

Organized Crime and the  
Smuggling of Cigarettes  
in the United States –  
The 1999 Update

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# Organized Crime and the Smuggling of Cigarettes in the United States – The 1999 Update

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# Organized Crime and the Smuggling of Cigarettes in the United States – The 1999 Update

## EXECUTIVE SUMMARY

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- Preliminary data indicates that cigarette smuggling—which rose moderately in 1998—has grown significantly in the first five months of 1999. Organized crime is at the forefront of this illicit activity. The major contraband markets are in California, New York, Michigan and Washington State.
- Americans consumed an estimated 1.3 billion packages of contraband cigarettes in 1998—the equivalent of about 5.7 percent of U.S. consumption. That represents nearly \$850 million a year in evaded federal and state taxes and is about \$100 million higher than in 1997.
- About 65 percent of the 1.3 billion packs—or about 819 million packs—evaded federal and state taxes. This is called international smuggling. That's up from 48 percent in 1997. In 1998, 35 percent of contraband packs evaded only state taxes through what's called inter-state smuggling.
- Preliminary data suggests that, in the first five months of 1999, an estimated 1.4 billion packs were smuggled internationally—more than the 1998 combined total for inter-state and international smuggling. If present trends continue, the total number of contraband packs in 1999 may be more than double 1998 levels.
- The incentive for organized crime to smuggle cigarettes—and conversely for consumers to acquire the cheaper, untaxed product—has now reached a critically high level in many parts of the United States. So much so that the ability of the federal government and many state administrations to further increase tobacco taxes without either exacerbating an existing contraband problem—or creating a new one—is severely limited.

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- International smuggling is much more lucrative than the inter-state variety. It allows organized criminals to evade the federal tax of \$2.40 a carton, plus the applicable state tax. In the continental U.S., it can be as high as California's \$8.70 a carton. International cigarettes also are not affected by the \$4.50-a-carton Tobacco Settlement price increase. Implemented in November 1998, it applies only domestically. As well, international wholesale prices are about \$10 less than domestic ones. Thus, in California, a smuggler's potential profit could total as much as \$25.60 a carton.
- The flash point concept was developed in the 1970s by the Advisory Commission on Intergovernmental Relations ("ACIR"), a Congressional agency, as a benchmark for gauging the impact of the economic stimulus on smuggling. It's the point at which the incentive to smuggle is high enough to entice organized crime to enter the contraband market.
- When inflation is taken into account, FIA estimates that the ACIR flash point of \$2.30 a carton in 1985 for inter-state smuggling translates into a 1998 flash point of about \$3.48 a carton. The flash point at the international level is higher because greater costs are incurred. Preliminary analysis suggests that the flash point at the international level may be in the range of \$15 a carton. International smuggling is more complex than the inter-state variety requires organized crime's expertise and capabilities
- Because it was applied so broadly, the Tobacco Settlement price increase had the same effect on demand as a federal tax rise, thus helping to significantly increase the incentive to smuggle in all 50 states. Before its implementation, the total tax that could be evaded in the lowest-taxed state—Virginia—was \$2.65 a carton (i.e. \$2.40 in federal tax plus \$0.25 in state tax). This was nearly \$1 a carton below the inter-state flash point. Avoiding the Tobacco Settlement increase would boost a smuggler's potential profit margin in Virginia to \$7.15 a carton. In addition, the lower international wholesale price would raise this by a further \$10 a carton to \$17.15—and thus exceed the international flash point.
- The factors increasing demand for contraband tobacco are also spurring the growing gray market in cigarettes. These U.S.-made cigarettes are intended for foreign markets, but are re-imported. They benefit from the difference between domestic and international wholesale prices. Although gray market cigarettes are legal as long as all applicable taxes are paid, labeling requirements met and no trademarks infringed, they are vulnerable to manipulation by organized crime.

- A number of legislative initiatives are supposed to curb the gray market in cigarettes, including new federal regulations that take effect on January 1, 2000. However, these supply-side efforts will not affect the underlying demand for cheaper cigarettes. To the extent that these initiatives are successful, law enforcement experts believe that much of this demand will simply shift to the contraband market. Demand for smuggled cigarettes is also expected to be stimulated next year by a federal tax increase of \$1.00 a carton to \$3.40.
- In cigarette smuggling, as in the drug trade, demand creates supply. Whenever the incentives for organized crime are sufficiently high, the supply of smuggled cigarettes expands to meet the demand.
- Supply-side initiatives to control cigarette smuggling are especially limited at the international level because there are so many sources of cigarettes. Consider: There are more than 200 independent, foreign-owned cigarette manufacturers around the world, and they supply about 57 percent of the global market. Many make local versions of international brands under license. There is also a significant capacity to produce counterfeit cigarettes in the Far East.
- Cigarette smuggling increases youth access to cigarettes, and thus undermines efforts to control youth smoking. Through the contraband market, young people can obtain cigarettes at much lower prices than in the legal market. Smugglers also do not comply with regulations prohibiting the selling of cigarettes to under-age consumers.
- Cigarette smuggling also corrupts individual Americans. They are invited to participate in criminal activity—just as during Prohibition many Americans consumed bootleg alcohol.
- Cigarette smuggling harms the legal distribution and retailing system. As a contraband tobacco market becomes established, competitors face the choice of either joining in, dramatically cutting their income, or going out of business.
- Cigarette smuggling provides organized crime with a low-risk source of revenue that can be used to finance other higher-risk activities.
- The power and influence of organized crime is enhanced by cigarette smuggling. Cigarette smuggling helps street gangs and other emerging organized crime groups to become established. This is similar to what occurred during Prohibition. Street gangs used the profits from alcohol smuggling to grow into the traditional crime families that dominated the North American underworld for decades thereafter.

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- Cigarette smuggling is a problem in many countries around the world, including Spain, Italy, the United Kingdom, China and South Africa. It emerges whenever government policies create a sufficient economic incentive.

## California

- FIA estimates that about 260 million packages of smuggled cigarettes were consumed in California in 1998, making it the largest single contraband market in the United States. This is the equivalent of about 16 percent of consumption, and resulted in state losses of about \$96 million in revenues. The state tax was increased from \$1.00 a carton to \$3.50 in 1989. In 1994, it rose further to \$3.70. And on January 1, 1999, the tax further went up to \$8.70 a carton, the highest in the continental U.S.
- With the stimulus of both the higher state tax and the Tobacco Settlement increase of \$4.50 a carton, the cigarette smuggling sector is flourishing in California. Preliminary data indicates that the contraband market in California has grown significantly in the first five months of 1999.
- Complex schemes are used to smuggle cigarettes from Mexico into California. Law enforcement reports an increase in contraband tobacco seizures at the Mexican border in 1999.
- Concern is rising over organized armed robberies. In one case, four armed men stole more than \$1 million in cigarettes from a warehouse in April 1999. Stolen cigarettes are the cheapest source of supply for the contraband market.

## New York State

- FIA estimates that, in New York State, the equivalent of about 20 percent of consumption—or about 236 million packages—was contraband in 1998, and that the state lost more than \$132 million in revenues. In 1993, New York State raised its tax from \$3.90 a carton to \$5.60. Preliminary data indicates that smuggling has expanded in the first five months of 1999.
- The use of counterfeit tax stamps is widespread, and growing. Sophisticated criminals employ the latest graphics software to produce high-quality fake tax stamps. They even produce counterfeit stamps for some other states.
- Contraband cigarettes are an especially acute problem in New York City. Major established and emerging organized crime groups are involved in this illegal activity.

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## Michigan

- FIA estimates that, in Michigan, the equivalent of about 20 percent of consumption—or about 156 million packages—was contraband in 1998. That represented state losses of more than \$117 million in revenues. In 1994, Michigan raised its state tax from \$2.50 a carton to \$7.50.
- Smuggling in 1998 declined from 1997 levels when the equivalent of about 28 percent was estimated to be contraband. The decline was the result of the imposition of state tax stamps. This had the effect of eliminating small-time, casual smugglers and opening the way for organized criminal groups to complete their dominance.
- Preliminary data suggests that smuggling in the first five months of 1999 may be starting to rise towards 1997 levels, as organized crime uses counterfeits as a means of adjusting to the introduction of tax stamps.
- Smuggled cigarettes consumed in Michigan are either obtained from some Indian smoke shops in western New York State or in low-tax states like Kentucky and North Carolina.

## Washington State

- FIA estimates that, in Washington State, the equivalent of about 19 percent of consumption—or about 59 million packages—was contraband in 1998. As a consequence, the state lost more than \$49 million in revenues. In 1995, Washington raised its state tax from \$5.65 a carton to \$8.15. One year later, it rose to \$8.25. Preliminary data suggests that smuggling is expanding in the first five months of 1999.
- Contraband cigarettes are available from a variety of sources, including some Indian smoke shops, corner stores and itinerant street vendors.

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# Organized Crime and the Smuggling of Cigarettes in the United States – The 1999 Update

## **SECTION 1: INTRODUCTION**

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### **Overview**

The National Coalition Against Crime and Tobacco Contraband (the "Coalition") has retained FIA International Research Ltd. ("FIA"), a member of the International Group of FIA companies, to update a 1998 study entitled "Organized Crime and the Smuggling of Cigarettes in the United States."

In particular, the Coalition asked FIA to:

- Investigate the nature and characteristics of organized crime and current cigarette smuggling activities across the United States;
- Quantify the extent of cigarette smuggling in key jurisdictions; and
- Analyze the societal consequences of cigarette smuggling.

During the spring and summer of 1999 FIA undertook field studies and analyzed data with respect to cigarette smuggling trends and activities. FIA also conducted interviews with a broad range of individuals, including law enforcement officials, distributors, retailers, tobacco industry experts and other sources who are knowledgeable about the illegal cigarette market.

This report utilizes the broad experience of FIA professionals in investigating and analyzing contraband tobacco activity in the United States, Canada, Europe and Africa.

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The involvement of FIA professionals in contraband tobacco investigations began in the early 1990s when Canada experienced a massive cigarette smuggling problem. FIA professionals conducted a number of studies that were widely regarded as fostering an in-depth understanding of the nature and characteristics of cigarette smuggling. Indeed, in praising one report, the then Solicitor General of Canada, the Honorable Herb Gray, stated:

*"I should like to commend you on the quality and detail of the analysis in the report. This document was forwarded to officials in this department for their use in the context of our examination of this very complex and difficult subject."*

In 1994, FIA professionals were asked by the Coalition to conduct the first national study of cigarette smuggling in the United States. This was followed in 1995 by a study of cigarette smuggling in Michigan, and the aforementioned national study published in August 1998.

In addition, and also on behalf of the Coalition, FIA professionals prepared a training manual for law enforcement on how to conduct effective cigarette smuggling investigations. FIA professionals have also participated in numerous training sessions for law enforcement.

## Definitions

Listed below are several terms used in this report:

- **Consumption:** The total volume of cigarettes purchased in a jurisdiction on which all applicable taxes were paid.
- **Currencies:** All amounts cited in this report are in U.S. dollars, unless otherwise noted.
- **Dual Inventories:** Suppliers and retailers who participate in the contraband trade often keep inventories of both taxed and untaxed cigarettes to conceal their illegal activities. Some dual-inventory suppliers conceal their illegal activities by mixing loads of taxed and untaxed cigarettes.
- **The Flash Point:** The point at which there is a sufficient economic incentive for organized crime to begin participating in a contraband tobacco market trade. The Advisory Commission on Intergovernmental Relations ("ACIR"), an agency established by Congress in 1959, first developed this concept. When inflation is taken into account, FIA estimates that the ACIR flash point of \$2.30 a carton in 1985 for interstate smuggling translates into a 1998 flash point of about \$3.48 a

carton. Preliminary analysis suggests that the international smuggling flash point may be in the range of \$15 a carton.

- **Intensity:** The average amount that smokers say they consume on a daily basis.
- **International Smuggling:** Involves either cigarettes made abroad and smuggled into the United States, or the diversion into the American black market of domestically produced cigarettes intended for export to foreign countries. In this type of smuggling, federal, state and local taxes are evaded. These cigarettes are also not affected by the Tobacco Settlement price increase of \$4.50 a carton implemented in November 1998, and they benefit from wholesale prices that are at least \$10 lower than domestic ones.
- **Inter-state Smuggling:** Involves the evasion of state tobacco taxes. Cigarettes are obtained in states with lower state taxes and moved by various means, including trucks, cars and light aircraft, into ones with higher taxes, such as Michigan. Federal taxes are always paid on these cigarettes.
- **Mail Order:** Groups advertise cheap cigarettes for bulk orders on the Internet. Buyers call a 1-800 number and operators fill orders by mail or courier. Many mail order operations are based on Indian reservations. Investigation and prosecution is more difficult because of jurisdictional problems.
- **Military Sales:** Federal law exempts military exchanges and commissaries from state and local taxes. When cigarette sales increase dramatically from these establishments, that is an indication the untaxed cigarettes are going into the black market.
- **National Contraband Market:** Comprised of all cigarettes in the United States that evade federal, state and local taxes.
- **Organized Crime:** A structured, disciplined group that engages in an ongoing criminal conspiracy. The organizational framework can range from the rigid, hierarchical structure found in the traditional crime families in the Mafia to more flexible associations. Participants come from every ethnic group and background. It is the profit motive—not their ethnicity—that brings individuals together as an organized crime group.
- **Package Sizes:** All references to packages in this report are based on 20 cigarettes to a package. One carton contains 10 packages, or a total of 200 cigarettes. One case contains 60 cartons, or 600 packages.
- **Prevalence:** The proportion of a population that smokes.

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## SECTION 2: CURRENT SMUGGLING ACTIVITY

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### Overview

After a moderate rise in 1998, preliminary data indicates that cigarette smuggling has grown significantly in the United State in the first three months of 1999.

FIA estimates that about 1.3 billion contraband cigarette packages—the equivalent of about 5.7 percent of national consumption—were consumed by Americans in 1998. That's about 130 million packs higher than in 1997. Total federal and state tax losses rose from more than \$750 million in 1997 to nearly \$850 million in 1998.<sup>1</sup> About 65 percent of the 1.3 billion contraband packs—or about 819 million packs—were smuggled internationally which involves the evasion of federal and state taxes. This is up from 48 percent in 1997. In 1998, 35 percent of contraband packs evaded only state taxes through what's called inter-state smuggling.

But beginning in late 1998 and continuing into 1999, initial indications are that the contraband tobacco market grew significantly, and that the trend to international smuggling accelerated. Preliminary data suggests that, in the first five months of 1999, an estimated 1.4 billion packs were smuggled internationally—more than the 1998 combined total for inter-state and international smuggling. If present trends continue, the total number of contraband packs in 1999 may be more than double 1998 levels.

These developments reflect the fact that the incentive for organized crime to smuggle cigarettes—and conversely for consumers to acquire the cheaper, untaxed product—has now reached a critically high level in many parts of the United States. As a result, the ability of the federal government and many state administrations to further increase tobacco taxes without either exacerbating an existing contraband problem—or creating a new one—is severely limited.

Indeed, John Magaw, Director of the Bureau of Alcohol, Tobacco and Firearms, has advised states contemplating tax increases to also consider their vulnerability

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<sup>1</sup> See Appendix A for details on FIA's Quantification Methodology.

to cigarette smuggling. Otherwise, he warned at Congressional hearings in February 1999,

*"you are going to have a real trafficking problem and we are going to have a real trafficking problem."*<sup>2</sup>

In cigarette smuggling, as in other criminal enterprises, demand creates supply. The higher the incentive to smuggle—and the greater the consumer demand for cheaper, untaxed cigarettes—the more intensive will be organized crime's efforts to supply them.

