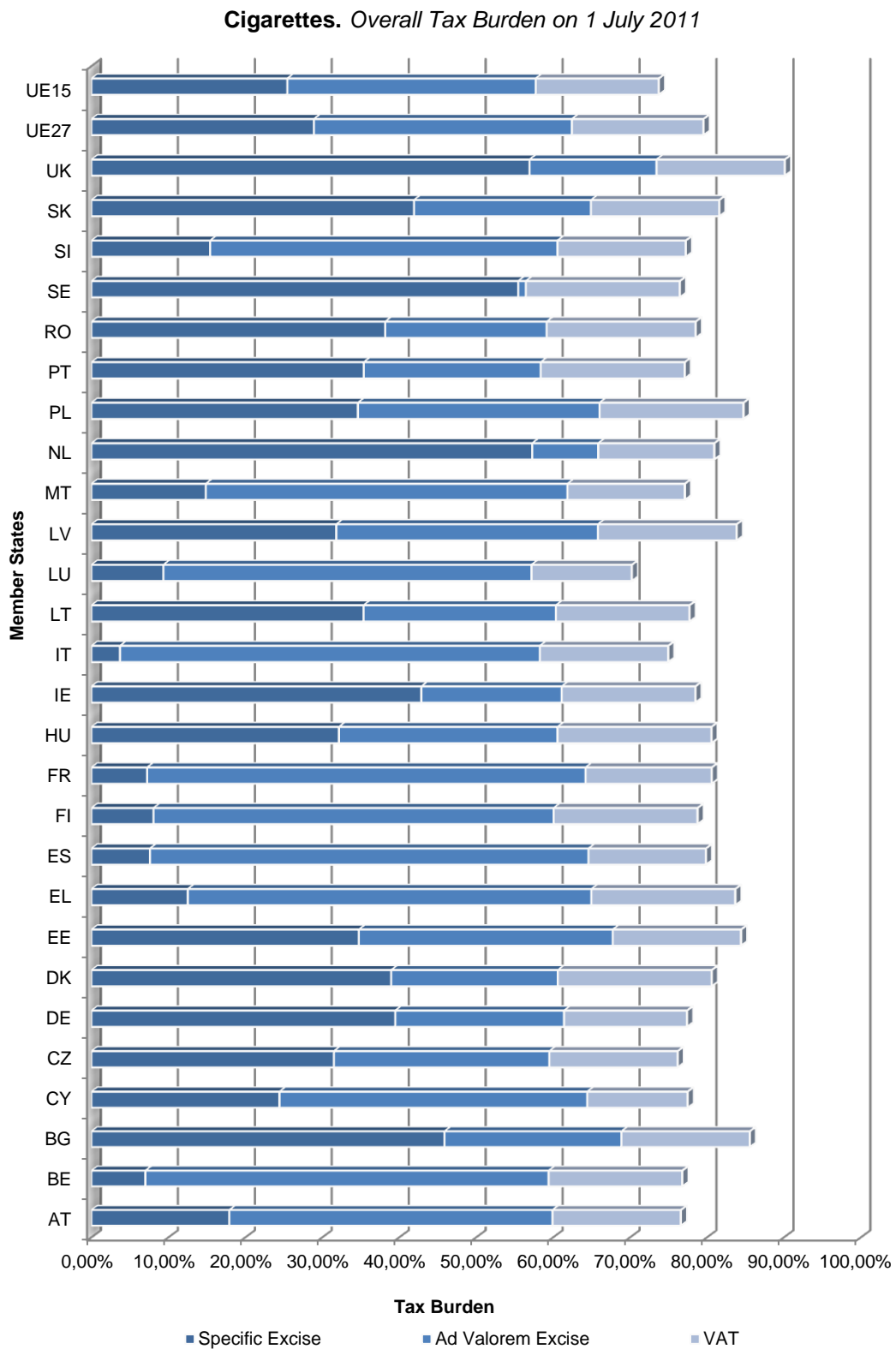
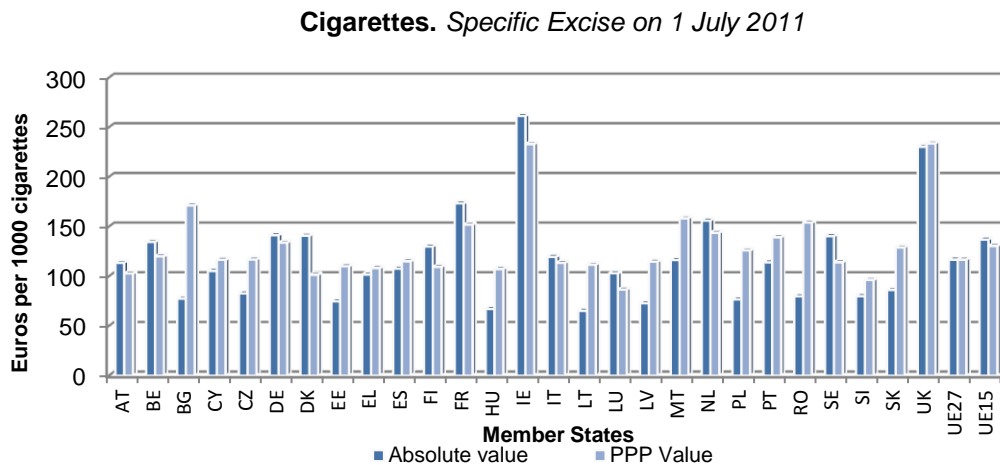




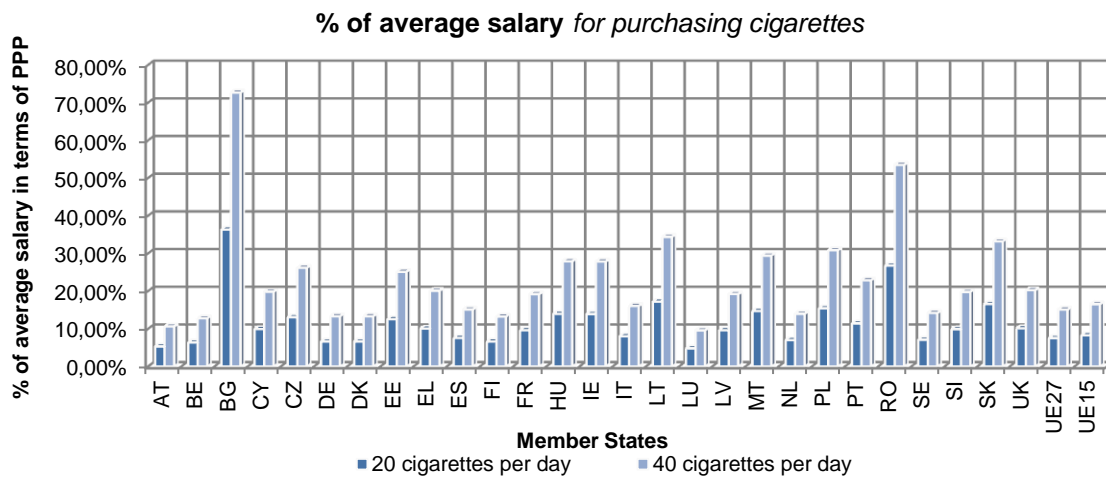
Figure 2. Cigarettes. Overall Tax Burden on 1 July 2011  
 Source: DG TAXUD. European Commission



