

# Cigarette Taxation Policies and Illicit Trade in the European Union

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Tobacco control advocates generally agree that taxes on tobacco products are the single most cost-effective policy tool to induce current smokers to quit, reduce consumption of heavy smokers and prevent uptake by non-smokers, especially youth.<sup>1</sup> The Framework Convention on Tobacco Control (FCTC), the first public health treaty negotiated by member countries of the World Health Organization (WHO), recognizes the importance of tax measures as “an effective and important means of reducing consumption by various segments of the population, particularly young persons.”<sup>2</sup> The goals of public health and those of fiscal authorities are seemingly in congress regarding the benefits of taxation on cigarettes.

However, the issue of how much and what kind of tax to levy depends on economic and political considerations and thus varies across countries and regions.<sup>3</sup> This variance has economic and health implications for populations because it produces incentives for illegal cross-border trade that undermines the purposes behind the tax increases. For Europe, European Union (EU) tobacco tax harmonization – a process whereby all member states of the EU have brokered uniform tax rules for tobacco products – has produced a concerted regional effort to reduce the health effects of tobacco, increase revenue for governments and mitigate the criminal activities associated with tobacco trade for member states.<sup>4</sup> However, comparisons among states and non-EU members highlight the complications produced by national tobacco tax policies that remain inconsistent with neighboring states despite harmonization efforts.

## EUROPEAN UNION TOBACCO TAX HARMONIZATION

The European Commission (EC) has evolved its tax policy for tobacco over the past 20 years as more comprehensive approaches have become necessary to harmonize health policy on the issue of tobacco related morbidity and mortality. Due to the increasing number of countries entering the EU, harmonization has increasingly been a way to mitigate the risk between price differentials among states that causes illicit trade to flourish.

The structure of the EU tobacco tax is a unique blend of different types of excise taxes called the hybrid tax. It is a hybrid structure because it combines *ad volarum* and specific tax amounts to the overall excise tax, which is a percent of the total price of the pack of cigarettes. A specific tax places a standard, fixed currency amount imposed per 1,000 cigarettes no matter what the production cost and diminishes the differences between cheaper and more expensive brands. *Ad volarum* is a percentage of the value of the product, such as 45% of the manufacturers’ price. Value-added tax is levied on businesses at all levels of manufacture based on the increase

in price at each level of production. Combining these types to form a hybrid has served to gain consensus among member states that have different economic considerations vis-à-vis tobacco. In the 1980s, the European Commission (EC) pushed for common indirect tax rates to discourage smoking behaviour. This essentially meant a preference for uniform VAT tax as this is the consumption tax.<sup>5</sup> However, the differences in prices between states barred this approach from coming to fruition and instead necessitated the current harmonization approach that sets minimum levels high enough to ensure revenues for governments and meet public health demands.

Since 1988, the EU Commission in charge of EU policy has stated that fiscal harmonization had to include an anti-tobacco component with uniform taxation rates that were “set at a level compatible with essential public health requirements.”<sup>5</sup> Sticking true to the fiscal imperative argument, tobacco taxation policymakers of the EC had initially had the objective of raising revenue and protecting national manufacturers and growers. In 1992, there were several directives made to harmonize tobacco tax levels across all the member states. Also, because cigarettes and tobacco products have low price elasticity in that people addicted to nicotine will smoke regardless of taxes, there was potential to raise revenue for the member states and the EU. And lastly, the existence of negative outcomes, or externalities, due to increases in tobacco related morbidity and mortality meant that the revenue for taxes could offset the increase in healthcare expenditures.<sup>6</sup>

The initial proposal in 1992 produced price differentials across northern and southern EU states.<sup>6</sup> The longer-term goal would be to impose a 57% *ad volarum* tax and a 0.43 euro-cent specific tax. However, these policies would result in a North-South divide. According to the EC there would be a 20% increase in expenditure on cigarettes across the EU because even as income rises, the demand for cigarettes does not change, leading to the conclusion that people continue to consume at their normal rate, leading to increasing expenditure on cigarettes (which means more profit for companies).<sup>5</sup> Given the differential growth rates between Northern countries and Southern countries, Northern countries would have more expenditure on cigarettes that would diminish the impact of increased prices at the levels proposed.<sup>5</sup> In the best-case scenario, policymakers posited a moderate decrease in consumption of 7% in all countries, but rising incomes would offset any decreases in expenditure on cigarettes.