On a national level, the demand for contraband cigarettes experienced a major boost as a result of a \$4.50-a-carton Tobacco Settlement price increase. While not strictly a tax, the Tobacco Settlement increase—implemented in November 1998 on domestic cigarettes—exerted the same broad impact on consumer demand as a federal tax increase. Consequently, it is regarded for the purpose of this report as a levy.<sup>3</sup>

The situation has become particularly serious in California, where a \$5-a-carton state tax rise also took effect on January 1, 1999. It pushed the state tax to \$8.70 a carton, the highest in the continental U.S., and further stimulated what was already the nation's single-largest contraband market. As the Orange County Register noted in a May 1999 editorial, the smuggling of cigarettes in California,

*"... has exploded. It's simple economics. Taxes are forcing dramatically higher taxes on cigarettes as a way to discourage people from smoking them. But people still want them, so black markets and smuggling rings emerge to fulfill the demand."*<sup>4</sup>

Cigarette smuggling is expected to worsen in the United States next year as a result of a number of factors, including the impact of efforts to eliminate the gray market in cigarettes. It has grown significantly in recent years due to the same

<sup>2</sup> John W. Magaw, Director, Bureau of Alcohol, Tobacco and Firearms, testimony before the subcommittee of the Committee on Appropriations, House of Representatives, 1<sup>st</sup> Session 106<sup>th</sup> Congress.

<sup>3</sup> For the purposes of this report, we are regarding the Tobacco Settlement-related price increases as a levy. According to the Merriam-Webster On-Line Dictionary (<http://www.w-m.com>), the etymology of levy dates back to 13<sup>th</sup> Century Middle English, when it referred to the "the act of raising". Currently, the primary definition of levy, according to Merriam-Webster, is "the imposition or collection of an assessment." Uniformly applied to all legally sold domestic cigarettes, we believe the Tobacco Settlement-related price increase falls into this category and thus exerts the same impact on consumer demand—the driving force in a contraband market—as a federal tax increase.

<sup>4</sup> "The Economics of Smuggling," *The Orange County Register*, May 2, 1999.

forces that have spurred the demand for contraband tobacco. Produced in the U.S. and intended for foreign markets, gray market cigarettes are instead re-imported. They benefit from the approximately \$10-a-carton difference between domestic and international wholesale prices. Although gray market cigarettes are legal as long as all applicable taxes are paid, labeling requirements met and no trademarks infringed, they are vulnerable to manipulation by organized crime.

A number of legislative initiatives are supposed to curb the gray market in cigarettes, including new federal regulations that take effect on January 1, 2000. However, these supply-side efforts will not affect the underlying demand for cheaper cigarettes. To the extent that these initiatives are successful, law enforcement experts believe that much of this demand will simply shift to the contraband market.

Demand for smuggled cigarettes is also expected to be stimulated next year by a federal tax increase of \$1.00 a carton to \$3.40.

### **The Flash Point Impact**

The flash point concept was developed in the 1970s by the Advisory Commission on Intergovernmental Relations ("ACIR"), a Congressional agency, as a benchmark for gauging the impact of the economic stimulus on smuggling. It's the point at which the incentive to smuggle is high enough to entice organized crime to enter the contraband market.

When inflation is taken into account, FIA estimates that the ACIR flash point of \$2.30 a carton in 1985 for inter-state smuggling translates into a 1998 flash point of about \$3.48 a carton. The flash point at the international level is higher because greater costs are incurred. Preliminary analysis suggests that the flash point at the international level might be in the range of \$15 a carton.

As the incentive in a particular state begins to exceed a flash point, the point at which organized crime actually starts to enter a contraband market will vary depending on such local factors as the level of risk, operational costs and market opportunities. There may also be a time lag before an organized crime group is able to adjust to the incentive created by a tax increase.

Because it was applied as widely as a federal tax increase, the Tobacco Settlement price rise helped to boost the incentive to smuggle in all 50 states.

Consider the impact on Virginia, which at \$0.25 a carton, has the lowest state tax in the United States. Before the Tobacco Settlement price increase, a smuggler

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could evade, at most, \$2.65 a carton (i.e. \$2.40 in federal tax plus \$0.25 in state tax). Avoiding the Tobacco Settlement increase would boost a smuggler's potential profit margin in Virginia to \$7.15 a carton. Through international smuggling, an organized criminal also benefits from paying lower world wholesale prices. For the smuggler in Virginia, this would drive his potential profit margin above the international flash point to about \$17.15 a carton.

Alternately, consider the impact of the Tobacco Settlement price increase on a smuggler in Michigan, with a state tax of \$7.50 a carton. If he participated in inter-state smuggling and bought his cigarettes in a low-tax state like North Carolina, with a tax of \$0.50 a carton, he would have a potential profit margin of \$7.00 a carton. If he now obtains his cigarettes on the world market, he can evade the state tax of \$7.50 a carton, the federal tax of \$2.40 a carton and avoid paying the Tobacco Settlement increase. His potential profit margin: \$14.40. Add in the international wholesale price savings, and the Michigan smuggler could improve his potential profit margin to about \$24.40 a carton.

At the same time, it's important to note the demand-side impact of high taxes and the Tobacco Settlement increase. American consumers have seen the average retail price of premium brands rise significantly from about \$20.60 a carton in 1998 to about \$27.70 one year later.

Retail prices in key urban areas are much higher, however. A recent telephone survey found the following price ranges for a carton of cigarettes (all taxes included) in four cities located in regions of significant contraband activity:

- Los Angeles - \$36-\$40
- New York City - \$29-\$33
- Detroit - \$30-\$37
- Seattle - \$34-\$38

By contrast, a duty-free shop in California at the Mexico-U.S. border—benefiting from the lower international wholesale price and the absence of any tax—may charge consumers about \$12 for the same carton. That's \$24-\$28 a carton less than the above-noted range of retail prices in Los Angeles.

A duty-free shop at the Canadian border in Michigan, on the other hand, may sell the same cigarettes for about \$15 a carton—\$15-\$22 less than nearby in Detroit.

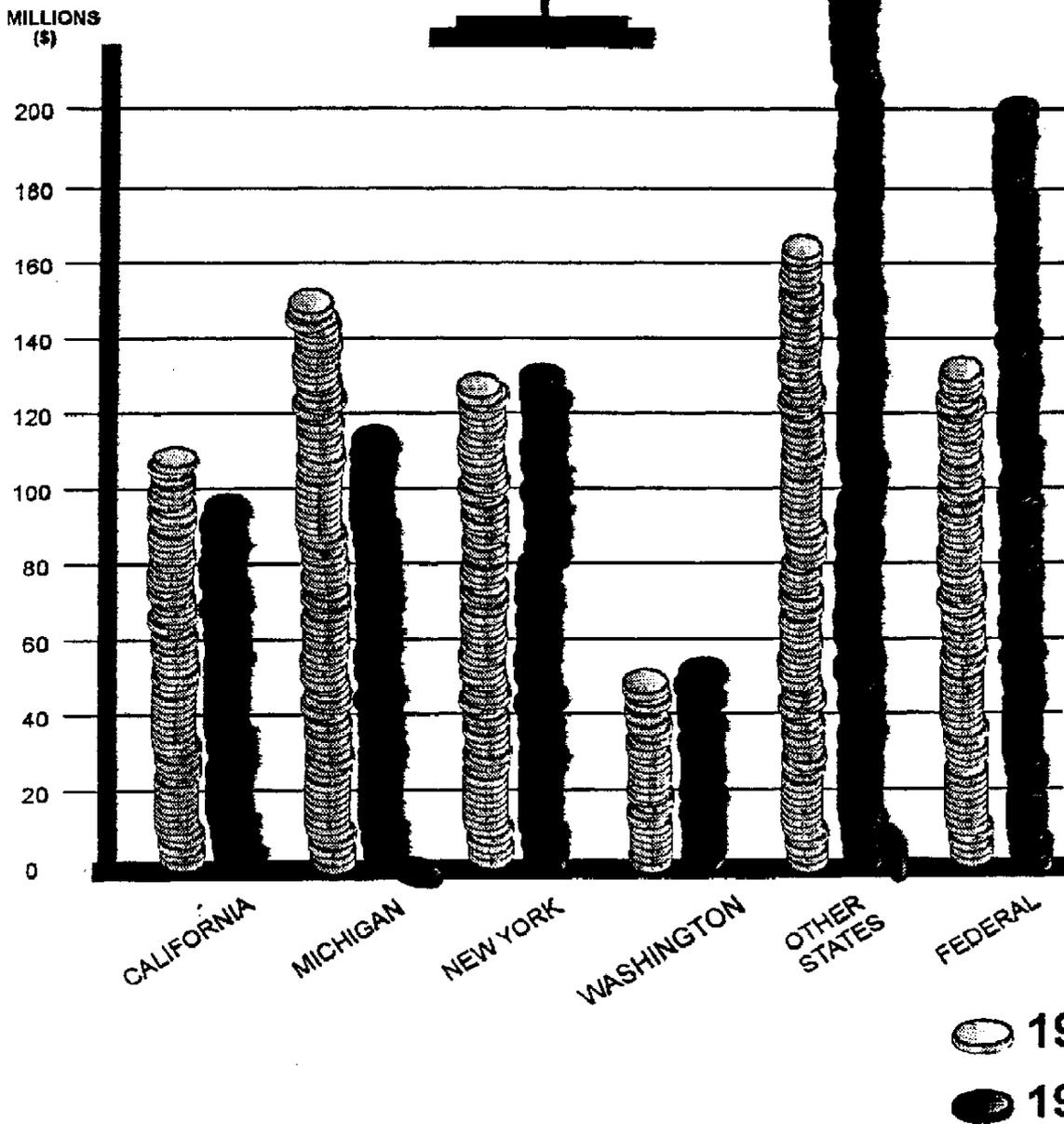
Figure - 1

### ESTIMATED CONTRABAND REVENUE LOSSES

**1997**  
 TOTAL TAX REVENUE LOSS  
 = \$750 MILLION



**1998**  
 TOTAL TAX REVENUE LOSS  
 = \$850 MILLION



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## Organized Crime

International smuggling is on the rise.

As the Attorneys General of Colorado, Ohio, Utah and Washington have stated in a joint letter:

*"For many years, the differential in tax rates on tobacco products was mainly an interstate problem with contraband products being smuggled into those states with the highest tax rates. The problem has now reached international proportions ... We are now seeing that as tobacco taxes rise nationwide, foreign manufactured cigarettes and other products are being smuggled into the United States."<sup>5</sup>*

Only organized crime has the sophistication, networks and expertise to fully take advantage of the profit-making opportunities available to international smugglers. Doing so requires organized crime's ability to:

- Camouflage its acquisition of commercial quantities of cigarettes on world markets. At its most sophisticated level, such operations may require front-companies and clandestine financial channels in offshore tax havens;
- Smuggle commercial quantities across the U.S. border, or alternately, fraudulently divert cargoes intended for foreign jurisdictions into the domestic contraband market; and
- Connect and supply local distribution networks.

According to the Bureau of Alcohol, Tobacco and Firearms, cigarette smuggling has attracted many major forms of organized crime:

*"In addition to illegal trafficking by traditional organized crime groups and Native Americans, ATF has also uncovered involvement in cigarette smuggling by Russian, Middle Eastern and Asian organized crime groups ... these groups are also*

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<sup>5</sup> Letter to Senator Orrin Hatch from the Attorneys General of Colorado, Ohio, Utah and Washington, April 24, 1998.

*involved in firearms and narcotics trafficking, alien smuggling and other illegal activities."*<sup>6</sup>

For many people, the term organized crime evokes images from movies like *The Godfather*. The reality of organized crime is more complex and varied, and involves participants from every ethnic group and background. What brings them together—i.e. what causes them to be organized—has nothing to do with ethnicity and everything to do with making money through planned criminal activity.

FIA defines organized crime as a structured, disciplined group of individuals who engage in an ongoing criminal conspiracy. The type of structure ranges from the rigid, hierarchical kind found in traditional crime families to the more flexible associations that characterize many drug trafficking groups. In the latter, there is an absence of formal corporate- or military-style organization.

Crime experts call this "the informal organization" and define it as:

*"A structure that naturally arises among people carrying on a continuous activity that requires numerous participants. This structure serves the participants well, eliminating the need for a more formal organization."*<sup>7</sup>

Organized crime is uniquely positioned to capitalize on another trend in cigarette smuggling: the rising use of counterfeit tax stamps in a number of states, including Michigan.

According to Assistant State Attorney General Dan Levy of Michigan, organized criminals who have the expertise to counterfeit stamps have displaced casual smugglers. He has stated:

*"We've seen an end to smuggling by the small-scale store. We used to see a lot of cases where someone's Uncle Fred would drive to Indiana to buy a few cases of cigarettes and bring them back to be sold here."*<sup>8</sup>

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<sup>6</sup> John Magaw, Opening Statement before the House Commerce Committee, December 9, 1997.

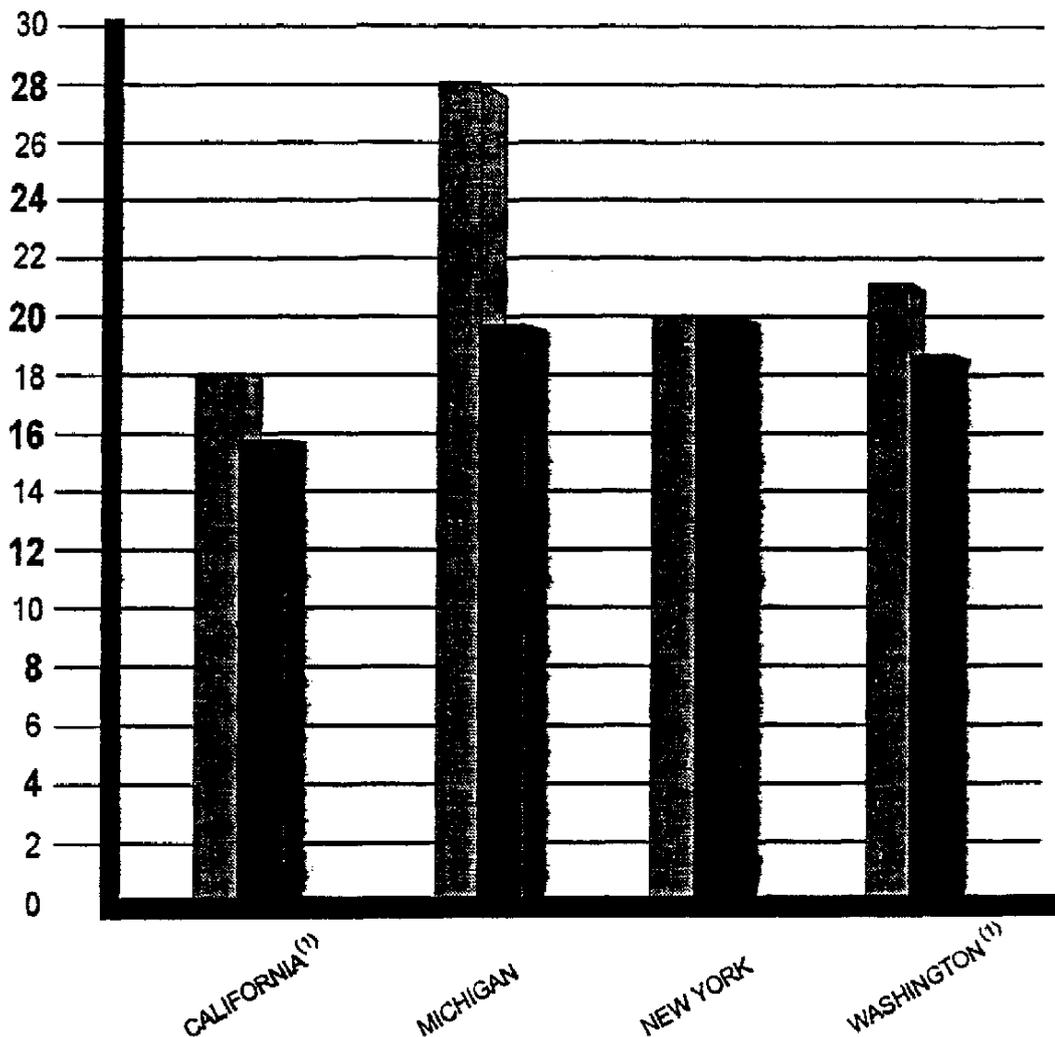
<sup>7</sup> Police Executive Research Forum, *Asset Forfeiture: Developing Plans to Attack Drug Traffickers' Assets*, Washington, D.C.: 6.