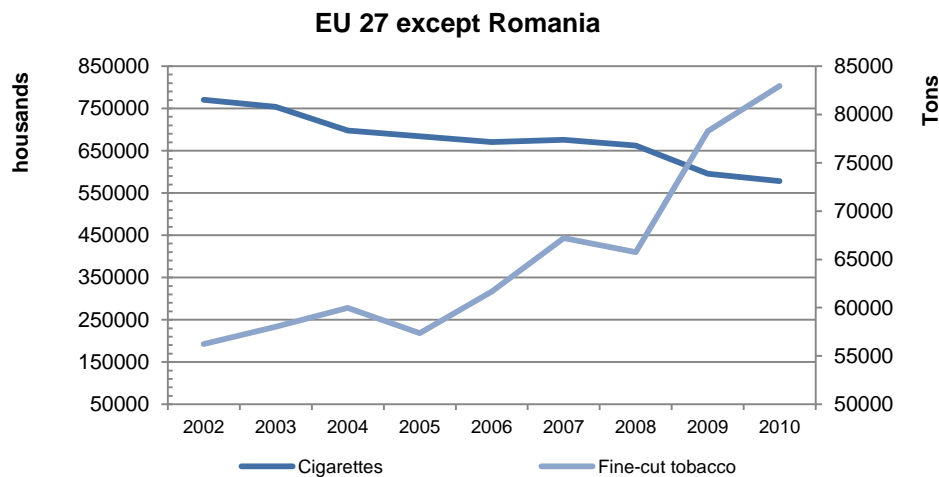
**Figure 3. Cigarettes. Specific Excise on 1 July 2011**  
 Source: DG TAXUD. European Commission



**Figure 4. % of average salary for purchasing cigarettes**  
 Sources: DG TAXUD and Eurostat. European Commission

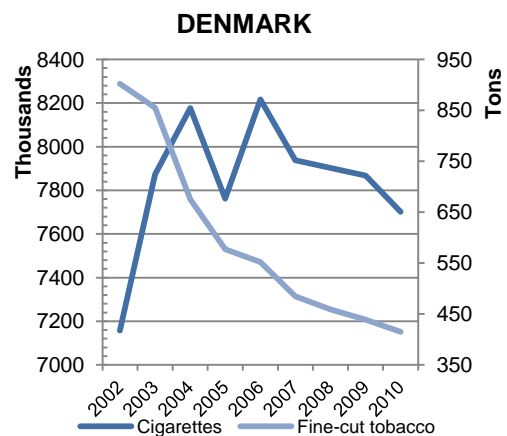
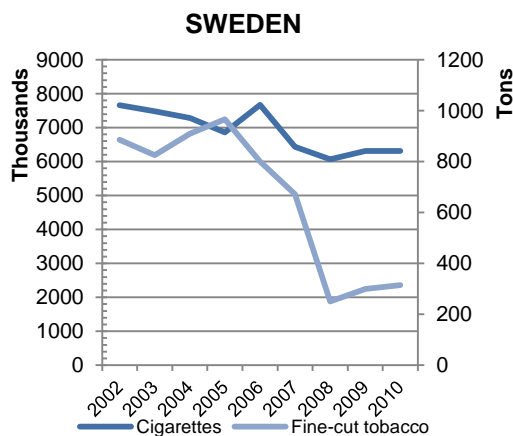
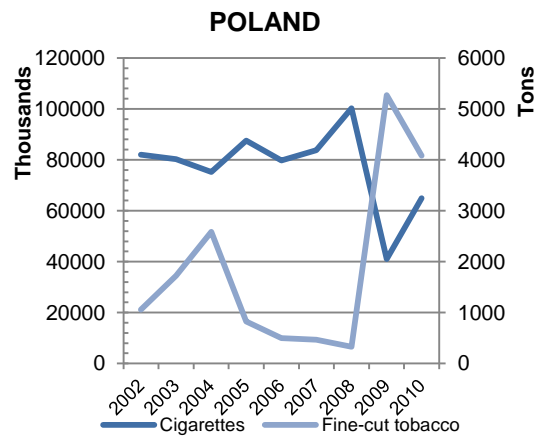
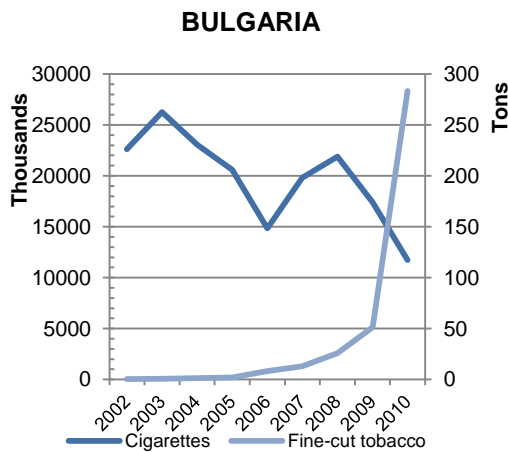
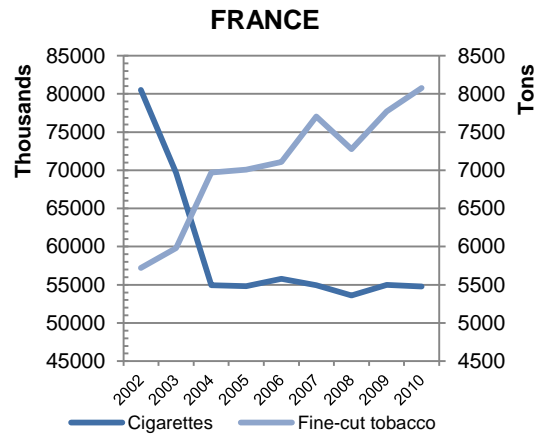
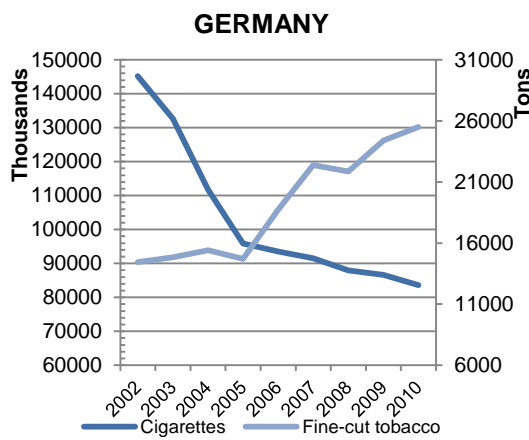
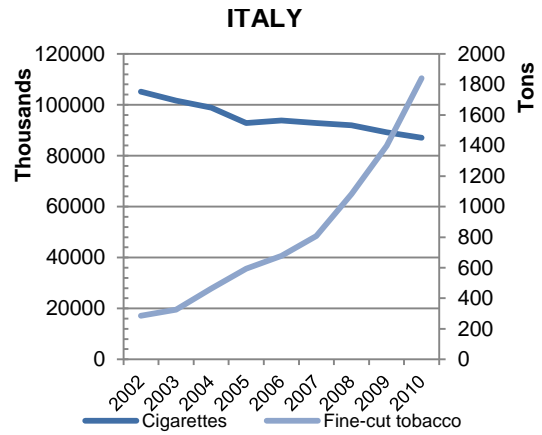
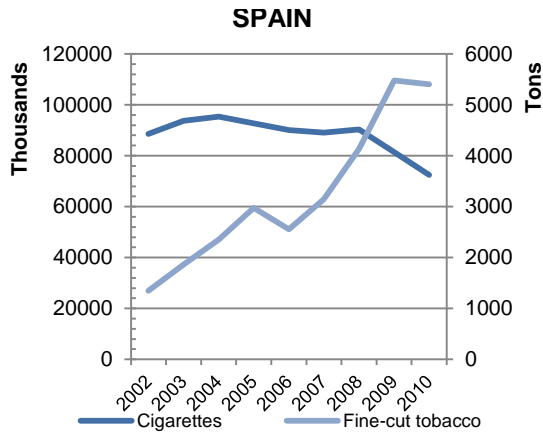