The EU developed more robust levels of taxation to maximize the political leverage provided by the FCTC, which was signed by the EU in 2003. Under the auspices of the WHO,

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the FCTC calls for strong tobacco control measures from signatory states, especially high tax measures.<sup>7</sup> Under the new policy, ad volarum taxes must be between 5% and 55% of the total tax on cigarette packs, reflecting the compromise with Southern member states that prefer the ad volarum taxes. Minimum excise tax – specific and ad volarum – must be 1.28 Euros per pack and the total level of excise tax must be 57% of retail price. When countries have only ad volarum taxes, producers can lower their prices because ad volarum taxes shifts according to the price of the product, whereas specific tax remains static. Placing the total level of excise tax as 57% of retail price means that producers cannot lower prices (i.e., switching to cheaper leaves, etc.) to an extent that will nullify the effect of the cigarette text.<sup>7</sup>

With these measures taken together, the level of taxation for cigarettes in the EU must be at a minimum of 70% per pack. Countries, however, are free to choose the proportion of specific versus ad volarum, as long as the minimum requirement is met. Ultimately, the harmonization process has set a standard for all member states and has increased prices in several states by a substantial amount. However, price differentials between states have not been significantly reduced, since member states can choose the proportion of specific and ad volarum to get to the 70% standard. This has led to intra-EU cross border shopping from high-price jurisdiction to low-price jurisdictions and to illicit trade between non-EU Border States and the EU.

## SMUGGLING IN THE EU

According to experts in the Commission on Transnational Crime (OLAF), the office charged with spearheading the EU-wide response to tobacco-related illicit trade and tax evasion, the main concern for the EU is the large-scale tax-evasion and illicit trade of popular brand cigarettes that are sold in all states. The media and tobacco industry has instead focused on the local level cross border shopping between low tax and high tax jurisdictions as the main adverse result of taxes. Cross border shopping is legal within the single market of the EU and accounts for 3% of all cigarette consumption. The tobacco industry argues that tax differentials between neighbouring states leads to high rates in smuggling via this method, emphasizing cross border smuggling as the crux of the issue of illicit trade. Taking France as a typical, western European case study, cross border shopping constitutes 14% of all sales in tobacco as of 2006<sup>8</sup> However, because of the Schengen agreement that allows unrestricted access across EU states, cross border shopping is a legal method of purchase, thus making it empirically difficult to measure just how much “smuggling” is done via this route.<sup>9</sup> Thus, the focus has instead fallen on large-scale smuggling, sometimes called “container fraud.”<sup>8</sup>

A major shortcoming of the harmonization policies is the focus on destination-based taxes, which means that taxes are applied for a good at the destination countries – not at the country of origin or the port country<sup>8</sup> The implication of this is a loophole that allows entrepreneurs, tobacco companies and organized criminal groups to circumvent the newly established taxation regimes.<sup>10</sup> The kind of smuggling

this engenders is the main area of focus of the forthcoming, WHO-sponsored Protocol on Illicit Trade in Tobacco Products and the main area of work for the OLAF. Large scale smuggling consists of 7% of all consumption in Europe, with Eastern Europe leading the way with 13% of consumption.<sup>11</sup>

In general, container fraud smuggling can be quantified by the difference in exports versus the volume of imports. The world production of cigarettes is known fairly accurately and thus it can be assumed that the production is equal of world consumption.<sup>12</sup> It is estimated that 586 million are imported each year, while 910 million are exported, with legal duty free sales accounting for about 45 million cigarettes. This means that over 300 million cigarettes are “lost” in the market.<sup>12</sup>

With focused attention on massive tax evasion as the main smuggling problem, OLAF says the direction of contraband cigarettes is from Western and Northern wholesale markets to non-EU states in the East, such as Ukraine and Serbia. From these countries, the cigarettes are either sold on the streets or imported clandestinely back to markets of the EU states (both North and South) where they do not pay any taxes.<sup>13</sup> The direction of the trade is paradoxical and against the economic assumption that smuggled goods flow from low-tax jurisdiction to high tax jurisdictions – meaning from Eastern Europe to Northern/EU regions. This does not happen because buying cigarettes even from these regions would mean paying some kind of tax, which would not yield high profits. Thus, it is cheaper for smugglers to pay 0.30 euro cents wholesale price for imports in the Northern European ports, ship the goods to low-tax Eastern European countries where they would not have to pay high taxes, and smuggle back into western Europe and sell them for market value, duty not paid.<sup>13</sup> The Schengen Agreement and the trade law that allows cigarettes destined for a European country to not pay any duties at the port of entry enable the exploitation of this route. Smugglers can easily re-route transport or forge documents to state that the end destination has been reached. In other cases, these cigarettes may actually be exported to Eastern Europe with large portions smuggled back via speedboat from Andorra, Cyprus, the former Yugoslavian countries, Albania and others.<sup>12</sup>

## TOBACCO POLICIES OF EU BORDER STATES

Given the method of obtaining contraband cigarettes, the border EU states have remarkably high percentages of total consumption coming from smuggled chains as well. In Lithuania a packet of Marlboros costs \$2.00, making it the lowest priced jurisdiction in the EU. However, as of 2008, 36% of all cigarettes consumed came from illicit trade<sup>14</sup> Conversely, in places like the Netherlands, Belgium and Denmark that have much higher prices for packs and over 70% tax incidence on the most popular brands, smuggling constituted 5% of the total consumption<sup>12</sup> The difference can be attributed, partly, to borders with non-EU states that have environments conducive for producing and importing cheap cigarettes, duty unpaid; links to organized crime that can enable smuggling; and smoke-friendly legislative environments that allow tobacco companies to profit from smuggling.