<sup>8</sup> "Cigarette bust boosts state's coffers by \$1 million," *Detroit Free Press*, January 12, 1999.

Figure - 2

### CONTRABAND MARKETS

CONTRABAND ( % )



■ 1997  
■ 1998

<sup>(1)</sup> Decline in contraband percentage in 1997-1998 in California and Washington is statistically insignificant.

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Cigarette smuggling is such a thriving line of business for organized crime in the United States that some traffickers have turned from drugs to tobacco.<sup>9</sup> Moreover, since 1992, the Bureau of Alcohol, Tobacco and Firearms has seen a more than 500 percent increase in its cigarette trafficking investigations.

### Smuggling Levels in Key States

California, Michigan, New York State and Washington State are the current smuggling hot spots in America.

- **California:** FIA estimates that the equivalent of about 16 percent of consumption—or about 260 million packs—was smuggled in 1998, costing the state more than \$96 million in annual revenues. Although this is just below the 1997 level of about 18 percent of consumption, the decline is statistically insignificant and reflects normal variations in contraband estimates. However, preliminary data suggests that California's contraband market has grown significantly in the first five months of 1999, and may be at least five percentage points higher than 1998 levels.
- **New York State:** FIA estimates that the equivalent of about 20 percent of consumption—or about 236 million packs—was smuggled in 1998, costing the state more than \$132 million a year in annual revenues. This is about the same level as in 1997. However, preliminary data suggests that smuggling levels in the first five months of 1999 may be at least two-to-four percentage points above 1998 levels.
- **Michigan:** FIA estimates that the equivalent of about 20.2 percent of consumption—or about 156 million packs—was smuggled in 1998, costing the state more than \$117 million a year in revenues. This is much less than estimated smuggling levels in 1997, when the equivalent of about 28 percent—or about 206 million packs—was smuggled. The decrease is likely due to the introduction of stamps on cigarette packs, which increased the risks of detection and forced out less sophisticated smugglers. However, preliminary data suggests that—through the use of counterfeits—organized crime has adjusted to the introduction of tax stamps, and that smuggling in the first five months of 1999 may be starting to rise towards 1997 levels.

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<sup>9</sup> John Magaw, speech to the International Association of Chiefs of Police, Dublin, Ireland, May 10, 1999.

- **Washington State:** FIA estimates that the equivalent of about 19 percent of consumption—or about 59 million packs—was smuggled in 1998, costing the state more than \$48 million a year in revenues. Although this is just below the 1997 level of about 21 percent of consumption, the decline is statistically insignificant and reflects normal variations in contraband estimates. However, preliminary data suggests that smuggling levels in the first five months of 1999 are rising to at least two-to-four percentage points higher than 1998 levels.

### The Previous Smuggling Boom

The United States experienced an earlier boom in cigarette smuggling in the 1970s.

Problems began to develop in the 1960s when differentials between state taxes widened significantly. Differentials in state taxes back then ranged from zero in places like Virginia to a high of eight cents in Texas. Then a number of states began raising their taxes. By 1970, 28 states levied tobacco tax of 10 cents or more on each pack. Just five years later, 14 states levied taxes of 15 cents or more, 39 states had a tax of 10 cents or more. At the time, the ACIR estimated that the inter-state flash point was about 10 cents a pack, or \$1.00 a carton.<sup>10</sup>

State tax differentials made the illicit tobacco trade lucrative and organized criminals did not miss the opportunity. By 1975, it had become a major law enforcement concern and the smuggling boom continued into the early 1980s. It was so extensive that as Herman Lisnow, then Deputy Controller of Texas, told *Forbes* magazine in 1977:

*"Cigarette smuggling is probably the most lucrative crime in America today."<sup>11</sup>*

*Forbes* reported that this criminal sector grossed \$1.5 billion in 1976.

Some smuggling involved inter-state schemes. Traditional organized crime families bought cigarettes in low-tax states like Virginia, Kentucky and North

<sup>10</sup> Advisory Commission on Intergovernmental Relations, *Cigarette Tax Evasion: A Second Look* (Washington, D.C.: March 1985), p. 6.

<sup>11</sup> Herman Lisnow, "Cigarette Bootlegging: Who Says Crime Doesn't Pay?" *Forbes Magazine*, December 15, 1977.

Carolina and transported them to the heavily populated states of the Northeast, especially New York.

On the Mexican border, complex export frauds were in operation—some quite similar to certain schemes currently in operation at the California border. According to a 1985 report by the ACIR:

*"In some Mexican border communities, the smuggling of cigarettes, alcoholic beverages and luxury items purchased from duty-free stores and smuggled back into the United States is a constant source of friction between customs and retail merchants."<sup>12</sup>*

State tobacco tax increases in the 1960s and early 1970s made the illicit trade in tobacco lucrative. But organized smuggling began declining in the early 1980s because profit margins were being eroded. Taxes remained relatively stable, while at the same time, inflation was soaring, effectively reducing the impact of taxes on consumer demand and, by extension, on the real value of the smugglers' earnings.

On the expense side, rocketing oil prices drove up transportation costs, helping to further erode the profitability of smuggling cigarettes.<sup>13</sup> In 1985, ACIR estimated the inter-state flash point to be \$2.30 a carton.

This illegal trade ebbed until taxes began rising in the 1990s.

## Many Negative Consequences

The rise in cigarette smuggling exerts a high cost on society. As cigarette smuggling expands, so do its attendant problems of organized crime, street crime, violence, government revenue loss, corruption of individual consumers and business, and increased pressure on law enforcement and justice system resources.

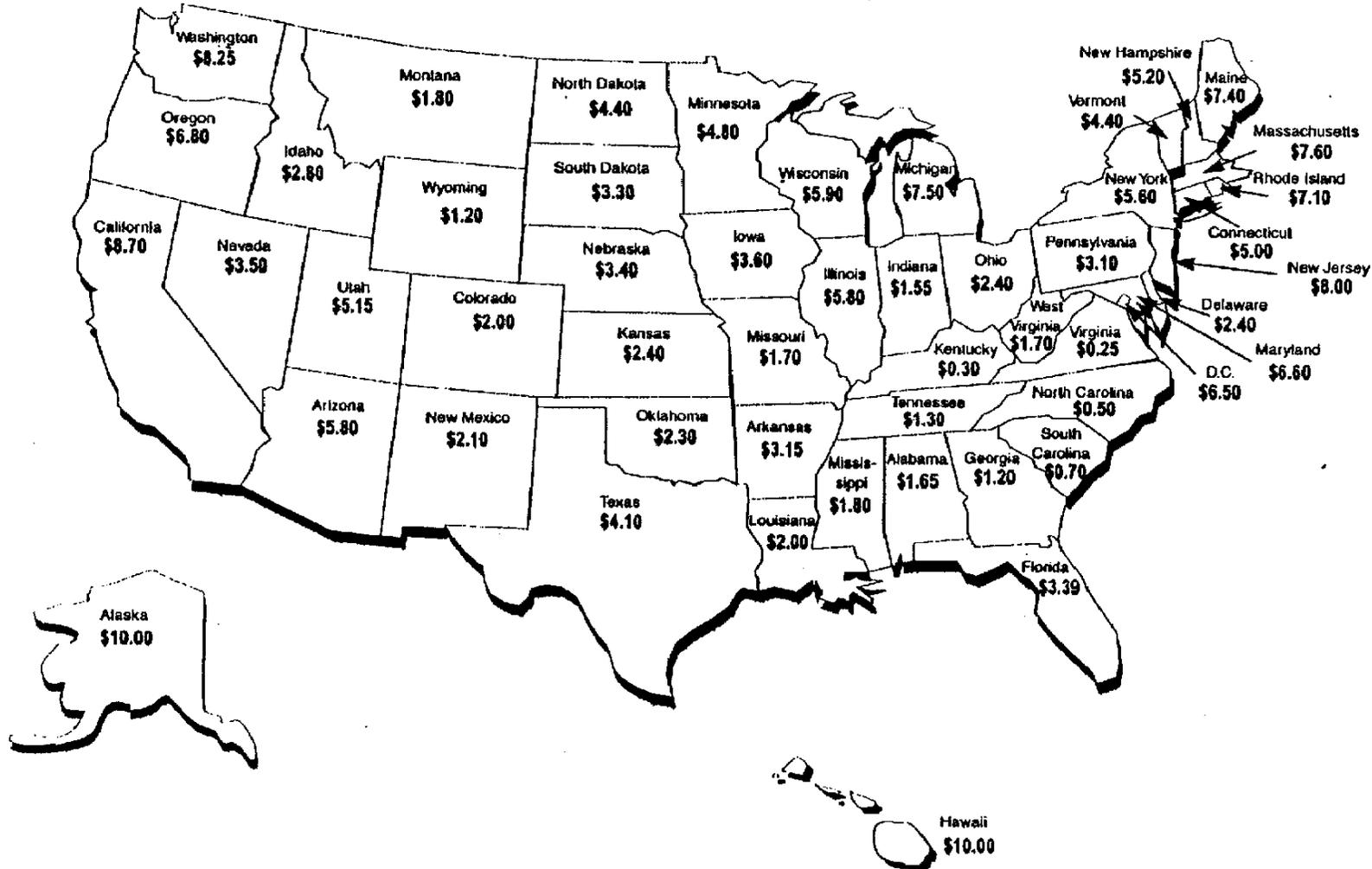
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<sup>12</sup> ACIR, *Cigarette Tax Evasion*, p. 19.

<sup>13</sup> Kenneth E. Warner, "Cigarette Excise Taxation and Interstate Smuggling: An Assessment of Recent Activity," *National Tax Journal*, December, 1982.

- Figure 3 -

### STATE EXCISE TAX RATE PER CARTON<sup>(1)</sup> OF CIGARETTES (As of August 1st, 1999)



<sup>(1)</sup> A typical carton contains ten packages of twenty cigarettes.

SOURCE: *The Tax Burden of Tobacco, Volume 33, 1998, The Tobacco Institute.*

August 1999



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Warns John Magaw, Director of the Bureau of Alcohol, Tobacco and Firearms:

*"We are only too familiar with the chilling reality that anything connected with organized crime is also connected to murders, beatings, extortion, and on and on."*<sup>14</sup>

Concern is rising in California, for example, over organized armed robberies. Just two examples:

- In April 1999, four armed men robbed a warehouse in California of more than \$1 million in cigarettes. Gang members forced warehouse employees to load the cigarettes on to a 48-foot tractor-trailer. It had been stolen specifically for the heist.<sup>15</sup>
- In February, police in Glendale, California, arrested four other armed men planning a raid on a cigarette and liquor distribution warehouse.<sup>16</sup>

Such robberies bear the hallmarks of organized crime—for they require not only sophisticated capabilities to undertake them, but also an established infrastructure to funnel such large quantities of stolen cigarettes into the contraband market. They are also indicative of a maturing contraband market. As competition heats up among organized crime groups to more efficiently meet the demand in lucrative markets (like California), so does competition to become the lowest-cost supplier. By stealing cigarettes, the cheapest illicit source of supply, organized criminals can thus lower their costs and improve their profit margins.

Thefts at the retail level are such a rising worry among merchants in California that Charles Janigian, President of the California Association of Retail Tobacconists has been traveling across the state, warning members to improve their security measures.

His advice:

*"Batten down the hatches. Tighten the ship."*<sup>17</sup>

Similarly in Michigan, police report a rise in cigarette truck hijackings.<sup>18</sup>

<sup>14</sup> John Magaw, speech to the International Association of Chiefs of Police, Dublin, Ireland, May 10, 1999.

<sup>15</sup> "Police hunt suspects in big cigarette heist," *The Press-Enterprise*, April 3, 1999.

<sup>16</sup> "Officer foils planned 'hit' on warehouse," *Los Angeles Times*, February 7, 1999.

<sup>17</sup> "Cigarettes prices light up black market; Specialty stores report increased theft", *The Fresno Bee*, February 7, 1999.

Another major heist was reported in Chicago on December 24, 1998. A trailer loaded with \$1.3 million worth of cigarettes simply disappeared from a trailer repair company yard.<sup>19</sup>

Armed robberies are not the only negative societal impact of organized crime and cigarette smuggling.

Quite often the systems and networks moving cigarettes are also used to handle other profitable contraband. For example, there's a huge problem involving illegal immigrants and drugs being smuggled into the United States using routes in upper New York State first pioneered by cigarette smugglers in the early 1990s.<sup>20</sup>

For established organized crime groups, cigarette smuggling provides a low-risk source of cash flow that can be used to finance other, far more hazardous, activities.

It is also a boon for street gangs and other emerging criminal groups. Contraband tobacco provides them with the opportunity to become established—much as Prohibition allowed mobsters like Lucky Luciano and Meyer Lansky to take control of the American underworld.

A headline in the *Chicago Tribune* underscored this process: "Stolen smokes are funding a new brand of street thug". The article stated:

*"It's an old mob trade that's fallen into new hands: Stealing cigarettes to peddle on the black market. Chicago area law enforcement officials say while the days of Al Capone and his mobster pals might be over, the old trick of selling stolen cigarettes is still smoking. It's just moved into the hands of gang members, burglars or petty criminals ..."*<sup>21</sup>

<sup>18</sup> "Michigan battles cigarette smugglers: Big-time criminals haul truckloads of cheap cigarettes into state, costing millions in taxes," *The Detroit News*, July 8, 1999.

<sup>19</sup> \$1.3 million in Cigarettes Stolen, *Chicago Sun-Times*, January 23, 1999.

<sup>20</sup> "26 are arrested in drug smuggling network using Mohawk Reservation," *The New York Times*, June 9, 1999; "Invisible border promotes smuggling through St. Regis," *The Post-Standard*, December 28, 1998.

<sup>21</sup> "Stolen smokes are funding a new brand of street thug," *Chicago Tribune*, December 30, 1997.