**Figure 5. Cigarettes and fine-cut tobacco released for consumption in EU27 except Romania**  
 Source: DG TAXUD. European Commission



**Figures 6-13. Cigarettes and fine-cut tobacco released for consumption in some Member States**

Source: DG TAXUD. European Commission



The first question we should consider is whether there is a real excise duties harmonisation within the European Union. Nominal tax rates range from 57.22% in Luxembourg to 73.47% in United Kingdom (70.26% and 90.14% if VAT is included). This is to say British citizens pay 28.5% more than Luxembourgish do or 18% more than the EU27 average (13% VAT included). If we compare this data with VAT standard rates, they vary  $\pm 25\%$  over the EU27 average<sup>27</sup>.

No one would doubt about the VAT degree of harmonisation (do not forget harmonisation is not uniformity), so there would be no reason to think that excise duties degree of harmonisation is low. However, we cannot state the same regarding the excise duties structure (figure 1). Being true that the European Commission aims at setting out a common excise duty structure, it is also true that the specific component varies from 5% to 76.5%, and there are countries like Italy with 5% specific component (as % of total taxation) and countries like Sweden, where the specific component rises up to 72.5%.

Increasing the specific component is nowadays the European trend: European Commission says it is a way to provide the Member States with more flexibility to determine freely the relative weight of both excise elements, in order to respect their national market for cigarettes<sup>28</sup>. Moreover is the best way to achieve the tobacco control policy goals, but it is not the panacea, because it promotes industry concentration and has a competition-distortion effect. This trend, along with the introduction of a minimum excise tax, is a victory of the “specificist” countries (UK, DE) but also of the tobacco industry.

The real problem of specific taxes is tax fairness and equity. European Union’s poorest countries like Romania or Bulgaria have higher excise duties (32% and

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<sup>27</sup> EUROPEAN COMMISSION, *Taxation trends in the European Union. Data for the EU Member States, Iceland and Norway. 2011 Edition*. Luxembourg: 2011, pag. 90, [http://ec.europa.eu/taxation\\_customs/resources/documents/taxation/gen\\_info/economic\\_analysis/tax\\_structures/2011/report\\_2011\\_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_structures/2011/report_2011_en.pdf), last visited 4 November 2011.

<sup>28</sup> EUROPEAN COMMISSION, *Excise duty on tobacco products: frequently asked questions*. Document MEMO/08/506, Brussels: 2008, 16 July 2008, <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/08/506&format=PDF&aged=1&language=EN&guiLanguage=en>, last visited 4 November 2011.

47%, respectively) than the EU average in terms of purchasing power parity. This is to say that Romanian two-daily-packs smokers will spend 53.48% of their average salary in tobacco; or 72.66% in the case of the Bulgarian ones. By contrast, Austrian or Luxembourgish smokers will only spend 9.57% or 10.61% of his salary. Moreover, if we consider the minimum wage, it is surprising to know that two-daily-packs Romanian or Bulgarian smokers will spend 101.25% or 110.02% of their salary, respectively. This situation is almost obscene, even though it is been established a transitional period until 31 December 2017 for many provisions. As said above, if integrating countries are so different, harmonisation would increase internal distortions and reduce welfare.

Moreover, this health-based approach of the tobacco taxation policy has forgotten or has not done enough with regard to fine-cut tobacco and other manufactured tobaccos (cigars, cigarillos, etc.). Although their taxation has been increased over the last years, these products are more affordable than cigarettes and have become their substitute. Proof of this is the released fine-cut tobacco increase happened in many European countries, especially dramatic in Member States like Bulgaria (11.000%), Estonia, Poland, but also Spain or Italy, as seen in figures 6 to 13. Because of this, the overall consumption of tobacco has fallen less than expected and, consequently, public health's impact has been also lower. It is necessary, therefore, increase fine-cut tobacco's taxation to cigarettes' taxation levels.

But not only fine-cut tobacco is the single cigarettes' substitute product: it is necessary to take into account smuggled tobacco. The cheapest price of a pack of cigarettes in Bulgaria and Romania is about EUR 2.15 (almost EUR 5.00 in terms of PPP). In neighbouring countries like Serbia, Ukraine or Moldova it is possible to find out brands for only EUR 0.64, EUR 0.35 and EUR 0.18, respectively (12 times cheaper)<sup>29</sup>. With these differences in price levels, a high level of social tolerance and lax border controls, it is no difficult to guess

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<sup>29</sup> KPMG, *Project Star. 2010 Results*. London: 2011, pag. 13, [http://www.pmi.com/eng/tobacco\\_regulation/illicit\\_trade/documents/Project\\_Star\\_2010\\_R esults.pdf](http://www.pmi.com/eng/tobacco_regulation/illicit_trade/documents/Project_Star_2010_R esults.pdf), last visited 5 November 2011.

that, as a way of example, Bulgarians will cross the border to buy tobacco in Moldova. But also criminal organisations will take advantage of this price differential produced by low taxation, even though this is not the determinant factor.

Harmonising tobacco taxation (and consequently, prices) all over Europe is not sufficient if our neighbouring countries sell cigarettes up to 12 times cheaper and there are not enough human and material resources to control our borders in an effective and efficient way. However, there are many modalities of smuggling, with different causes and consequences.

#### IV. The threat of smuggling

##### 5. World overview

Tobacco smuggling is a very profitable business which encourages transnational organised crime and corruption, loots public coffers, increases tobacco addiction and causes more health problems than the legal tobacco. In fact, tobacco has become the legal substance with a higher rate of smuggling. Nowadays, China is the largest counterfeited tobacco factory in the world. Smuggling encompasses many legal phenomena: legal circumvention (legal cross border purchasing, legal tourist purchases and legal duty-free purchases -non within the EU-), quasi-legal circumvention (internet sales and grey-market purchases) and illegal circumvention (*bootlegging* and large-scale organised smuggling)<sup>30</sup>.