From the findings of crime investigators, tobacco control

experts and health economists, container fraud is supply-driven, related to organized crime, the culture of street selling and the complicity of the industry.<sup>13</sup> The inability of harmonization thus far to produce blanket results is even more apparent when comparing the non-EU states that border the EU and the taxation policies therein. In the realm of trade and the movement of goods, the major ports of Europe are located in the EU – Rotterdam, Antwerp, Rostock and Hamburg – and goods move across via train to non-EU border countries daily.<sup>10</sup> During negotiations between EU member states and newly independent states from the former Soviet Union, countries emphasized that what has worked in the developed countries of western Europe regarding tobacco taxation would not work in these developing states. The reliance on a strong civil society and a basis for non-governmental organizations to educate the public on the harmful effects of tobacco and the need for taxation was not a viable recourse for the governments.<sup>15</sup> Likewise, the bureaucratic structure to implement taxation and ensure the transparent and effective transfer of revenues to different departments was underdeveloped compared to the evolved governments of the Western and Central European states in the EU.

The reality is that nearly half of the 6% of cigarettes sold with duty not paid (contraband) come from Eastern Europe, according to BAT, at \$85 billion in sales. Sales of contraband cigarettes are at 13% in Eastern Europe, compared with 7% in Western Europe (despite it being the highest priced region).<sup>13</sup> This is due to environmental factors, such as lax legal regimes, need for foreign investment to boost new market economies, and easy access to lucrative markets in the West. In the interesting case of Andorra, the complicity of the industry is highlighted, demonstrating that taxes are subject to circumvention not just by criminal networks and entrepreneurs, but by the industry itself.

### Andorra Case Study

BAT and Imperial Tobacco shipped upwards of 1520 million cigarettes to the small principality by 1997, increasing from previous shipments of 13 million. Unless Andorrans were smoking 60 British-brand cigarettes a day each, these excess cigarettes were smuggled back either to the United Kingdom, where they would have entered the black market or gone onto other destinations, duty not paid since packets would have “Andorra” as the destination.<sup>16</sup> It was possible to conduct such operations in Andorra because of the lax rules regarding imports and exports and a strong organized crime base that would act as legal distributors of BAT and Imperial Tobacco products. Most importantly, Andorra is a tax-free zone, making it a tax haven for banks, customers and companies alike. Thus, the profit margin of conducting business through Andorra illustrates why this is such a lucrative business: a container of cigarettes, which has 5-10 million cigarettes, originating in the UK can be bought for \$200,000 and resold for \$2 million. Lost revenue for the UK government reached 2.5 billion pounds by 1997, even as industry officials collected their profits, since their money comes from the initial sale of the product.<sup>16</sup> Manufacturers are technically within the law in such countries’ jurisdictions, because

they are separate from the handlings of dealers and retailers. Manufacturers of British cigarettes could sell these exorbitant amounts of tobacco to Andorra and not be required to follow up on where the end-market lay.<sup>16</sup>

### POTENTIAL SOLUTIONS

As identified by the EC and OLAF, smuggling has gone from wealthier, high-tax countries to less developed, low-tax countries rather than the other way around. As explained above the main reasons for this have been: 1) EU trade laws that allow goods to be taxed at destination points, allowing companies to ship to countries where taxes are low; 2) smoke-friendly legal and business environments in non-EU countries such as Andorra allows companies to produce cheaply and in excess, fuelling the illicit trade; and 3) prevalence of criminal organizations that have networks reaching throughout Europe.

One main solution is to “turn off the tap” of supply driven tax circumvention by criminal organizations and the tobacco industry that are at the heart of the smuggling problem.<sup>13</sup> Given their focus on domestic circumstances, member states often overlook the regional considerations necessary in staving off illicit trade.<sup>17</sup> Giving into the fear mongering by industry officials, Sweden reduced taxes due to concern over smuggling after having two substantial tax increases in December 1996 and August 1997. The main reason was an overblown misconception that cross-border shopping would flood the Swedish market.<sup>16</sup> Conversely, Spain has been one of the most successful in reducing smuggling despite having one of the cheapest cigarettes markets in the EU. Contraband from Andorra flooded the Spanish market to an extent that 15% of all cigarettes sold within Spain were duty not paid. Efforts between French, UK and Spanish governments and OLAF sealed off the Andorran border and civil guards were mandated to patrol hills and valleys to control smuggling at the “container” level (5-10 million cigarettes). These coordinated policing efforts decreased contraband market from 15% of all sales to 5% by 1999 without any change to the tax incidence of 76.1% on the most popular brand cigarettes.