Indeed, cigarette smuggling has, in itself, proved to be a useful training ground for two major international crime groups:

- In Colombia, the founders of the Medellin cartel had participated in cigarette smuggling before they turned to cocaine.<sup>22</sup>
- The Sicilian Mafia was smuggling cigarettes before it moved on to heroin. Indeed, there's strong evidence that the techniques and infrastructure used to traffic in heroin had their roots in the illegal cigarette trade.<sup>23</sup>

Cigarette smuggling often acts as a lynch pin, connecting otherwise law-abiding business persons with organized criminals. In New York City, for example, there have been reports of cigarette smugglers using intimidation to get their products "placed" with some retailers.

In areas where smuggling has taken root, contraband cigarettes are available from a variety of retail sources. Corner stores, gas stations, taverns and lunch wagons may carry dual inventories of legal and illegal cigarettes to conceal their illicit activities. There may also be street vendors, or itinerant sellers who sell cigarettes out of the trunks of their cars.

The effect of this unfair competition can be devastating. Cigarettes are an important retail product as they invite ancillary purchases of beer, wine and other items. For convenience stores, tobacco products are the single most important category of merchandise purchases.<sup>24</sup>

Retailers and wholesalers who dutifully remit their taxes can't compete against those selling the much cheaper, black market product.

In New York City, one wholesaler has seen his business drop by 70 percent in the past four years.

Some retailer are driven out of business by the unfair competition. For example, the Associated Food Dealers of Michigan estimates that, since the state tax was raised in 1994 from \$2.50 a carton to \$7.50, cigarette smuggling has played a significant role in pushing the rate of convenience store closings in the state to more than twice the national average.

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<sup>22</sup> Guy Gugliotta and Jeff Leen, *The Kings of Cocaine* (New York, 1993), p. 21.

<sup>23</sup> Claire Sterling, *Octopus: The Long Reach of the International Sicilian Mafia* (New York, 1990); Claire Sterling, *Thieves' World: The Threat of the New Global Network of Organized Crime* (New York, 1994).

<sup>24</sup> *Food and Beverage Report* (Southfield, Michigan; February 1995)

In a dynamic contraband market, some retailers may be forced by economic necessity to participate in this illegal activity:

In California, for example, state regulators set up a reverse sting operation in which corner stores were offered illegal cigarettes that they could resell. Officers conducting the operation indicated that at least 10 percent of merchants targeted in this operation were willing to engage in this facet of the illicit tobacco trade.

Law breaking can become habit forming. Once a small corner store begins selling untaxed cigarettes to compete, it is tempted to do the same with other products, such as untaxed alcohol. They also might go another step and fail to remit income and other taxes on sales of other products. Moreover, once in contact with their organized crime suppliers, they are vulnerable to getting caught up in other illegal activity.

As cigarette smuggling takes root, consumers may begin to become desensitized to illegal activities. They may get into the habit of breaking the law—much as some of their forebears did during Prohibition, when smuggling seemed relatively benign and bootleggers were viewed as being glamorous.

## Law Enforcement Challenge

In many parts of the United States, the incentive for organized crime to smuggle cigarettes is at a critically high level. As a result, the ability of the federal government and many state administrations to further increase tobacco taxes without either exacerbating an existing contraband problem—or creating a new one—is severely limited.

Cigarette smuggling is a demand-driven criminal activity. Trying to control it on the supply side—by seizing contraband shipments, arresting individual smugglers and attempting to limit smuggling opportunities through the imposition of expensive product tracking systems—can have only a limited impact. Smuggling will continue as long as it remains lucrative enough for organized crime to meet the contraband demand.

As Director Magaw has stated in Congressional testimony:

*“Question: ... is the economic incentive the key factor at creating that smuggling link or line?”*

*Mr. Magaw: It's really the only factor.*

*Question: It's the only factor?”*

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*Mr. Magaw: Yeah, once you take the funds and the money away, your problem goes away ...* <sup>25</sup>

Where there are sufficient incentives, demand for contraband cigarettes will overcome any supply-side controlling effort—much as occurred during Prohibition.

More evidence that enforcement alone cannot stop the smuggling is found in the illegal drug trade. Initiatives to stop the global trafficking of cocaine, for example, have reduced supplies temporarily but generally have failed. The New York Times has commented:

*"It is an indication of how little the flow of drugs have been disrupted over time that cocaine prices have remained stable and even dropped in the last 15 years."* <sup>26</sup>

A key problem in trying to control the contraband tobacco market from the supply-side is that there are so many sources of supply around the world. This is especially the case where international smuggling is concerned.

At the global level, there are huge quantities of cigarettes. Many are manufactured by more than 200 foreign-owned producers. Independent of the main international manufacturers, they are located in every corner of the globe, and supply about 57 percent of the world market. Many make local versions of international brands under license.

There is also a significant capacity in the Far East to produce counterfeit cigarettes. In Hong Kong, for example, authorities have seized 13 containers of counterfeit cigarettes in the first half of 1999 alone.<sup>27</sup> This development is particularly worrisome because it underlines an effort by organized crime to become vertically integrated—i.e. to control every level from the manufacturing to the distribution of contraband cigarettes.

There are also numerous (and highly competitive) primary distribution networks and channels. There is also a thriving secondary market—involving hundreds of brokers around the globe—that efficiently re-allocates excess inventories and end-of-shelf-life products.

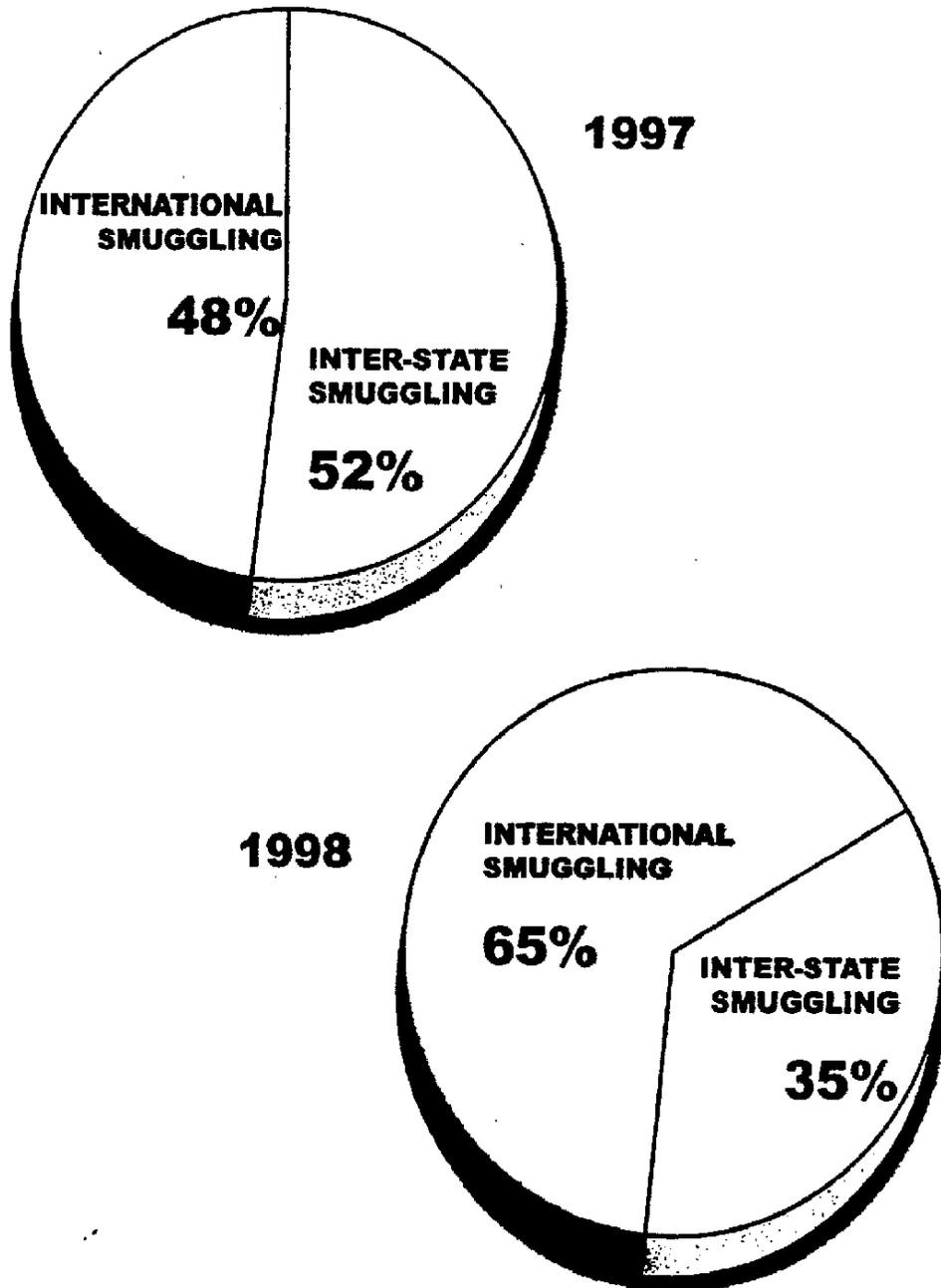
<sup>25</sup> Transcript of Testimony before the House Commerce Committee (December 9, 1997), p. 53.

<sup>26</sup> "With Alternations, Trade in Drugs Revives Route," *The New York Times*, May 31, 1998.

<sup>27</sup> "Smuggler's cash in SAR's good reputation," *The South China Morning Post*, August 5, 1999.

- Figure 4 -

**INTERNATIONAL<sup>(1)</sup> VS. INTER-STATE<sup>(2)</sup> SMUGGLING<sup>(3)</sup>**



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(1) International smuggling involves the evasion of federal and state taxes. These cigarettes are also not affected by the Tobacco Settlement price increase of \$4.50 a carton implemented in November 1998.

(2) Interstate smuggling involves the evasion of state tobacco taxes. Federal taxes are always paid on these cigarettes.

(3) See page 82 for an explanation of how international vs. inter-state quantifications are calculated.

The bottom-line: the international supply of cigarettes is so large that it can easily frustrate any supply-side initiatives.

Many countries around the world have learned the lesson that economic incentives to smuggle cigarettes can overcome supply-side control efforts.

Consider:

- In the European Union, it is estimated that 60 billion contraband cigarettes stream into the community each year.<sup>28</sup> Britain, Spain and Italy have serious smuggling problems that impact on daily life.
- In China, cigarette smugglers cost the government more than \$1 billion a year in revenues.<sup>29</sup>

There are two countries, however, where demand-driven solutions have proved effective.

Canada suffered through a massive contraband tobacco crisis in the early 1990s. At its height, FIA experts estimate that about 30 percent of all cigarettes consumed were untaxed. Canada attacked this problem in 1994 by lowering taxes and thus eliminating profit margins. The Auditor General of Canada, the Canadian equivalent of the General Accounting Office in Washington, has said:

*"Enforcement alone cannot eliminate evasion; it will continue as long as there is profit to be made."<sup>30</sup>*

Similarly in Sweden, which also cut taxes in 1998 to reduce criminal profits. Its Finance Minister, Erik Asbrink, said Sweden had to act:

*"If we remain passive, I am afraid the smugglers will take over more and more."<sup>31</sup>*

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<sup>28</sup> European Parliament, *Community Transit System*, Section 6.5.4.2.

<sup>29</sup> "Smugglers Stoke B.A.T.'s Cigarette Sales in China," *Wall Street Journal*, December 18, 1996.

<sup>30</sup> Auditor General of Canada, *1996 Annual Report*, Section 18.40.

<sup>31</sup> "Sweden Cuts Taxes on Tobacco to Curb Growth of Smuggling," *Financial Times of London*, April 15, 1998.

Significantly in the United States, some editorial voices are coming to a similar conclusion. As the Detroit News noted recently:

*"There is only one surefire solution: eliminate the profit from smuggling by reducing the excise tax."<sup>32</sup>*

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<sup>32</sup> "Chasing Smoke," *The Detroit News*, July 9, 1999.

## SECTION 3: CALIFORNIA

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*Estimate of Contraband Market in 1998: The equivalent of about 16 percent of consumption, or 260 million packages*

*Estimate of State Tax Losses in 1998: \$96 million*

*State Tax History: Raised from \$1.00 to \$3.50 a carton in 1989; from \$3.50 to \$3.70 a carton in 1994; from \$3.70 to \$8.70 a carton in 1999*

### Overview

California was already the single-largest contraband market in the United States. Now, the \$5.00-a-carton increase in the state tax (effective January 1, 1999) has combined with the \$4.50-a-carton Tobacco Settlement increase to worsen the situation.

The smuggling of cigarettes "has exploded," according to the Orange County Register. It added:

*"It's simple economics. Taxes are forcing dramatically higher prices on cigarettes as a way to discourage people from smoking them. But people still want them, so black markets and smuggling rings emerge to fulfill the demand.*

*The higher the taxes, the more profitable the smuggling, and the more willing people are to defy the law."<sup>33</sup>*

Brand-name cigarettes sell for about \$36-40 a carton (all taxes included) in Los Angeles. At duty-free stores at the Mexican border, the same brands may cost about \$12 a carton. The price difference is just too much for organized crime—let alone many consumers—to ignore.

Mexico remains a major source of contraband cigarettes. U.S. border officials report a large increase in seizures. In 1998, they made one or two seizures a month. But, during a single week in April 1999, agents made 10 cigarette seizures. U.S. Customs reports that cigarette seizures at the Mexican border were 14 percent higher during the first two-thirds of fiscal 1998-1999 than the entire

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<sup>33</sup> The Economics of Smuggling, *The Orange County Register*, May 2, 1999

previous fiscal year.<sup>34</sup> At retail, smuggled cigarettes may cost around \$25 a carton—\$11-\$15 less than the legal retail price.

There has also been a spate of cigarette thefts across the state. Stealing cigarettes is the cheapest way of obtaining untaxed cigarettes for the burgeoning contraband market. A truckload of stolen cigarettes is virtually pure profit, minus the expenses of the theft and distribution.

In April 1999, four armed men robbed a Corona warehouse of more than \$1 million in cigarettes. The gang, carrying handguns, tied up most of the 15 warehouse employees. They got others to drive forklifts for loading the cigarettes onto a 48-foot tractor-trailer. The tractor-trailer had been stolen specifically for the heist. The truck was later found abandoned on a street in Long Beach. The cigarettes disappeared into the Los Angeles contraband tobacco market.<sup>35</sup>

Some other examples:

- In June, a tractor-trailer carrying \$100,000 worth of cigarettes was stolen after the cargo was picked up at the Port of Long Beach.<sup>36</sup>
- In May, a grocery store clerk in Los Angeles was arrested while loading 149 cartons from the store into his car. About \$170,000 worth of cigarettes had gone missing at that store in recent months.<sup>37</sup>
- In February, police in Glendale arrested four armed men planning a raid on a cigarette and liquor distribution warehouse. The men were armed with loaded rifles and "cop killer" bullets.<sup>38</sup>
- In early January, cigarette thieves broke into a specialty cigarette vendor in Fresno in early January. They stole \$3,100 worth of cigarettes and returned a week later for more.<sup>39</sup>
- In Alameda, two specialty cigarette stores were raided 10 times in December 1998.

<sup>34</sup> "Customs Reports Rise in Cigarette Smuggling," *San Diego Union-Tribune*, June 22, 1999.