Within the large-scale smuggling (the most important in absolute terms) it is possible to distinguish three types: genuine tobacco introduced in the EU without paying taxes, *cheap whites* (cheap tobacco legally produced outside the EU with the only purpose of being smuggled into and sold illegally in

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<sup>30</sup> JOOSSENS, L., *Smuggling and cross-border shopping of tobacco products in the European Union*. London: 1999, pags. 6-7, <http://www.nice.org.uk/nicemedia/documents/smuggling.pdf>, last visited 5 November 2011.

another market) and counterfeited cigarettes, very dangerous for health and often produced in China (in 2004, 47% of apprehensions in the European Union came from China; 7% came from the UAE and 6.5% from Gambia. In the US, 99% of the apprehensions came from China<sup>31</sup>).

Smuggling is a historical problem concerning all countries in the world and today has an increased incidence. Its existence is as obvious as the data showing that tobacco exports exceed one third of imports. That is to say one third of all exported cigarettes "disappears"<sup>32</sup>. Scientific studies concluded that in 2000, between 6% and 8.5% of tobacco consumption corresponded to smuggled tobacco<sup>33</sup>, which meant a loss for governments between EUR 28.000 and EUR 35.000 million per year. Recent studies increase that amount up to 11.6% (16.8% in low income countries, 11.8% in middle income countries and 9.8% in high income countries), with similar tax losses<sup>34</sup>.

## 6. The situation in Europe

Smuggling has been an endemic problem in Europe, due to economic causes but also to social and psychological reasons. During the nineties, smuggling activities experienced a dramatic increase in countries like UK, Spain and Italy. According to the British Customs and Excise, the illicit trade in tobacco increased from 3% in 1996-97 to 21% in 2000-01. However, an appropriate strategy has reduced these numbers to acceptable levels. The current

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<sup>31</sup> OECD, *The economic impact of counterfeiting and piracy*. Paris: 2008, pag. 388, [www.oecd.org/dataoecd/13/12/38707619.pdf](http://www.oecd.org/dataoecd/13/12/38707619.pdf), last visited 5 November 2011.

<sup>32</sup> First studies came from 1974, but regarding tobacco, the first main works were: JOOSSENS, L., "Tobacco smuggling: an optimal policy approach", and CHALOUPKA, F.J. and CORBETT, M., "Trade policy and tobacco: towards an optimal policy mix". Both in ABEDIAN, R; VAN DER MERWE, R.; WILKINS, N. and JHA, P., eds. (1998): *The Economics of Tobacco Control: Towards an Optimal Policy Mix*. Cape Town: 1998, <http://idbnc.idrc.ca/dspace/bitstream/10625/26321/1/118634.pdf>, last visited 5 November 2011.

<sup>33</sup> MERRIMAN, D; YUREKLI, A. and CHALOUPKA, F.J., "How big is the worldwide cigarette-smuggling problem?", in JHA, P. and CHALOUPKA, F.J., *Tobacco Control in Developing Countries*. Washington DC: 2000, <http://siteresources.worldbank.org/INTETC/Resources/375990-1089904539172/393TO406.PDF>, last visited 5 November 2011.

<sup>34</sup> JOOSSENS, L.; MERRIMAN, D; ROSS, H. and RAW, M., *How eliminating the global illicit cigarette trade would increase tax revenue and save lives*. Paris: 2009, pag.9, [http://www.tobaccofreecenter.org/files/pdfs/en/ILL\\_global\\_cig\\_trade\\_full\\_en.pdf](http://www.tobaccofreecenter.org/files/pdfs/en/ILL_global_cig_trade_full_en.pdf), last visited 5 November 2011.

economic crisis poses a threat to this *pax delicti*, due to the high incentives and low relative cost of this illegal activity.

The threat of smuggling has moved to the eastern border of the European Union, especially to the borders with Moldova, Ukraine, Russia and Belarus. It is a large-scale smuggling favoured by many causes. In one hand, there is insufficient exchange of operational information between national and international authorities; custom's infrastructure and equipment has no the adequate capacity for problem's magnitude; corruption is usual in these countries and the smugglers use it frequently. On the other hand, differences between the smuggling repressive provisions between EU countries are an incentive to enter in Europe by the lowest penalty points (forum shopping). Tax differential between the EU and neighbouring countries also favours that phenomenon.

The European Union and its Member States have signed effective cooperation agreements with the "big four" largest tobacco companies to tackle smuggling, but smuggling still causes a financial loss to the EU budget of more than EUR 10.000 million annually, according to the European Anti-Fraud Office (OLAF)<sup>35</sup>.

## 7. Excise duties and smuggling

The aim of this paper is to demonstrate that tobacco tax increases do not involve necessarily a higher smuggling incidence, as tobacco industry defends tooth and nail. They argue that higher taxes lead to high tax avoidance and evasion, thereby reducing the most expensive brands' sales but not total consumption, because demand shifts to legal or illegal substitute products. In other words, smuggling is caused by tax differential between countries: this statement would be valid only regarding *bootlegging*, a minor smuggling

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<sup>35</sup> EUROPEAN COMMISSION, *Action plan to fight against smuggling of cigarettes and alcohol along the EU Eastern border*. Brussels: 2011, 24.6.2011, document SEC(2011) 791 final, [http://ec.europa.eu/anti\\_fraud/documents/Working-paper.pdf](http://ec.europa.eu/anti_fraud/documents/Working-paper.pdf), last visited 7 November 2011.



accounting for only 13% of total smuggling<sup>36</sup>, but no with large-scale smuggling, including counterfeiting, because it does not pay any tax.

Industry's argument falls if we consider, as most of the doctrine does, that smuggling is a supply-side problem and not caused by demand<sup>37</sup>. It is obvious that a tax increase will impact on demand but not on supply, so therefore the causal link between increased taxes and smuggling will be broken<sup>38</sup>.

Moreover, the empiric experience shows that 1) countries with high taxes (Nordic countries) have less smuggling than other areas of the world; 2) tax cuts reduce revenue, increase the prevalence of smoking and even do not eliminate the problem of smuggling and 3) it is possible to maintain high taxes (or even increase them) and lower smuggling. Canada, Sweden, Italy, United Kingdom and Spain are a good example of each of these statements.

## A) Canada and Sweden

In the eighties, tobacco prices were higher in Canada than in USA. Between 1980 and 1984, Canadian government doubled taxes (prices were five times higher than in USA), smuggling became 30% of the tobacco sales in 1993<sup>39</sup> but tobacco consumption fell by 14%. Moreover, tax collection was higher.