Secondly, in order to mitigate the unintended consequences of the European trade law allowing taxes to be levied at destination points, a “track and trace” regime could label all products with the port of destination so that products cannot be diverted to illegal channels.<sup>18</sup> An effective track and trace regime is a major issue of negotiation during the current intergovernmental session of the Protocol on Illicit Trade in Tobacco Products. Article 15.2 of the FCTC also highlights the need for the Parties to the treaty to set up effective measures to trace at which point products are directed to identify where the criminal activity originates.<sup>19</sup>

The harmonization policies also have issues of contention between public health and fiscal goals. In order to ensure that tobacco taxes meet the health objectives of decreasing prevalence and preventing uptake, taxes must be earmarked for tobacco control programs. Earmarking has been proven to multiply the beneficial health effects of increasing taxes, with examples from the United States showing that when even a portion of the tax revenues goes to anti-smoking activities,

decreases in consumption levels and prevalence are larger than expected.<sup>20</sup> Additionally, the issue of smuggling is recognized as an important public health issue as it introduces cigarettes at low prices all over the EU, threatening efforts to decrease prevalence and preventing uptake, especially by youth.<sup>13</sup> One way to earmark taxes is to set up health promotion foundations that provide sponsorship to sports, arts and other organizations to replace tobacco sponsorship.<sup>13</sup>

Overall, the harmonization of tobacco taxes in Europe is a unique regional experiment in curbing the tobacco-related health outcomes by tackling the economics of tobacco. Additionally, harmonization in tobacco has been an experiment in setting regulations under the single market system where transport and trade are nearly borderless among countries within the EU and for most border states not in the EU. The battle now is to fine-tune this regime so illicit trade cannot undo its successes.

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## NEWS AND VIEWS

### Study Shows that Robots Can Aid Stroke Patients

A randomized trial has recently shown that rehabilitation assisted through the use of robots actually results in improvements in motor function and quality for patients who suffer from chronic disability following a stroke. *The New England Journal of Medicine's* researchers reported that significant progress has been observed in basic motor function. Time taken to complete everyday tasks for the robot-assisted group was at only 36 weeks, as compared with usual care. Albert Lo, MD, PhD, of the Providence Veterans Affairs Medical Center in Rhode Island, and his colleagues have cited that these findings "provide evidence of potential long-term benefits of rehabilitation and challenge the widely held clinical belief that gains in motor function are not possible for long-term stroke survivors."

Results demonstrated that compared with usual care, robot-assisted therapy was superior on one of the secondary endpoints, the Stroke Impact Scale, which measures quality of life and social participation. Certain criticisms have come up, however, such as that it might have been difficult to observe between-group differences because of the effects of certain patient characteristics, like depression. Nonetheless, "the potential for robotic therapy after stroke remains enormous," Steven Cramer, MD, of the University of California Irvine, wrote, noting that "robots never get tired, can design training regimens in reproducible ways, reduce the need for human oversight, can measure performance during therapy, and can provide simultaneous cognitive training by interfacing with computers."

**Reference:** Neale, Todd. (2010, April 16). Robots May Aid Stroke Recovery. *MedPage Today*.

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### Addition to Chemotherapy Helps Survival Rate of Pancreatic Cancer

Data from a small phase I clinical trial shows that pancreatic cancer patients given an insulin growth factor (IGF) inhibitor combined with chemotherapy resulted in durable responses beyond one year. According to Rachna Schoff, MD, of M.D. Anderson Cancer Center of Houston, this data shows that "for a subset of patients, IGF-1 receptor is integral to pancreatic cancer." IGF type 1 receptor (IGF-1R) initiates signaling pathways involved in the pathogenesis and pathophysiology of pancreatic and other cancers: MEK/Erk and PI-3Kinase/Akt. MK-0646 is a human antibody against IGF-1R that leads to the receptor's internalization and subsequent degradation. Preclinical studies have shown that IGF-1R signaling increases the efficiency of chemotherapeutic drug. For this study, of the six patients who had partial responses, the shortest that was 14 weeks. The remaining five patients had response durations of 32 to more than 59 weeks.

**Reference:** Bankhead, Charles. (2010, April 26). AACR: Durable Responses Seen In Pancreatic Cancer. *MedPage Today*.

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