<sup>35</sup> "Police hunt suspects in big cigarette heist," *The Press-Enterprise*, April 3, 1999.

<sup>36</sup> "Truck with \$100,000 in cigarettes stolen," *Press-Telegram*, June 23, 1999.

<sup>37</sup> "Police arrest clerk in cigarette pilfering," *Los Angeles Daily News*, May 1, 1999.

<sup>38</sup> "Officer foils planned 'hit' on warehouse", *Los Angeles Times*, February 7, 1999.

<sup>39</sup> "Cigarette prices light up black market", *Fresno Bee*, February 7, 1999.

Charles Janigan, president of the California Association of Retail Tobacconists, has been traveling the state warning retailers to protect themselves with improved security systems.<sup>40</sup>

The market for stolen or smuggled cigarettes is ready and willing. Law enforcement officers conducting a reverse sting operation said that at least 10 percent of merchants that they targeted were willing to buy stolen cigarettes for resale in their establishments. The retailers, mom-and-pop stores, were offered what they thought were stolen cigarettes for about \$7.25 a carton.

Stolen cigarettes are also being sold in school yards. In one instance, a group of teens stole five cartons from a store. They sold the packs for about \$1 each in nearby school yards and recreation centers. Some of their young customers then broke the packages down and sold individual cigarettes.

### **Stimulating Organized Crime**

The rise in cigarette smuggling is helping low-level aspiring criminals to get organized. According to one law enforcement expert:

*"At the lower end, if a couple of newly-arrived guys get together and do a cigarette heist or bring in a load (of smuggled cigarettes) they can either go door to door and make a few bucks, or they can use the product as a kind of calling card, to show their skill, taking it to an established player. By selling a load in one piece they make less money, initially, but they form the link to the established group.*

*"Along the way they'll ask advice and guidance and pay a tribute. By itself the tribute is nothing, really. Maybe 500 bucks, which is breakfast money to a player.*

*"But two things happen here: one, the established group, like a legitimate company, gets access to more profits and grows a larger work force. Two, the new guys get some criminal legitimacy and contracts and access to seed money to grow their own business. They'll get fronted, say \$15,000 to go down to Mexico and bring in a load of cigarettes or some other cheap product; they then share their profits to pay back the seed money, and then some.*

<sup>40</sup> "Cigarette prices light up black market", *Fresno Bee*, February 7, 1999.

*"All of a sudden they aren't freelance criminal entrepreneurs, they're just part of a group that increases its power. It's like a twister that grows larger and larger as it picks up houses and trees and cars. It also becomes more dangerous."*

Cigarette smuggling also has a wider impact in corrupting ordinary citizens and young people. Stated one law enforcement officer:

*"We're making mafias where there shouldn't be mafias. Whether Mexican, or Russian or Asian. School kids who get a hold of a carton break them down in solos or individual packages and makes 15 or 25 bucks. Old folks in trailer parks who stuff the headliner with a dozen extra cartons from Mexico and sell them to other old folks from the back of the camper van."*

## Smuggling Techniques

The history of the cigarette contraband market in California began in the early 1990s following a \$2.50 a carton tax increase on January 1, 1989 to \$3.50 a carton. The state tax was increased in 1994 to \$3.70 a carton.

Mexican brands were the main smuggled product in the beginning. The Board of Equalization, the state's tax administrative agency, has noted:

*"The California Board of Equalization began investigating cigarette and tobacco product fraud cases in 1989 after a voter approved initiative increased the State excise tax on cigarettes from 10 to 35 cents per package of 20 cigarettes. During the early 1990s, Board of Equalization cigarette and tobacco fraud cases primarily focused on Mexican brand name cigarettes which were smuggled from Mexico and traded in California's underground economy."<sup>41</sup>*

That was only a beginning, and since then California has seen a wide diversity of cigarette smuggling techniques. It also has seen the involvement of organized crime grow.

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<sup>41</sup> California Board of Equalization, *Catalog of Contraband Cigarette and Tobacco Products*, August 1997.

According to the Board of Equalization:

*"Since January 1990, the infrastructure for smuggling cigarettes and tobacco products has flourished ... California's underground economy now trades in cigarettes and tobacco products which are smuggled in from all over the world."<sup>42</sup>*

Mexican officials also have acknowledged an increase of cigarette smuggling from their country since the taxes began to rise.

*"An official of the Mexican Embassy in Washington, D.C., also told us that the Mexican government has recently become aware of cigarette smuggling occurring between the United States and Mexico. Although his government did not have data on the extent of this activity, he believes it is increasing. He told us that cigarettes are being brought into Mexico and then being smuggled back into the United States."<sup>43</sup>*

The schemes used to smuggle cigarettes into California can be quite complex.

One method involves purchasing cigarettes at duty-free stores near the Mexican border. These cigarettes are manufactured in the U.S. and are intended for foreign markets. They are commonly called "Export Only" cigarettes and bear the following label:

*"U.S. tax exempt  
For Use  
Outside U.S."*

In some cases, these cigarettes never physically leave the United States. In others, they are transported into Mexico and then smuggled back using techniques such as:

- Co-mingling the smuggled cigarettes with other commercial truck loads;
- Concealing them in hidden compartments of vans; or

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<sup>42</sup> California Board of Equalization, *Catalog*, August 1997.

<sup>43</sup> General Accounting Office, *Tobacco: Issues Surrounding a National Tobacco Settlement* (Washington; April 1998), p. 37.

- Hiding them in old vehicles whose loss to seizure could easily be absorbed.

Specialized organized crime groups control the Mexican border cigarette trade. These are groups that control the smuggling routes, which are also used for drugs, and illegal aliens. They often hire drivers, known as mules, who transport shipments of illegal cigarettes for a small fee. In one case, a mule stated that he was paid \$50 to drive a car containing about 280 cartons of smuggled cigarettes from the Mexican border to Los Angeles.

According to the General Accounting Office:

*" ... officials from the Bureau of Alcohol, Tobacco and Firearms told us that such international smuggling activity is widespread, and they suspect the main source of the cigarettes is duty-free shops located along the [Mexican] border. They stated that instead of permanently leaving the United States through the export market, cigarettes are diverted mostly back to the Los Angeles area, where they are sold on the black market."*<sup>44</sup>

Sometimes shipments of American-made cigarettes intended for foreign markets never leave the U.S. Paperwork is falsified to make it look like the cigarettes have been exported. In other cases, they are simply smuggled back after brief journeys.

State experts note that some shipments are:

*"either re-routed back from a free-trade zone such as Panama, Antwerp, Cyprus or Hong Kong, or are falsely manifested and never leave the country. Free trade zones enable products, such as cigarettes, to enter and leave their ports without the payment of duty."*<sup>45</sup>

Cigarettes smuggled from Mexico may also include local brands and premium American brands licensed for manufacture in Mexico. Packaging on the Mexican-produced U.S. brands is virtually indistinguishable from the American variety, except for the marking "Heche En Mexico" (Made in Mexico).

<sup>44</sup> General Accounting Office, *Tobacco*, p. 36.

<sup>45</sup> California Board of Equalization, *Catalog*, August 1997.

## SECTION 4: NEW YORK STATE

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*Estimate of Contraband Market in 1998: The equivalent of about 20 percent of consumption, or 236 million packages*

*Estimate of State Tax Losses in 1998: \$132 million*

*State Tax History: Raised from \$2.10 to \$3.30 a carton in 1989; from \$3.30 to \$3.90 a carton in 1990; and from \$3.90 to \$5.60 a carton in 1993*

### Overview

Using a 700-pound printing press and a home computer, the 44-year-old man was reputedly the no. 1 counterfeiter of tax stamps in New York City. He allegedly produced millions of high-quality stamps that he sold to smugglers for about four cents apiece—until, that is, he was arrested in June 1998. Indeed, authorities found fake stamps worth \$1.4 million at his house.<sup>46</sup>

Yet, the arrest did little to stem the growing use of counterfeit stamps in New York City. In the last year alone, at least seven counterfeit operations have been broken up by law enforcement. Two large ones were shut down by law enforcement in March 1999 alone. Law enforcement officials estimated the two operations were handling \$250,000 in contraband cigarettes every week.

New York City remains a key contraband market in the state. On top of the state tax of \$5.60 a carton, it adds \$2.20 a carton of its own local taxes, thus creating a total potential profit margin of \$7.80 a carton. On the legal retail market, consumers may pay as much as \$33 a carton (all taxes included) in New York City. By contrast, cigarettes may retail in the range of \$20-\$25 a carton on the contraband market.

A variety of established and emerging organized criminals are involved in meeting the demand in New York City.

In Asian communities, organized crime keeps a tight control over the sale of contraband cigarettes. Independent vendors are required to pay a percentage to the locally dominant group, or face the consequences.

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<sup>46</sup> "Smoked out in Cig-Tax Scam," *New York Daily News*, June 4, 1998.

Major Asian smugglers will use street runners to deliver 50 to 100 cartons a day to factories, barber shops, tea rooms and other places where people congregate. A street runner, for example, may deliver, on behalf of his boss, two or three shopping bags full of cigarettes to a retail outlet at least twice a day, three or four times a week. He may also retail about 100 cartons a week on his own. By some estimates, about 50 percent of cigarettes handled by Asian organized criminals are of the "for export only" variety.

Eastern European crime groups are also involved. They are typically hierarchical in structure, headed by "a man of influence" who will assign the "franchise" to supply black market cigarettes to a particular section of New York City. The threat of violence is used to keep out competitors.

Some traditional organized crime figures also participate in this illegal activity. A member of one crime family was distributing 4,000 to 5,000 cartons a month through his distribution channels. His purchase price was about \$15 a carton, and his customers paying about \$25. His estimated profit: \$40,000 to \$50,000 a month.

In the past year, some organized criminals rooted in Hispanic communities have become significantly larger players in the contraband market. They have access to very high-quality counterfeit stamps.

Cigarette smugglers may also be involved in other criminal activities, including the handling of stolen automobiles, narcotics, illegal guns, contraband alcohol and forged documents.

## Sources of Supply

Crime groups obtain their supplies from a variety of sources, including low-tax states, some Indian smoke shops, export diversions and vendors of stolen cigarettes. With the increase in counterfeit stamp activity, there has been an increase in demand for un-stamped cigarettes.

Smugglers frequently travel to a low-tax state like Virginia or North Carolina, pick up a typical load of about 1,000 cartons, and then drive them into New York State. According to Bruce Knowlton of the Virginia Alcoholic Beverage Control:

*"The average smuggler will do three loads a week."<sup>47</sup>*

<sup>47</sup> "Multistate probe of contraband yields indictments," *Richmond Times-Dispatch*, April 24, 1997.

Consider how one such large-scale operation worked:

Unlicensed persons borrowed permits from licensed Virginia retailers, then bought tax-free cigarettes from wholesalers.

Distribution points were established where couriers, known as runners or mules, took delivery of the illegal cigarettes. They were given lists of buyers in New York, Pennsylvania and Maryland, plus advice on the best routes to avoid detection. Loads were often broken down into smaller loads to escape detection.

Some other schemes are less elaborate. Certain smugglers will drive from one retailer to another in Virginia and North Carolina buying 299 cartons at a time to stay within federal laws. One group is known to have bought 6,000 cartons from one outlet in Virginia over the period of one month. Once acquired, the trail of the cigarettes is similar. They are hidden in warehouses, hotel rooms or apartments, and then transported north to New York.

Large smuggling groups often use local agents in a low-tax state to get storage space and to accumulate loads. The typical charge for this is \$1 a carton. Runners then use rental vans, with all but the front seats removed, to move the cigarettes into New York City. Cigarettes are loaded, then covered with blankets. Sometimes luggage is placed on top to make it look as if the driver is moving.

High taxes also continue to offer smugglers in upper New York State profit-making opportunities too rich to ignore. In Rochester, the owner of a local importer was charged in July 1998 after 4,414 cartons of untaxed cigarettes and 826 counterfeit stamps were seized. And in Buffalo, an individual linked to a major traditional organized crime family was fined in October 1998 for possession for sale of untaxed cigarettes.

The Internet is also a source of supply for consumers, who can save about \$10 a carton on each purchase.

### **The Threat of Counterfeit Stamps**

Counterfeiting has become so pervasive that fake stamps are used like currency. There are cases where some smugglers pay for cigarettes with counterfeit tax stamps.

The popularity of counterfeit stamps is understandable. It reduces the risk of detection—both by law enforcement and consumers. With the presence of a counterfeit stamp, cigarette smokers may be less aware they are buying black market product. That increases profits because the smoker does not receive a discount since he believes he's buying legal product.

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Counterfeiters in New York City have also been supplying retail businesses in neighboring New Jersey. Some have also gone further afield. In a case last year, a criminal was arrested with counterfeit Massachusetts stamps.

Using readily available computer technology, most of the stamps are made in the United States. Some, however, are imported. In one case, about 150,000 counterfeit stamps produced in Turkey were seized.

The technical quality of current counterfeit stamps is excellent. Some suppliers even offer a lower-priced adhesive stamp of superior quality.

Counterfeiters who produce counterfeit stamps may also be involved in making fake vehicle registrations, social security cards, drivers' licenses, immigration forms and checks. The key to the work is high-quality computer equipment and software. The counterfeiters are so sophisticated that they change the stamp number whenever they feel the tax department is on the lookout for a particular number.

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## SECTION 5: MICHIGAN

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*Estimate of Contraband Market in 1998: The equivalent of about 20 percent of consumption, or 156 million packages*

*Estimate of State Tax Losses in 1998: \$117 million*

*State Tax History: Raised from \$2.50 to \$7.50 a carton in 1994. Starting in May 1998, wholesalers could only sell stamped cigarettes to retailers. Starting in September 1998, retailers could only sell stamped cigarettes to consumers.*

### Overview

As a result of Michigan's introduction of tax stamps on cigarettes in 1998, FIA estimates that the state's contraband market decreased to the equivalent of about 20 percent of consumption in 1998, down from about the equivalent of 28 percent in 1997.

However, preliminary data suggests that smuggling in the first five months of 1999 may be starting to rise towards 1997 levels, as organized crime adjusts to the introduction of tax stamps by using counterfeit stamps.

Indeed, one law enforcement official says Detroit is "swamped" with counterfeit stamps. In the process, organized crime is increasing its dominance of the contraband market. According to the Detroit News:

*"The cigarette tax stamp has all but eliminated small-time smugglers, but organized criminals are producing fake stamps with home computers or stealing authentic stamps and ironing them on to contraband packages of cigarettes in basement labs."<sup>48</sup>*

The contraband market is dominated by organized crime groups with elaborate transportation and distribution networks. Like traditional organized crime, they tend to be hierarchical in nature with different levels of responsibility and authority.

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<sup>48</sup> "Michigan Battles Cigarette Smugglers: Big-time criminals haul truckloads of cheap cigarettes into state, costing millions in taxes," *Detroit News*, July 8, 1999

At the bottom are the runners, who drive loads into Michigan. A runner may be paid about \$500 per trip and can make two to three trips a week. An ambitious runner can also work his way up the organization. In some cases, they may break off and start their own group. In such cases, they will typically retain their ties to their original group.

With regards to the advent of counterfeit stamps, some organized crime groups appear to have undertaken an efficient division of labor. Some groups bring in the cigarettes; others handle the counterfeit stamps.