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<sup>36</sup> ACTION ON SMOKING AND HEALTH-ASH, *ASH Fact Sheet on: Tobacco smuggling*. London: 2003, pag. 2, [http://www.ash.org.uk/files/documents/ASH\\_122.pdf](http://www.ash.org.uk/files/documents/ASH_122.pdf), last visited 7 November 2011. However, this percentage rises to between 41% and 52% with regard to smuggled fine-cut tobacco. See HM REVENUE & CUSTOMS, *Departmental Autumn Performance Report. December 2009*. London: 2009, pag. 35 [www.official-documents.gov.uk/document/cm75/7509/7509.pdf](http://www.official-documents.gov.uk/document/cm75/7509/7509.pdf), last visited 7 November 2011.

<sup>37</sup> JOOSEENS, L. and RAW, M., "Turning off the tap: the real solution to cigarette smuggling", *International Journal of Tuberculosis and Lung Disease*, vol. 7, issue 3, 2003, pages. 214.

<sup>38</sup> Only the International Tax & Investment Center talks about smuggling as a demand-side problem: it is an "independent" NGO focused on research and education. However, it is a powerful industrial lobby, funded by the largest multinationals in the world, including the tobacco industry. Not surprisingly, its board has representatives from BAT, PMI, JTI and Imperial Tobacco. See TOBACCO FREE CENTER, *The Truth about the International Tax and Investment Center (ITIC)*. Washington DC: 2010, [http://www.tobaccofreecenter.org/files/pdfs/en/IW\\_ITIC\\_Alert.pdf](http://www.tobaccofreecenter.org/files/pdfs/en/IW_ITIC_Alert.pdf), last visited 7 November 2011.

<sup>39</sup> CANADIAN CANCER SOCIETY; THE NON-SMOKERS' RIGHTS ASSOCIATION y PHYSICIANS FOR A SMOKE-FREE CANADA, *Surveying the Damage: Cut-Rate Tobacco Products and Public Health in the 1990s*. Ottawa: 1999, <http://www.nsra-adnf.ca/cms/file/pdf/oct99taxrepag.pdf>, last visited 7 November 2011.

However, and because of an aggressive tobacco industry's campaign, the tax fell from CA\$10 to CA\$26 per carton and the tobacco export tax was reintroduced<sup>40</sup>. The result was that revenue fell sharply in the provinces implementing these tax cuts, consumption increased and, surprisingly, although prices remained below the US level, there was not a reverse flow of smuggling into the United States.

Something similar happened in Sweden. Although Swedish always had high taxes and no smuggling<sup>41</sup>, the government raised them by 43% (up to EUR 4.50 per pack), increasing tax collection by 9% and reducing consumption. Some report suggested that smuggling was increasing and also apprehensions raised: that fact and the lack of popular support lead to a tax cut. Tax collection fell by 10% and tobacco consumption per capita increased from 34 to 52 packs.

## **B) Italy, United Kingdom and Spain**

Italy had a serious problem with smuggling in the southern regions (Campania and Puglia), where criminal organisations (mafia) started to collaborate with tobacco industry: millions of cigarettes were imported in Anvers from the USA and were “lost” during its transit to the Balkans, being sold finally in Italy. Italian authorities signed a Memorandum of Understanding with Phillip Morris, but apprehensions began to decline only after the Commission's litigation against PMI.

The United Kingdom had smuggling rates over 20% and revenue losses around EUR 3.000 million annually. Tobacco industry was an accomplice in so far as British Customs (HMRC) estimated that 65% of Imperial Tobacco exports were

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<sup>40</sup> In order to tackle smuggling, the Canadian government set out a tax of CA\$8 per carton of tobacco exported. The tobacco lobby exerted so much pressure that caused the abolishment of the tax only two months after.

<sup>41</sup> JOOSSENS, L.; CHALOUPKA, F.J.; MERRIMAN, D. and YUREKLI, A., “Issues in the smuggling of tobacco products...”, *op.cit.*, pag. 402, quoting PERSSON, L.G.W. and ANDERSSON, J., *Cigarette Smuggling*. Stockholm: 1997.

illegally reintroduced in the country<sup>42</sup>. The British Government got a strong commitment to tackle smuggling and launched the *Tackling Tobacco Smuggling Strategy*, to be implemented by HMRC and the UK Border Agency. It was a new approach of the fight against fraud and it included non-binding agreements with the tobacco industry.

The plan was based around four axes: investment in human and material resources, fiscal and criminal measures, collaboration with industry and social awareness. British Government invested more than EUR 250 million to create new jobs fraud-related and an advanced network of container scanners. It introduced tax stamps on cigarettes' packs and increased substantially the smuggling penalties (up to 7 years of imprisonment and unlimited fines<sup>43</sup>), inspired by the US racketeering legislation (RICO Act)<sup>44</sup>. Results have been so satisfactory: 11.000 million of cigarettes apprehended, 320 people convicted of large-scale fraud, 2.500 people prosecuted and forfeiture orders accounting for EUR 25 million. Tobacco smuggling has been reduced to levels of 15 years ago (10%)<sup>45</sup>.

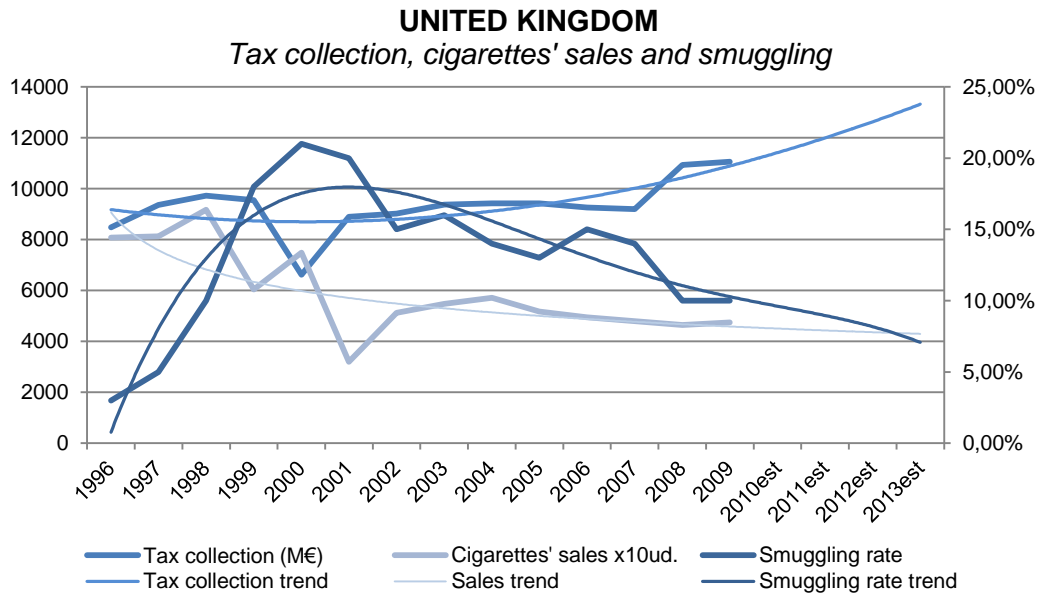
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<sup>42</sup> JOOSSENS, L. and RAW, M., "Progress in combating cigarette smuggling: controlling the supply chain", *Tobacco control*, vol. 17, 2008, pag. 399, <http://tobaccocontrol.bmj.com/content/17/6/399.full.pdf>, 7 November 2011.