There is also a hot market for stolen tax stamps. In June 1999, for example, police confiscated more than 150,000 cigarette packs marked with stolen stamps.<sup>49</sup>

### **Started With Tax Increases**

Michigan's tobacco problems began in 1994 with a huge tax increase that ran the state tax on a carton from \$2.50 to \$7.50.

Retail prices of premium brands in Detroit range between \$30-\$37 a carton. A duty-free shop at the Canadian border will sell the same cigarettes for \$15 a carton.

This disparity has produced a golden opportunity for cigarette smugglers. They were able to run cigarettes from lower-tax states like Kentucky or North Carolina. The case of a major smuggler gives a clear example of the profits to be had. He was caught selling 240,000 cartons of contraband cigarettes obtained in Kentucky to Detroit-area retailers and was ordered by the courts to pay \$1 million in back taxes.<sup>50</sup>

Indian reservation smoke shops in western New York State continue to be an important source of supply for Michigan. Numerous Michigan residents have been arrested driving loads of illegal smokes obtained there. The route along Interstate 90 from western New York to the Ohio-Michigan border is a quick and easy one.

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<sup>49</sup> "Michigan Battles Cigarette Smugglers"

<sup>50</sup> "Cigarette bust boosts state's coffers," *Detroit Free Press*, January 12, 1999

No number of police officers could stop all the vehicles hauling contraband along the route. The only way to stop the Interstate smuggling, says one Indiana State trooper, is to stop and search every vehicle.

Hijackings of trucks carrying cigarettes are a growing concern. The heists are not of a random nature. According to a law enforcement expert:

*"It's organized. Someone is watching patterns of drops and someone is getting together a group of individuals to make the hit."*<sup>51</sup>

Some illustrative snapshots:

- In August 1999, a major wholesaler reported that insurance premiums have soared and he has been forced to post guards on all his delivery trucks.
- In June 1999, two armed men hijacked a delivery van in suburban Detroit and stole \$70,000 worth of cigarettes.
- In May 1999, four men robbed a truck distributing cigarettes at a major convenience store in suburban Detroit. The driver was assaulted during the robbery.

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<sup>51</sup> "Michigan Battles Cigarette Smugglers"

## SECTION 6: WASHINGTON STATE

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*Estimate of Contraband Market in 1998: The equivalent of about 19 percent of consumption, or 59 million packages*

*Estimate of Current State Tax Losses: \$48 million*

*State Tax History: Raised from \$3.10 to 3.40 a carton in 1986; \$3.40 to \$5.40 in 1993; from \$5.40 to \$5.65 in 1994; from \$5.65 to \$8.15 in 1995; and from \$8.15 to \$8.25 in 1996*

### Overview

On November 21, 1998, law enforcement officers in eastern Washington State stopped a 53-foot tractor-trailer just after it crossed the state border. Inside, they found nearly 30,000 cartons of untaxed cigarettes—the largest seizure in the state's history. They had been smuggled from Arizona. The estimated state tax revenue loss: about \$247,000.

The tractor-trailer was believed by state authorities to be heading to some Indian smoke shops in the state's interior. Law enforcement believes that more than 60 percent of contraband cigarettes consumed in Washington are sold through such outlets.

Tribal members are allowed to buy cigarettes for personal use on the reservation without paying the state tax of \$8.25 a carton. However, any Indian smoke shop selling to non-tribal members is supposed to charge state tax. State officials believe that a number of Indian retailers do not collect the state tax. Some Indian smoke shops also sell over the Internet in "virtual smoke shops" and through toll-free telephone order numbers. They ship tax-free cigarettes anywhere in the United States.

Law enforcement is making a concerted effort to tackle the state's contraband problem. Consider the following initiatives:

- In January 1999, Liquor Control Board agents seized 7,000 cartons of cigarettes from a grocery store on the Yakima reservation. Officials say the seized cigarettes lacked tax stamps and were being sold over

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the Internet to customers in Alaska, where the cigarette tax is \$1 a pack.<sup>52</sup>

- In April, agents confiscated more than 1,400 cartons of cigarettes from a smoke shop on Indian land at Tacoma, Wash., saying the owner had neither a business license nor one to sell tobacco.

These kinds of major investigative operations are resource intensive. The aforementioned case involving the seizure of 30,000 cartons, for example, required four months of surveillance and investigation. Stated a Liquor Control Board member:

“That has been a costly effort. And it takes a lot of time.”<sup>53</sup>

However, as has occurred in other jurisdictions, these supply-side initiatives—though well-intentioned—have failed to end the cigarette smuggling problem.

In Washington State, as in other smuggling hot spots, the demand for cheaper cigarettes—and the incentive to organized crime to meet that need—can readily frustrate such supply-side efforts.

Smugglers once relied on hollowed-out campers and pick-up trucks to bring in cigarettes from low-tax states. But there is evidence of more tractor-trailers—like the one seized in November 1998—being used for big hauls.

Smugglers are also employing complex schemes to tap into international sources of supply. State agents have also confiscated quantities of a brand of cigarettes that had been shipped from the People’s Republic of China via Hong Kong. As John Hough, the State’s Senior Assistant Attorney General, has told a Senate Committee:

“Washington State ... is beginning to see significant smuggling of cigarettes manufactured in China. These smuggled cigarettes are usually more potent than American brands.”<sup>54</sup>

Smugglers are also acquiring cigarettes through outlets that supply ships and other customers with duty-free cigarettes and other goods.

<sup>52</sup> Associated Press report, July 11, 1999.

<sup>53</sup> “Cigarette seizures too little to light up lawmakers,” *The News Tribune*, June 24, 1999.

<sup>54</sup> Hearings Before the Senate Committee on the Judiciary, April 30, 1998.

In one case, dozens of cases of cigarettes were sold to a fishing vessel with a small crew. When the ship returned to port after a few days at sea, all the cigarettes were gone. In another, a large quantity of cigarettes intended for export were delivered to a vessel in dry dock.

Law enforcement has found crew members of foreign-registered ships and visitors either in possession of untaxed cigarettes—or in the process of unloading them from the ship without declaring them.

Contraband cigarettes have also been sold in corner stores and out of the trunks of cars.

Some drug abusers sell stolen cigarettes to drug dealers for about \$10 a carton. The drug dealers, in turn, sell the cigarettes to itinerant street vendors.

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## SECTION 7: OTHER STATES

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### Texas

In 1998, FIA estimates that about 141 million packs of contraband cigarettes—or the equivalent of about 10 percent of consumption—were consumed in Texas. That represents an estimated state tax loss of about \$58 million.

Mexico continues to be a source of contraband cigarettes consumed in Texas. Says Joe Ratcliff of the Texas Association of Wholesale Distributors:

*"People will look for ways to reduce the costs of cigarettes as the price escalates up. You can go out-of-state and save five dollars a carton; you buy in Mexico and it's more like \$10."*

According to law enforcement, there is growing demand for cheaper, smuggled cigarettes. Stated one official:

*"There isn't a street in the city—any city—where I can't take a trunk-load of cigarettes and sell them in a day. Not as much profit as dope, but low risk, good return and a stable market."*

Contraband cigarettes bought in neighboring states are a problem in northern Texas, near the Oklahoma border. Texas has a \$4.10-a-carton state tax compared with \$2.30 in Oklahoma, \$2 in Louisiana and \$3.15 in Arkansas.

### Florida

In 1998, FIA estimates that about 123 million packs of contraband cigarettes—or the equivalent of about nine percent of consumption—were consumed in Florida. That represents an estimated state tax loss of about \$42 million.

Law enforcement sources say Russian organized crime groups have a well-beaten path between Florida and the northeastern states. This pipeline is used to move cigarettes, liquor, cocaine and other illegal cargoes.

One Russian crime group had been buying stolen cigarettes in Miami and shipping them by truck to a related group in New York City. Police intercepted one shipment in Georgia, another in New Jersey. The cigarette smuggling blended in with the Miami-based group's other illegal activities: supplying

imported Russian prostitutes, cloning cellular telephones, passing counterfeit currency, selling steroids and smuggling liquor.

## **New Jersey**

FIA estimates that the equivalent of about 9.6 percent of consumption—or about 53 million packs—was contraband in 1998 in New Jersey, representing annual revenue losses of about \$42 million. It is important to note that 1998 was the first year of the state's tax increase—from \$4.00 a carton to \$8.00. The 1998 estimate is comparatively low—in view of the high state tax—because in late 1997 wholesalers, retailers and consumers built up their inventories in anticipation of the increase. Those stocks were drawn down in early 1998, temporarily postponing the onset of the consumer demand for cheaper, smuggled product.

New Jersey is being hit hard by counterfeiters. Perhaps the most unusual seizure occurred in December 1998 when 86,000 counterfeit New Jersey stamps were seized in Texas after coming across the Mexico border. The stamps were in a brightly wrapped gift package that the smuggler said contained pajamas.<sup>55</sup>

Law enforcement reports that many types of foreign-made cigarettes have been found, including product from Canada and the United Kingdom.

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<sup>55</sup> "Smuggling fake cigarette tax stamps alleged," *San Antonio Express-News*, December 1, 1998.

## **SECTION 8: THE GRAY MARKET IN CIGARETTES**

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### **Overview**

State tax increases and the Tobacco Settlement price rise are not just stimulating the contraband market. They are also spurring the gray market in cigarettes.

Gray market cigarettes are produced in the United States and exported to foreign markets. Independent brokers purchase them abroad and re-import them into the U.S. They benefit from the difference between domestic and international wholesale prices.

Currently, as long as all applicable taxes are paid, labeling requirements met, and no trademarks infringed, gray market cigarettes are legal—unless they are also outlawed by the rising number of state anti-gray market laws.

The gray market in cigarettes has raised numerous concerns about its negative consequences. The most important is its vulnerability to being manipulated by the organized criminals who dominate in cigarette smuggling. This is because the gray market tends to be less tightly regulated than the domestic system used to distribute cigarettes.

Florida is a hot spot for the gray market. Some estimates suggest that 3.37 million packs of gray market cigarettes are sold there each month.<sup>56</sup> The situation is especially acute in Miami-Dade County, where a July 1999 survey—commissioned by the National Coalition Against Crime and Tobacco Contraband—found that 51 percent of the 288 locations surveyed sold gray market cigarettes.

California is another area of intensive gray market activity. According to one state official, a preliminary review of tax stamp sales suggests that about 18 percent of the California market may be served by the gray sector.

Gray market sales also have been reported in numerous other states including Texas, New York, Ohio, Kentucky, Indiana, Oklahoma, Louisiana and Michigan.

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<sup>56</sup> Sun-Sentinel, *Florida losing millions to 'gray market' cigarette sales*, March 3, 1999.

Besides the vulnerability to the contraband market, there are many other concerns with regards to gray market cigarettes, including the fact that they:

- Reduce states' revenues under the Tobacco Settlement, as payments under the Settlement framework are calculated on the basis of the domestic sales of manufacturers;
- Create unfair competition for domestic wholesalers and retailers who charge higher prices as a result of the Tobacco Settlement and other factors;
- Undermine qualitative product standards, like freshness. Concerns have been raised about the manner in which cigarettes outside normal distribution channels are handled;
- Sow confusion among consumers because gray market cigarettes are often different from the versions consumed in the United States. Cigarettes are blended to meet the different taste requirements of individual markets; and
- Often carry warning labels that are different from the federally required Surgeon General's messages which are rotated through a rigorously pre-determined cycle. In some cases, gray market wholesalers have attempted to affix their own Surgeon General's warnings, but these are of concern to manufacturers because they affect the overall presentation quality of the packaging.

The gray market problem has become so significant that various initiatives are being undertaken to address the issue. These include:

- New federal regulations—as enacted through the Balanced Budget Act of 1997—that will take effect in the year 2000. They will make it illegal to import "for export only" cigarettes and introduce them directly into the domestic U.S. market—regardless of whether all the applicable taxes have been paid, and labeling requirements met. Under the proposed new regulations, "for export only" cigarettes re-entering the United States must either go to a manufacturer—or be re-exported.
- More than 20 states, including California, Michigan, Washington and Wyoming, either have enacted, or are in the process of enacting, state laws against gray market cigarettes.
- Major manufacturers have either filed lawsuits, or are contemplating doing so, against retailers and/or wholesalers who handle gray market cigarettes. The lawsuits filed to date allege trademark infringement, unfair competition, trademark dilution and unlawful importation.

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It is important to note that these supply-side initiatives will not affect the underlying demand for cheaper cigarettes. Indeed, to the extent that these initiatives are successful, law enforcement experts believe that much of this demand will simply shift to the contraband market.

## Black Market Vulnerability

The current system under which gray market cigarettes are imported, distributed and sold is far less regulated than the domestic distribution system. Moreover, it does not yield the kind of comprehensive audit trail that ensures compliance in the domestic distribution system. The result: The gray market is much more vulnerable to black market diversion.

Take California, for example. As a background document on the state's gray market law by the Board of Equalization, the state's tax administrative agency, indicated:

*" ... 'export only' cigarettes comprise the vast majority of smuggled cigarettes because those cigarettes are not subject to the same reporting and tracking requirements of cigarettes shipped within the United States."<sup>57</sup>*

This disparity among the two types of regulatory regimes creates a tremendous opportunity for cigarette smuggling. Consequently, this is an area of investigative interest for Bureau of Alcohol, Tobacco and Firearms. As ATF Director John Magaw has confirmed in a statement to a Congressional Subcommittee:

*"ATF is currently exploring allegations that some U.S. taxes are not being paid upon re-entry."<sup>58</sup>*

Further, according to the aforementioned California Board of Equalization background document:

*" ... recent Board staff investigations have revealed that not all 'export only' cigarettes cleared through licensed distributors have been properly cleared and stamped. The Excise Tax Division is*

<sup>57</sup> California State Board of Equalization, *Background Document: Senate Bill 2134 (Burton) Chapter 292*, 1998. This document is located at <http://www.boe.ca.gov/legdiv/sptleg/sb2134.htm>.

<sup>58</sup> John Magaw, Testimony before the Subcommittee of the Committee on Appropriations, House of Representatives, February 23, 1999.

*beginning to see signs of increased smuggling of these types of cigarettes through licensed distributors ...*<sup>59</sup>

The domestic distribution system is extremely tightly regulated. The federal tax is paid at the manufacturer's level. Then, when cigarettes are shipped to licensed warehouse in a particular state, the manufacturer sends a copy of the documentation to state tax officials. They can then attend at the warehouse to ensure that the amount of tax stamps purchased by the wholesaler match the amount he's receiving from the manufacturer.

When gray market cigarettes enter the United States, the importer/wholesaler is supposed to file the appropriate federal document and pay federal cigarette taxes. After clearing U.S. Customs, these cigarettes move from a bonded to a non-bonded warehouse where the importer is either supposed to affix the tax stamps of the local jurisdiction or ship them to another state where, in theory at least, the local wholesaler is supposed to affix the local tax stamps of the second state. It is important to note that the Customs clearance procedure does not entail the type of comprehensive audits undertaken by federal authorities at all domestically licensed manufacturers.

For state officials, it is very difficult to track those gray market cigarettes. Take the example of Florida. According to Florida Tax Watch:

*"The Florida Department of Business and Professional Regulation's Division of Beverages and Tobacco ('DABT') has limited ability to monitor gray market transactions since they occur outside the state's jurisdiction.*

*"In normal cigarette distribution, the product is invoiced directly from the manufacturer to the Florida wholesale distributor and a copy of the invoice goes to the DABT. At that point, the DABT knows how many un-stamped cigarettes are in possession of the Florida wholesaler. Each year, the state audits every wholesaler to reconcile the number of cigarettes handled with the number of tax stamps purchased. By contrast, the state has no knowledge of the quantity of cigarettes in a gray market operation and thus does not know how many state tax stamps the wholesaler should be*

<sup>59</sup> California State Board of Equalization, *Background Document*.

*buying. The state has no audit trail to evidence payment of state excise taxes on [gray market] products.”<sup>60</sup>*

Criminals love a system where they can mix, and therefore conceal illegal activities with legal ones. The classic example of this is money laundering where criminals blend drug or contraband tobacco profits with lawfully earned money and conceal their illegal work. Thus, the California Board of Equalization has viewed efforts to control the gray market as part of a broader initiative to combat smuggling. It has stated:

*“As smugglers become more aware of the potential profits and easier method of bringing untaxed cigarettes into California without the risk associated with the reporting requirements of domestically produced and shipped cigarettes, ‘export only’ cigarettes are expected to become a greater problem.”<sup>61</sup>*

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<sup>60</sup> Florida Tax Watch, *Primary Source of Supply Law Would Add Needed Safeguards to Cigarette Regulation in Florida*, May 1997.

<sup>61</sup> California State Board of Equalization, *Background Document*.

## SECTION 9: THE INTERNATIONAL CIGARETTE MARKET

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### Overview

Organized crime groups dramatically increase their profits when they can tap into the international contraband market. This is because international duty-free wholesale prices are at least \$10 a carton less than the domestic wholesale prices. To understand why such prices are lower, it is important to understand two important influences.

The first is competition.

In addition to the major name-brand manufacturers, there are more than 200 independent, foreign-owned cigarette producers around the world. They supply about 57 percent of the world market.<sup>62</sup> Many of these independent, foreign-owned companies are licensed to produce local versions of international name brands, and benefit from the lower costs of production found in the developing world.

Consequently, cigarettes sold internationally have to be able to compete on price and quality against a broad range of competitors. For the major international cigarette manufacturers, these competitive pressures mean that prices—and thus profit margins—on the global market tend to be lower than in their home markets.

The second factor involves marketing and other related costs. Domestic wholesalers often pay a higher price for domestically produced cigarettes than their foreign counterparts. This is because the domestic price typically includes the cost of such domestic activities as maintaining distribution networks, advertising and marketing, after-market servicing, and customer relations. (A similar situation exists with a variety of products from appliances to pharmaceuticals.)

In the primary market, there are large numbers of independent brokers (big and small) in major ports like Antwerp, Rotterdam, Singapore, and Hong Kong, and in less prominent shipping centers like Vietnam. They have access to significant inventories of major brands. Many have operations in free trade zones, whose efficiency requires minimal red tape. They compete on price and speed of

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<sup>62</sup> Davenport & Company Limited, *The Maxwell Consumer Report* (Richmond, Virginia: April 1998).

delivery to supply wholesalers and smaller distributors in various regions and national markets.

A carton of cigarettes, therefore, typically passes through the hands of a number of intermediaries before reaching the final end-user. It is during these myriad transactions that cigarettes may be diverted to the illegal market.

A 1997 European Parliamentary inquiry in Europe's massive smuggling problems noted:

*"Fraudulent transactions typically involve several separate buyers between the initial purchase of the cigarettes and their disappearance from legitimate circulation. Intermediate changes of hands can take place almost simultaneously in far-flung locations around the world, generally in countries which discourage inquisitive investigators."<sup>63</sup>*

Diversions from legal to illegal markets occur in other industries, even tightly regulated ones such as pharmaceuticals. The United Nations has raised concerns that legally manufactured drugs are being diverted into illegal markets through complex smuggling techniques.

*"One effective smuggling technique has been to set up legitimate trading companies to buy pharmaceuticals from drug manufacturers in developed countries, ostensibly for re-export to the Third World. The drugs are then diverted back into Europe or North America for street sale."<sup>64</sup>*

Pharmaceuticals, cigarettes and different types of luxury goods all are difficult to track through legitimate market places. Some recent examples for three popular consumer goods:

- The maker of some well-known golf equipment discovered that a product introduced into the Chinese market resurfaced a few months later in Sweden. "Go figure," said a surprised company official. "It's all operating right below the surface."<sup>65</sup>

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<sup>63</sup> European Parliament, *Community Transit System*, Section 6.5.4.2

<sup>64</sup> "Loopholes nourish illegal tranquilizer network," *The Financial Times of London*, February 27, 1995

<sup>65</sup> "Gray Wail," *The Los Angeles Times*, March, 30, 1997

- A U.S. manufacturer of upscale bicycles made a deal to break into the potentially lucrative Russian market. The bikes intended for Moscow began showing up in American retail outlets at prices much lower than are normally charged in the U.S., thus undercutting its own home market.<sup>66</sup>
- An Eastern European company bought a shipment of eyeglass frames from a Western manufacturer. A condition attached to the sale was that the frames be sold only in Eastern markets. The frames subsequently showed up in Western Europe, much to the manufacturer's unhappiness.<sup>67</sup>

What also complicates the process of tracking cigarette movements—and many other consumer products, for that matter—is that there is a huge secondary market for excess inventories, or end-of-shelf-life products. Here are two scenarios on how cigarettes enter the secondary market:

- A wholesaler in Latin America orders two container loads of cigarettes. While the shipment is en route to his warehouse, he realizes he only needs one container load. He would then sell the extra load—at a discount—to an international broker who would try to sell these cigarettes on the secondary market.
- A distributor in the Middle East notices that 1,000 cases in his warehouse are near the end of their shelf life, and are of no interest to his regular customers. Again, the distributor would try to unload these cigarettes—at a deep discount—to an international broker before they became too stale to sell.

The aforementioned primary market brokers may also be participants in this secondary market. But it also features brokers around the world who specialize in secondary markets in a variety of other products—from tires and electronic goods to cigarettes and pharmaceuticals. Some secondary market brokers advertise and conduct business on the Internet. Individual countries may also have their own secondary markets for excess inventories, or end-of-shelf-life products.

The result is that there is a huge pool of cigarettes—comprising both the primary and secondary markets—around the world.

Consequently, there are myriad points in the world commercial system where cigarette smugglers can tap into international supplies of cigarettes. They might

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<sup>66</sup> "Gray Wail"

<sup>67</sup> "A gray area," *The Economist*, June 13, 1998

set up an import-export company, or get an existing broker to act as its agent, ordering larger quantities than he can actually handle. Uncovering such transactions is virtually impossible. It's much like trying to find a needle in a haystack.

This helps to explain why there are billions and billions of so-called "homeless" cigarettes around the world. These are cigarettes that are exported but never register in world import data figures.

The gaps between worldwide exports of cigarettes and worldwide imports are huge, as can be seen by the following statistics from the U.S. Department of Agriculture (USDA):

- In 1992, there were 40.2 billion packs of cigarettes exported throughout the world. Only 28.4 billion packs were recorded as imported—for a total of 11.8 billion missing packs.
- By 1995, data indicated the gap had grown to 16 billion packs.
- Estimates for 1998 indicate this had reached a staggering 18.7 billion "missing" packs worldwide.<sup>68</sup>

This pool of "homeless cigarettes" provides a ready source of low-cost supply for cigarette smugglers around the world. Smugglers have proved adept at shifting these cigarettes through a complex web of offshore tax havens, front companies and middlemen so that they disappear off the world's trade balance sheets.

## International Smuggling and Organized Crime

Drawing on this huge accumulation of cheap international cigarettes, organized crime is readily able to supply markets around the world.

In major Chinese cities, street stalls sell a variety of smuggled cigarette brands. Chinese officials estimate that they lose more than \$1 billion a year in revenues to cigarette smugglers.<sup>69</sup>

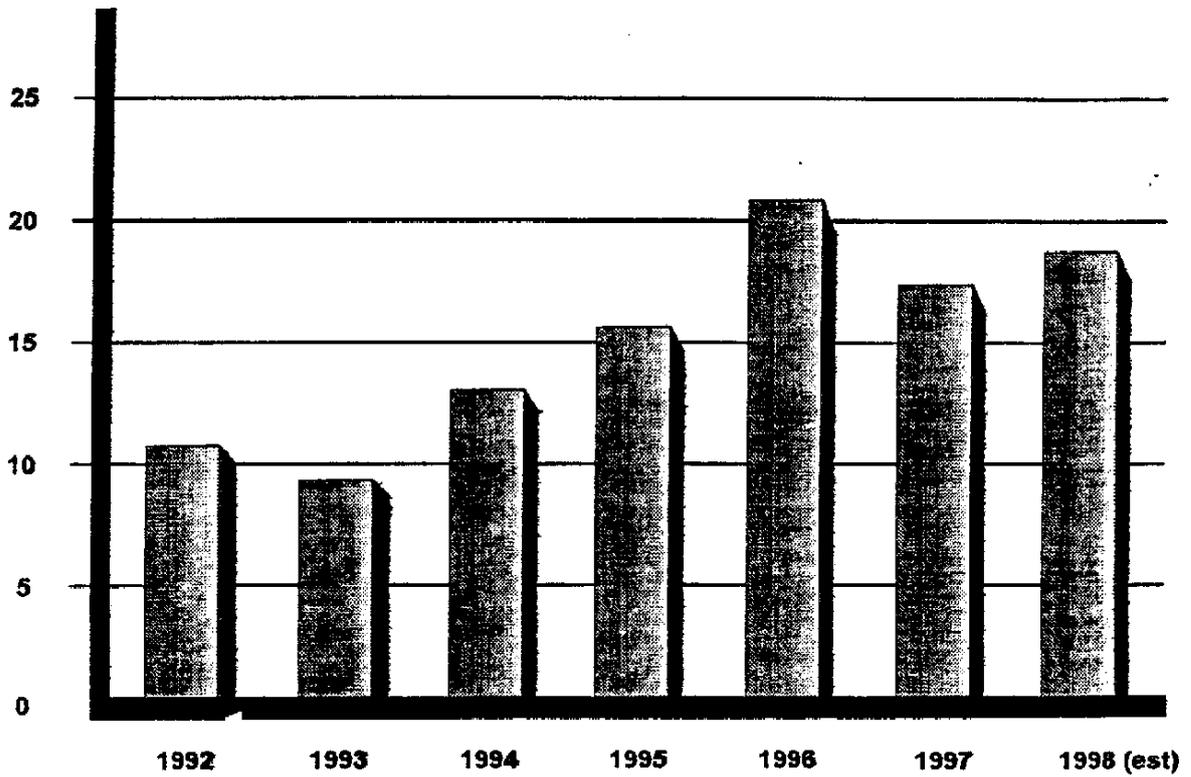
<sup>68</sup> "World Cigarette Exports and World Cigarette Imports", *World Tobacco Situation Outlook, 1999*, Foreign Agricultural Services, U.S. Department of Agriculture.

<sup>69</sup> "Smugglers Stoke B.A.T.'s Cigarette Sales in China"

Figure - 5

### WORLD TRADE: HOMELESS CIGARETTES (International Exports Less Imports)

**BILLIONS  
OF  
PACKAGES**  
(packages of 20)



(SOURCE: FOREIGN AGRICULTURAL SERVICE, UNITED STATES DEPARTMENT OF AGRICULTURE)

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In South Africa, sophisticated cross-border schemes have been used to smuggle hundreds of millions of cigarettes from bordering states.<sup>70</sup>

In parts of Europe, tobacco smuggling has reached crisis proportions. For instance, the British government estimates that it has a shortfall of more than £1.7 billion in revenue due to tobacco smuggling.<sup>71</sup>

Sweden encountered a tobacco smuggling crisis after following a path of regular tobacco tax increases. Swedish Match, the country's main cigarette manufacturer, reported its regular deliveries to the Swedish market plunged 27 percent in 1997 alone.<sup>72</sup> The Swedish government cut tobacco taxes in 1998 to cut the profits of organized smugglers.

Lost revenues total more than \$5.5 billion a year for the European Union as a whole.<sup>73</sup> As the European Parliament's Committee of Inquiry into the EU's Transit System concluded in 1997:

*"The most frequently targeted product of transit fraudsters is the cigarette trade."<sup>74</sup>*

Though there are some significant differences in tax-fully-paid cigarette prices among EU member nations—i.e. the equivalent of inter-state tax differentials in the U.S.—European smugglers have tended to forego such profits in favor of the much more lucrative returns possible by purchasing on the international market.

As the European Inquiry stated in 1997:

*"It should be stressed that the interest for the smuggler lies in obtaining cigarettes at duty-free prices. Even though there is a potential difference of up to 240 percent between the cheapest cigarettes in Europe ... and the most expensive ... the duty-free dockside price ... is vastly more attractive ... Studies have shown*

<sup>70</sup> "Smuggling Benefits Tobacco Firms," *Business Day*, May 5, 1998.

<sup>71</sup> "Treasury's £2 billion revenue shortfall", *Times of London*, March 1, 1999.

<sup>72</sup> Swedish Match annual report for 1997.

<sup>73</sup> European Parliament, *Community Transit System*, Section 6.2.2.3.

<sup>74</sup> European Parliament, *Community Transit System*, Section 6.6.1.

that cross-border smuggling of duty-paid cigarettes is relatively unimportant ...<sup>75</sup>

Organized smuggling in Europe has also been accompanied by violence:

- In Naples, the battle for control of the Italian city's lucrative cigarette smuggling trade claimed at least 50 lives in 1998.<sup>76</sup>
- In Berlin, key members of a Vietnamese gang have been charged with committing nine murders as part of the bloody fight for control of city's lucrative contraband trade.<sup>77</sup>
- In Copenhagen, a gang leader was assassinated during an ongoing turf war between cigarette smuggling groups in Denmark.<sup>78</sup>
- The Confederation of Tobacconists in France reports that on average there is one robbery of a tobacconist every week. The Confederation says that over a period of four years, 12 tobacconists have been killed in holdups.

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<sup>75</sup> European Parliament, *Community Transit System*, Section 6.1.1.3.

<sup>76</sup> "Brother of Alleged Italian Crime Boss Killed in Shooting," *Los Angeles Times*, May 18, 1998.

<sup>77</sup> "Vietnamese mafia chief gets life in prison in Germany," *Agence France-Presse*, February 24, 1998.

<sup>78</sup> "Booming Business in Smuggled Smokes Turns Deadly," *The Associated Press*, June 12, 1996.

## SECTION 10: COUNTERFEITS AND COPYCATS

### Overview

Counterfeit cigarettes are an increasing concern in Asia and Europe. This development is particularly worrisome because it signals that organized crime is becoming more vertically integrated as it engages in illegal manufacturing activities that complement its distribution and retailing networks.