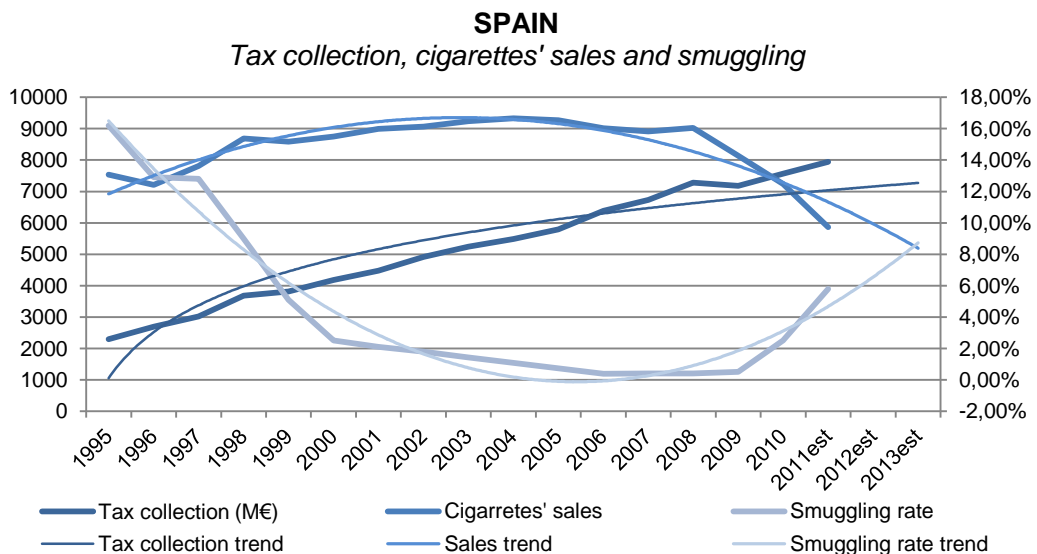
<sup>43</sup> Due to legal certainty and proportionality reasons it is difficult to imagine the existence of unlimited fines. It will refer to high-value fines.

<sup>44</sup> *Racketeer Influenced and Corrupt Organizations Act 1970*, Title IX of the Organized Crime Control Act of 1970, Pub. L. No. 91-452, 84 Stat. 922, codified at 18 U.S.C. §§ 1961-1968. See also ROWELL, A. and BATES, C., *Tobacco smuggling in the UK*. London: ASH, 2000, pag. 4, [http://www.ash.org.uk/files/documents/ASH\\_257.pdf](http://www.ash.org.uk/files/documents/ASH_257.pdf), last visited 7 November 2011.

<sup>45</sup> HMRC, *Tackling Tobacco Smuggling - building on our success. A renewed strategy for HM Revenue & Customs and the UK Border Agency*. London: 2011, [http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE\\_PROD1\\_031246](http://customs.hmrc.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_PROD1_031246), last visited 7 November 2011.



The situation in Spain is similar: during the last decades, it is possible to distinguish a growing phase (1991-1993), stabilisation (1994-1997), reduction (1998-2006) and upturn (2007-ongoing). The key issue to reduce smuggling was again the investment done: AEAT's (Spanish Tax Agency) Customs Department increased its investment from EUR 4 million to EUR 40 million and generalised the use of IT technologies, especially risk management systems. Even though the smuggling upturn registered last years, the international literature says Spanish fight against smuggling is a success, achieved without cutting taxes



In conclusion, it is possible to tackle and reduce smuggling without cutting taxes, and thereby increasing tax collection. Doing in this way, States will be able to achieve a triple goal: reduce smuggling, reduce smoking incidence -by lowering consumption- and increase tax revenue.

## **V. Tackling tobacco smuggling**

### **6. Cooperation between States. European Anti-Fraud Office's role and taxation**

OLAF's role in the field of the fight against fraud, and thereby, tobacco smuggling, is very significant. OLAF is responsible for the negotiation of administrative cooperation agreements with third countries and international organizations, many of them on behalf of the European Union and its Member States. Together with these agreements, OLAF also promotes joint customs operations, considered an effective tool to identify smuggling and fraud risk in certain areas or trade routes.

It also very important its coordination tasks between States. Each one of them appoints a representative who is in constant contact with Brussels, so the transmission of information between them ensures greater efficiency. However, in many cases, all the information is not transmitted because the suspicion between authorities. Therefore, it is necessary to improve and automate information exchange mechanisms. Finally, it is also a must to improve the transit regime information systems, as it is the usual way to introduce smuggled tobacco.

Regarding taxation, being true that taxation has only a little influence on the total amount of smuggling, it is also true that it is, in absolute terms, so harmful for the EU and Member States' financial interests. As seen above, the

European Commission and the Member States have to strengthen their efforts to homogenise the excise duty level all over the EU. EC is favourable to a specific taxation scheme, very interesting in terms of public health policy, but harmful in terms of tax equity, because poor countries will have to bear an excessive tax burden (regarding parity of purchase power). However, only this system allows setting out uniform prices, the only way to avoid bootlegging within the EU. Anyway, that action shifts the problem to the external borders, so it is necessary a stronger action.

In any case, the European action in this field is so difficult, because the only way to respect the tax equity principle is increasing the wealth of these countries. And this takes time, but especially money. And it is not the best moment to spend money.

## **7. Supply-side control**

The active role of the tobacco industry in smuggling has amply demonstrated that smuggling is mostly a problem of supply and not of demand. If we consider that most of the sector's production is concentrated in a few multinational companies, the control of the supply is technically easy, but this requires the active collaboration of all stakeholders in the supply chain and, in particular, of producers.

The main measure to be adopted should be the establishment of a secure supply chain, which would allow the distribution of cigarettes to retailers in the targeted market for later sale to the final consumer fully respecting the customs tax and health care provisions. The way forward to achieve this goal is setting up a regulation applied to all layers of distribution, manufacturers, their customers and their subsequent purchasers, retailers, logistics operators (e.g., storage and transportation) and any other participant in the legitimate

channel<sup>46</sup>. Governments, in turn of the involved agents' collaboration, should protect the legitimate channel, assuring this is the only way to purchase cigarettes. To this end, the authorities must prevent infiltration (counterfeiting), distraction (illegal output of goods to other destinations) and evasion (street vendors, unlicensed retailers, internet sales, etc.).

Once defined the goals, it is necessary to implement them, and is the most difficult task. Being smuggling a global problem, solutions must also be global, and hence the need to develop a Protocol on Illicit Trade in Tobacco Products expanding and supplementing Article 15 of the WHO Framework Convention on Tobacco Control. Until its adoption it is necessary to adopt other kind of measures. The two most recent and successful examples of these solutions correspond to the United Kingdom (Tackling Tobacco Smuggling Strategy) and the agreements signed between the EU, its Member States and the multinational tobacco companies<sup>47</sup>.

The origin of such agreements dates back to 2000 when the European Commission filed a civil suit against Philip Morris, RJ Reynolds and Japan Tobacco alleging violations of the RICO Act for their smuggling activities. In the end, EC withdrew the suit but agreed with Philip Morris and Japan Tobacco International a 12-year payment, of \$1.250 and \$400 million, respectively, and agreed to sign such binding agreements. Imperial Tobacco and British American Tobacco agreed to pay \$300 million and \$200 million, respectively, but did not finish the legal conflict. \$2.150 million in total. These provisions are similar to Article 15 Protocol drafts provisions' regarding the supply chain control.

These agreements imply, firstly, the recognition by the tobacco industry of its active role in tobacco smuggling; secondly, the compensation for a part (very

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<sup>46</sup> PHILIP MORRIS INTERNATIONAL, *Confronting cigarette contraband*. New York: 2003, [http://www.icde.org.br/artigos/Confronting\\_Contraband.pdf](http://www.icde.org.br/artigos/Confronting_Contraband.pdf), last visited 7 November 2011.

<sup>47</sup> HEYWARD, M., *Legal analysis of the agreements between the European Union, Member States and multinational tobacco companies*. Geneva: 2011, pag. 5, <http://www.fctc.org/images/stories/Executive%20summary%20-%20legal%20analysis%20of%20EU%20agreements.pdf>, last visited 7 November 2011.

small) of the damage caused to the public budgets; and thirdly, the beginning of a new phase of collaboration between the European Union, Member States and the industry. It is a positive sum game (win-win) and this is the key of its success.

However, these agreements are much more burdensome for the tobacco industry, committed to "abandon" a very profitable market sector (smuggling). It is not strange to imagine or suppose that there is a hidden counterpart of the European Union and Member States: providing the tobacco industry with more influence when drafting the legislative provisions relating to tobacco. Such influence could be seen in the European Commission's preference for specific taxation versus ad valorem taxation or in the future regulation of the so-called smokeless products (including electronic cigarettes).

Finally, these agreements may be contrary to Article 5.3 FTCF, in so far as payments from tobacco industry to government institutions can create conflicts of interest, as mentioned in the guidelines for the implementation of this article<sup>48</sup>.

## 8. Improvement of the technical capacity of customs

As seen in the Italian, British and Spanish cases, the improvement of the technical capacity of customs is a key issue when designing an effective anti-smuggling strategy: it is necessary to increase human and material resources within the limits set by a cost-benefit analysis and assuring these measures will not interfere with international trade's normal development. EC's Action plan to fight against smuggling of cigarettes and alcohol along the EU Eastern border meets these requirements.

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<sup>48</sup> WHO, *Guidelines for implementation of Article 5.3 [FTCF]*. Geneva: 2011, pag. 6, [http://www.who.int/fctc/guidelines/article\\_5\\_3.pdf](http://www.who.int/fctc/guidelines/article_5_3.pdf), last visited 7 November 2011. See also HEYWARD, M., *Legal analysis of...*, *op.cit.*, pag. 5, <http://www.fctc.org/images/stories/Executive%20summary%20-%20legal%20analysis%20of%20EU%20agreements.pdf>, last visited 7 November 2011.



Firstly, it suggests Member States to adopt common risk criteria within the field of EU external border's security and protection, helped by the CRMS (Customs Risk Management System), a real-time risk-related information exchange system<sup>49</sup>. Secondly, it is necessary to strengthen fight against custom officers' corruption (more common in the Eastern border). Thirdly, Hercule II program<sup>50</sup> helps Member States to undertake investment in technology, especially in container scanners. Fourthly, custom officers must improve their formation and capacities: in this sense, EC organises several workshops, seminars and conferences regarding illegal distribution channels, fraud, smuggling, corruption, etc.

## 9. Repressive measures

The use of sanctioning law (administrative or criminal) is a recurring temptation of many governments, often without respecting the principle of minimum intervention and proportionality<sup>51</sup>. That said, sanctioning law is a key element in shaping an effective policy to combat smuggling, in so far as sanctions are a clear disincentive for criminals. The problem of tobacco smuggling does not involve a single State: nowadays, like most economic crime, is a transnational problem requiring joint solutions. The European Union is a single market, also for criminals. Nevertheless, disincentives to crime are not equal in all Member States, appearing therefore the forum shopping phenomenon, i.e., the offense is committed in the State where the penalty is more favourable.

Moreover, penalties faced by smugglers are not harmonised (the only

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<sup>49</sup> EUROPEAN COMMISSION, *Standardised framework for risk management in the Customs Administrations of the European Union*. Brussels: 2004, [http://ec.europa.eu/taxation\\_customs/resources/documents/framework\\_doc.pdf](http://ec.europa.eu/taxation_customs/resources/documents/framework_doc.pdf), last visited 8 November 2011.

<sup>50</sup> Decision No 878/2007/EC of the European Parliament and of the Council of 23 July 2007 amending and extending Decision No 804/2004/EC establishing a Community action programme to promote activities in the field of the protection of the Community's financial interests (Hercule II programme), OJ L 193, 25.7.2007, pages. 18-22.

<sup>51</sup> GIL SORIANO, A., "¿Despenalización del contrabando de tabaco?", *Tribuna Fiscal: revista tributaria y financiera*, vol. 252, 2011, pages. 32-35.

approximation exists for crimes committed against the budget of the European Union, with a threshold fixed in EUR 50.000, as required by the Convention on the Protection of the European Communities' Financial Interests<sup>52</sup>). Based on Articles 83 and 325 TFEU, the Action Plan Implementing the Stockholm Programme<sup>53</sup> and the Commission Work Programme 2011<sup>54</sup> contemplate the possibility of developing a harmonisation proposal for customs-related crimes. It will not be easy, because Member States are particularly reluctant to lose sovereignty in this sensitive area.

## VI. Conclusions

**Economic importance of tobacco.** World tobacco production is estimated, according to FAO, in almost 7 million tons. Tobacco global market, which includes cigarettes, cigars and cigarillos, fine-cut tobacco and rolling pipe tobacco, has a turnover estimated of EUR 300.000 million per year. It has been a strategic sector for the States, which obtained considerable revenue from its monopoly exploitation. Currently, in several countries, like Spain, only the retail monopoly remains. In the EU, revenues from excise duties on tobacco and alcohol account for 2.2% of total tax revenues, ranging from 1.2% in the Netherlands to 8.8% in Bulgaria<sup>55</sup>. Spain collected almost EUR 7.500 million in 2010, 0.7% of its GDP<sup>56</sup>.

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<sup>52</sup> Council Act of 26 July 1995 drawing up the Convention on the protection of the European Communities' financial interests, OJ C 316 of 27.11.1995.

<sup>53</sup> Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions - Delivering an area of freedom, security and justice for Europe's citizens - Action Plan Implementing the Stockholm Programme, pag. 22, document COM(2010) 171 final.

<sup>54</sup> Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions - Commission Work Programme 2011, volume I, pag. 7, document COM(2010) 623 final

<sup>55</sup> This 2.2% refers to the weighted average based on each State's weight. EU27 arithmetic average is 3.2%. In turn, this collection represents 0.9% of EU27 GDP (from 0.5% in the Netherlands to 2.9% in Bulgaria). See EUROPEAN COMMISSION, *Taxation trends in the European Union. Data for the EU Member States, Iceland and Norway*. Brussels: 2010, pags. 332-333, [http://epags.eurostat.ec.europa.eu/cache/ITY\\_OFFPUB/KS-DU-10-001/EN/KS-DU-10-001-EN.PDF](http://epags.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-DU-10-001/EN/KS-DU-10-001-EN.PDF), last visited 8 November 2011.

<sup>56</sup> AGENCIA ESPAÑOLA DE ADMINISTRACIÓN TRIBUTARIA, *Informe Anual de Recaudación Tributaria 2010...*, op.cit.

**Taxation structure.** Taxes on tobacco usually have specific and ad valorem components, depending on the tradition of each State: producing countries (of low-quality tobacco) have traditionally ad valorem systems because they keep the price differences between the lower-middle range cigarette's and the higher ones, so national tobacco maintains its market share against imported tobacco. Manufacturing countries prefer a specific tax because of its greater efficiency in assuring tax revenue.

Each component has advantages and disadvantages: ad valorem taxation keeps prices updated to inflation but is vulnerable to industry's pricing strategies. At the same time it creates incentives to not invest in quality, advertising, promotion or any other fixed costs demand-improving. By contrast, a specific tax is much more difficult to evade and induce consumers to consume expensive brands because their lower relative price. The disadvantage is that tax collection is not sensitive to price increases or inflation, so it is necessary to update taxes periodically according to consumer prices' index.

For these reasons, there is no magical balance between both components, and that equilibrium depends on the interests of each country. European Commission is opting for a specific tax, because that system maintains the quality of the product (in order to be less harmful), harmonises the tax burden in all Member States (and therefore, the price of cigarettes) and impedes bootlegging (small cross-border smuggling). However, looking at the EU27 tax structure's figures, the situation is far from being fully harmonised: the level of taxes is similar, but the structure is totally different.

The harmonisation of specific types becomes a problem in terms of fairness and equity in many Eastern countries, which are subject to a higher tax burden in terms of purchasing power parity (even confiscatory for heavy smokers). The only solution in the short-term horizon consists on setting up transitional periods in the harmonisation process; in the medium-term horizon, per capita income should converge with the European average.

Unfortunately, the current financial and economic scenario will not help to achieve this goal.

**Smuggling today.** Tobacco smuggling is one of the biggest problems faced by States. Despite the significant decline in tax collection, smuggling is also a danger to public health and public order, in so far as mafias and terrorist groups control this business and subvert the political order in many parts of the globe. The incidence of smuggling varies widely depending on the concerned State, but the most recent studies talk about 11.6% incidence over the total trade.

Smuggled tobacco can be counterfeited, cheap whites brads or genuine tobacco. The first two variants have become important in recent years and China is now a giant factory of counterfeited tobacco, flooding European and American markets. In addition, new very cheap (and poor-quality) brands are emerging both in China and Russia (in particular, Jin Ling brand<sup>57</sup>), being a serious threat to smokers' health. Genuine tobacco smuggling, where the tobacco industry has actively participated, is the classic example: the difference between exports and imports shows that one third of exported tobacco is lost and, therefore, gone into the illegal market.

From the early 2000's, tobacco industry, accused of smuggling, has changed its strategy and now is collaborating with States in exchange for protection: in the European context, tobacco companies have signed some agreements with the EU and its Member States, agreeing to securise the supply chain and to pay substantial compensations in exchange for a preferential treatment of these bodies. Only in Europe, smuggling produces losses of EUR 10.000 million a year, as noted by the European Anti-Fraud, especially in the eastern border.

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<sup>57</sup> Jin Ling, originally imported from China, now is manufactured by Baltic Tobacco Factory, a company formerly controlled and still with some links to Japan Tobacco International, as well as British American Tobacco, which has provided them with high quality tobacco. From the Russian enclave of Kaliningrad (and more recently from other factories in Russia, Ukraine and Moldova) is flooding the European market with cigarettes costing less than EUR 0.01 per unit. As a way of example, a Jin Ling container, which costs EUR 73.000, can be sold for EUR 2.3 million in Germany or Sweden or EUR 4 million in the UK.

**Links between taxation and smuggling.** It is obvious that taxation and smuggling are connected: the more increases taxation, the greater benefit obtains the smuggler. However, most developed countries have (or should invest enough to get it) appropriate mechanisms to discourage smuggling and break this causal link. Theory and practice show that tax increases do not imply smuggling increases or, on the contrary, a decrease of taxation does not result in a lower rate of smuggling.

UK, Italy and Spain are positive examples, because they have managed to increase taxes, reduce consumption and smuggling rates to very low levels (for the Italian and Spanish case). The opposite case is Canada and Sweden, which reduced taxes due to the pressures of the industry (and citizens in the Swedish case), and only managed to reduce revenue without cutting smuggling levels as expected.

**Tackling smuggling.** Having regard to the Italian, British and Spanish cases, action to tackle smuggling should reach a comprehensive and global consensus among the largest number of actors concerned, both public and private. The first element, within the European Union, is to undertake a harmonised legislative framework for anti-smoking policies and, in particular, regarding the taxation system. Similar taxes in all Member States will prevent many inequalities and cross-border smuggling.

Secondly, we need to have an absolute control over the tobacco supply chain. Smuggling problem is not of demand but supply. Therefore, it is necessary to securise the supply chain, having a full traceability throughout all the process, since tobacco is collected until it is sold as a tobacco cigarette. It is the only way of preventing the loss of items that end up systematically on the black or grey market. For that purpose, it is also essential a close collaboration between industry and governments. Being true that no one gives something for nothing, the agreements signed by the largest multinationals with the European Union and its Member States are a model to develop in the coming years.

Thirdly, we need to strengthen the most important conventional instrument of the international community, WHO Framework Convention on Tobacco Control. Nowadays there is a draft a protocol on illicit trade of tobacco, which extends and complements the provisions of Article 15 of the Treaty. Signing this protocol is a political priority for the European Union, which seeks to fix in an international instrument many of the stipulations contained in the agreements with the tobacco industry.

Fourthly, it is essential to increase the technical capacity of customs. The action plan to fight against smuggling of cigarettes and alcohol along the EU Eastern border develops the way to do that: 1) adopting common risk criteria in the field of safety and security of the EU external border; 2) strengthening customs officers' fight against corruption; 3) undertaking investment in technology, especially in container scanners and 4) investing in training for staff responsible for monitoring and combating customs fraud.

In conclusion, there is a collective gain to be made from policies to harmonise (and even increase) taxes and to reduce the duty differentials between Member States, but this will only be achieved with more coordination between Member States and with a strong political will to tackle a common problem. The road will not be easy, because some Member States will have to lose part of its tax collection. And that hurts.

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