Fake cigarettes are not a unique phenomenon. The counterfeiting of consumer goods is a growing problem worldwide, affecting such industries as computer chips, software, videos, music CDs, clothing, shoes, leather goods and other fashion accessories. The extent of counterfeits is staggering. According to *Forbes* magazine:

*"Counterfeit goods are a headache of gargantuan proportions for global industry. U.S. Manufacturers alone suffer to the tune of \$200 billion."*<sup>79</sup>

Organized crime has proven adept at taking advantage of any profit-making counterfeiting opportunity:

*"As in any industry, fat profits attract new competitors. The Russian mob has become a force in video piracy and Chinese triads have become heavily involved in counterfeit software. The former leader of the Vietnamese gang Born to Kill boasted of making \$13 million off counterfeit watches before he was jailed for murder."*<sup>80</sup>

With regards to a high-value product such as cigarettes, the attraction of counterfeiting to organized crime is very significant. The extent of this activity is illustrated by the following cases:

- In August 1999, authorities in Hong Kong seized three containers holding a total of 1.8 million cartons of counterfeit cigarettes. The shipments had come from mainland China. In all, 13 containers of

<sup>79</sup> Faker's Paradise, *Forbes* ASAP, April 5, 1999

<sup>80</sup> "Riskless Crime?" *Forbes* Magazine, August 11, 1997.

counterfeit cigarettes were seized in Hong Kong in the first eight months of 1999.<sup>81</sup>

- In July 1999, French customs authorities seized four containers holding 1.8 million cartons of counterfeit cigarettes. The containers were from China and were en route to the Canary Islands.<sup>82</sup>
- In November 1998, a Hong Kong businessman pled guilty to smuggling 10 containers of counterfeit cigarettes to Vietnam.<sup>83</sup>
- In March 1998, customs officials in Dubai broke up a major counterfeit operation that was supplying markets in the Far East and the former Soviet Union. More than 20 internationally known brands were faked.<sup>84</sup>

### **The Canadian Experience – Counterfeits**

In the early 1990s, high taxes had caused a revolt among Canadian smokers and the contraband market flourished. Criminals found they could boost their already significant profits through counterfeits.

In November 1993, police raided an industrial complex in the Toronto suburbs and seized cigarette-manufacturing machinery, 4.5 tons of tobacco and counterfeit packages of a major brand. The quality of the fake packaging materials rivaled the genuine brand. Police estimated the operation could have turned the tobacco into 34,000 cartons of cigarettes in just 24 hours.

In May 1993, U.S. law enforcement discovered a warehouse in Detroit, Michigan, which was set up for mass production of phony Canadian cigarettes. They seized sophisticated printing equipment that churned out perfect copies of Canadian cigarette packages right down to health warnings. The equipment also duplicated the official Government of Canada cellophane seals, which state that Canadian duty was paid on each cigarette package.<sup>85</sup>

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<sup>81</sup> "Smugglers cash in on SAR's good reputation"

<sup>82</sup> AFX News Summary, July 29, 1999.

<sup>83</sup> "Time runs out for cigarette conspirator," *Hong Kong Standard*, November 12, 1998.

<sup>84</sup> "Huge Cigarette Counterfeiting Ring Broken Up," *Gulf News*, March 7, 1998.

<sup>85</sup> *The Toronto Star*, May 16, 1993

## The Canadian Experience – Copycats

Canada tried to curb smuggling with a special tax designed to stop Canadian exported cigarettes from being brought back into the country. The smugglers simply adjusted to the situation, producing copycat brands—cigarettes sold in packaging that mimicked popular brands.

Here's what happened:

Large quantities of Canadian-made cigarettes were being legally exported to licensed wholesalers in the U.S. The cigarettes then passed through a number of intermediaries before being acquired by smugglers who ran them back into Canada at enormous profits.

The Canadian government decided to deter the practice with an \$8-a-carton export tax on cigarette shipments. This worked temporarily, and the supply of contraband Canadian brand name brands dried up.

In response, smuggling groups began producing their own copycat cigarettes. They also began tapping the international market for excess inventories.

The export tax was lifted after six weeks. It is interesting to note that even after this tax disappeared, copycat brands remained available on the contraband market, as organized criminals had developed "a market niche" for their product.

As Fred O'Riordan, a senior official of Revenue Canada, the country's national tax collection and customs enforcement agency, stated:

*"[The export tax's] operation had been suspended shortly after it was announced when it became clear that it was not effective."<sup>86</sup>*

It was ineffective because the Canadian government had made three miscalculations. It believed that:

- There was only one source of supply for the contraband market and so they could control smuggling by supply-side initiatives;
- It could repeal the central law of smuggling—that where there is sufficient demand, organized crime will find a way to supply it; and
- It grossly underestimated the ingenuity of criminal entrepreneurs.

<sup>86</sup> Fred O'Riordan, "Developments in Tobacco Taxation in Canada: The Federal Perspective." Presentation to the Federation of Tax Administrators Annual Meeting (Chicago, Illinois: August 1995), p. 2.

The most significant part of this government failure was that part of the Canadian cigarette manufacturing capacity was being shifted to organized crime and to foreign manufacturers.

In commenting on why an export tax in Canada failed, David Anderson, Canada's then Revenue Minister, stated:

*"You could have put on an export tax ... and for a week or two there would have been an interruption in the flow ... [But] it would take two, maybe three weeks at the most, and you would find that the market in smuggling would have been re-established ... The only difference would be that we would not be dealing with Canadian-manufactured cigarettes, we would be dealing with foreign manufactured cigarettes."<sup>87</sup>*

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<sup>87</sup> "Interview of David Anderson, Federal Minister of Revenue," CBC Television, February 9, 1994.

## SECTION 11: THE CONSEQUENCES OF SMUGGLING

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### Overview

The British first learned a lesson about tobacco taxation in the 1600s when King James I levied a tobacco tax and continually pushed it higher. By 1730, historians say, one-third of all tobacco smoked in Britain was smuggled to evade taxes.<sup>88</sup>

They learned the lesson again at the Boston Tea Party. The British excise tax on imported tea was 119 percent. Not only were the people of America enraged and fed up with the high taxation, Britons at home were showing their displeasure through rampant tea smuggling. It was estimated at one point that two-thirds of the tea drunk in Britain at that time was smuggled to evade the outrageously high tax.

The British government finally realized the high tax was actually creating less revenue and promoting lawbreaking so it cut the tea tax. The rate was slashed from 119 percent to 12.5 percent. Smuggling collapsed.

As the Attorneys General of Colorado, Ohio, Utah and Washington stated in a 1998 joint letter:

*"There is a definite correlation between tax rates and the level of smuggling."<sup>89</sup>*

Consider the following examples:

- In March 1999, the British government revealed a £1.7 billion shortfall in revenue due to tobacco smuggling. It has the highest cigarette taxes in Europe.<sup>90</sup>
- Canada drastically slashed cigarette taxes when organized tobacco smuggling reduced government revenues and created a national

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<sup>88</sup> "Stamping out smuggling of cigarettes can be less taxing," *Detroit News*, May 18, 1997.

<sup>89</sup> Letter to Senator Orrin Hatch from the Attorneys General of Colorado, Ohio, Utah and Washington, April 24, 1998.

<sup>90</sup> Treasury's £2 billion revenue shortfall, *Times of London*, March 1, 1999.

crisis. At the height of the problem, a contraband carton cost as much as \$50. A contraband carton cost less than half that amount.

- Sweden also cut taxes at the height of a similar crisis in 1998.
- The contraband tobacco trade in Germany resulted in dozens of murders a year, mainly in ethnic turf wars. In the first six months of 1996, a total of 40 Vietnamese were shot in tobacco-related gang slayings, 15 in Berlin alone.<sup>91</sup>

### Cause and Effect

Governments rarely consider the stimulus that their policies will exert on organized crime. Government policies do this in three ways:

1. High taxation is the primary means. Raising taxes above the flash point—the level at which it becomes economically attractive for organized crime to begin furnishing tax-evaded product—will stimulate a contraband market. Increases like the one arising from the Tobacco Settlement can exacerbate the tax-driven problem.
2. The second way is by restricting availability. The classic example involved Prohibition in the United States. During the 1920s and early '30s, alcohol was banned. Organized crime made it obtainable. Availability can also be a factor in promoting black markets even when there are no complete bans as there was during Prohibition. In some countries, restrictions on product price and availability can stimulate contraband demand.
3. The third involves quality. In markets like China, government monopolies produce an inferior domestic product. Consumers enter the black market to obtain better-quality—and much more expensive—international brands. (A Chinese survey found that 30.8 percent of urban Chinese smokers prefer foreign-brand cigarettes than local brands, and that 21.1 percent of them smoke foreign cigarettes only.)<sup>92</sup>

Organized cigarette smuggling is like any other business. Profit margins are not static. They increase as the criminals learn the business, improve their efficiencies, diversify and are able to handle more volume.

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<sup>91</sup> "German Cigarette Wars Bloody and Profitable," *The Associated Press*, June 13, 1996.

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For instance, when a contraband market develops, there may be many different criminal participants, small or large. It's a bit like the early days of the video rental business. But, as the market matures, bigger, more dominant players emerge and take over the market. In the cigarette smuggling trade, smaller competitors are either swallowed, allowed to operate under a licensing arrangement by more established organized crime groups, or are simply put out of business. Alternately, street gangs and other emerging crime groups can grow so strong that they emerge as important players.

## How Society Gets Hurt

The initial act of law breaking has an important influence on subsequent behavior. Studies have shown that once people begin to break the law, it can become habit-forming. As one expert put it:

*"It's a real issue that once people develop a taste for cheating, they might keep on cheating."<sup>93</sup>*

During the Canadian smuggling crisis, the federal government said cigarette smuggling and tax evasion was creating "frightening growth in criminal activity" and was "a threat to the very fabric of Canadian society." Governments were concerned about the overall impact on Canadians' respect for the rule of law.

Put another way, crime promotes more crime and adds to the already heavy burden of law enforcement agencies.

U.S. criminologists George Kelling and James Wilson have developed the "broken window" concept, an influential crime-control strategy credited with significantly lowering crime rates in New York City and Jacksonville, Florida, among other places.<sup>94</sup>

They explain the concept this way:

*"If a window in a building is broken and left un-repaired, all the rest of the windows will soon be broken ... One un-repaired window is a signal that no one cares."*

<sup>92</sup> "One-Third of Urban Smokers Prefer Foreign Brands," *Xinhua English Newswire*, May 31, 1998.

<sup>93</sup> "Hearings of the Standing Committee on Finance and Economic Affairs," Legislative Assembly of Ontario (Toronto: November 25, 1993).

They add:

*"Vandalism can occur anywhere once communal barriers—the sense of mutual regard and the obligations of civility—are lowered by actions that seem to signal that 'no one cares'."*

Cigarette smuggling is similar. Many people don't see it as a crime. Rather, they see it as a way to defeat the tax man. As a result, there is a general lowering of respect for the law—of the community barriers to criminal behavior.

Consider the following disturbing cycles of behavior:

- When consumers get into the habit of buying cheaper, untaxed cigarettes, they start thinking: If it's OK—and relatively risk-free—to commit this crime, why should I stop? Why not try another illegal activity? Breaking the law becomes habit-forming.
- When a segment of the population buys smuggled cigarettes and evades taxes, fellow citizens begin to feel cheated. They ask themselves: Why should I dutifully pay taxes, when others are getting a free ride? Why should I carry all the burden?

Lack of respect for the law tends to lead people into other criminal activities. One broken window leads to others.

## **Smuggling and Under-age Smokers**

Smuggling makes it easier for under-age smokers to obtain cigarettes.

Consider the example of Canada during its contraband tobacco crisis. High school students acquired cartons of contraband cigarettes and then re-sold single packs to their classmates. Cigarette smuggling brought teenagers into contact with criminals and criminal activity. As one high school student noted at the height of the contraband tobacco problem in Canada in the early 1990s:

*"Just as every school has a drug dealer, now every school has a cigarette dealer."*

Itinerant street vendors—lugging knapsacks or duffel bags full of untaxed cigarettes—frequented video arcades and sold packages and single cigarettes to

<sup>24</sup> George Kelling and James Wilson, "Broken Windows," *The Atlantic*, March 1982.

under-age smokers in some parts of Canada. They also visited donut shops, coffee shops and other venues that teenagers patronize.

Commenting on the ease with which young people obtained smuggled cigarettes, David Anderson, Canada's then Revenue Minister, stated in 1994:

*" ... the people who are most likely to buy those smuggled cigarettes are young people. So those people who claim that you must keep taxes high to prevent young people from smoking simply don't understand that right now, young people have very cheap cigarettes, contraband and cheap, and they're smoking them. And they're more fun to smoke because they're contraband."*<sup>95</sup>

Then Health Minister Diane Marleau found that, in her own constituency,

*" ... children who appear to be as young as 12 years old have been buying smuggled cigarettes."*<sup>96</sup>

Health Canada surveys found that prevalence among 15-to-19-year-olds actually began to rise in 1991—at the height of the taxes and three years before tax cuts were implemented to curb smuggling. Indeed, this rise coincided with the sharpest increase in cigarette smuggling activity.

In this regard, it is worth noting comments by Megan Stephens ("Stephens"), a leading researcher at Statistics Canada, the country's highly regarded national statistical agency.

Stephens examined the above-cited data that showed that the proportion of 15-to-19-year-olds who smoke rose from 21 percent in 1991 to 28 percent in 1994-5. Dismissing claims that linked the rise to the lowering of Canadian tobacco taxes in 1994, she noted that the increase began when taxes were at their highest:

*"But we saw the increase starting in 1991, which was three years prior to the tax cut on cigarettes. It's highly speculative to say this trend is the direct result of a tax cut. It remains a mystery. It's possible this is just a change in youth culture, but we don't really know, and we can't really tell from these data."*<sup>97</sup>

<sup>95</sup> Interview of David Anderson

<sup>96</sup> "The worst fear: Young people are most vulnerable when prices drop", *Maclean's*, February 21, 1994.

<sup>97</sup> "Early smokers find it hard to quit", *The Toronto Star*, April 30, 1998.

## U.S. Youth Don't See Criminal Aspect

Sellers of untaxed cigarettes simply don't care who their buyers are.

In the mid-1990s, a police lieutenant supervising a major cigarette smuggling investigation in southern California detected an alarming correlation between smuggling and youth access to cigarettes:

*" ... a large percentage of cigarettes found in the possession of minors are contraband."*

In his experience, smugglers sold untaxed cigarettes to anyone—even minors:

*" ... street vendors of tobacco products, like street vendors of narcotics, don't care about the buyer's age."*

A series of interviews by FIA with young people in 1998 underlined the ease with which young people in areas of intensive contraband tobacco activity have access to illicit cigarettes. They also show how illicit contraband can connect young people to organized criminals.

A seventeen-year-old male in Detroit told an FIA investigator that he knew gang members who hauled cigarettes into Michigan in several cars.

The youth said:

*"They drive out (to Ohio), and they drive back, same day. If one car gets stopped, there's four more behind it with the trunk full. End of the day the trunk's empty and they're partying hard. They're into everything. Smoke, girls, action. They make lots of money."*

He said the gangs supply non-chain stores in his neighborhood. Cigarette smuggling is just one of several criminal activities of gangs:

*"Nobody is into just one thing ... If you're making money selling booze to people after hours, what's the difference if you sell rocks [i.e. crack cocaine] or guns or cigarettes."*

In one interview, two youths fantasized about getting a lot of money together, buying a truck, and going into business. These two Detroit youths had said they visited retail outlets in Ohio on a semi-regular basis and "stocked up" on a few cartons, but they noted the trip was usually in conjunction with a social trip, to attend concerts or to see friends or relatives.

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They indicated they would have no shortage of clients:

*"You take a truck of cigarettes up there (indicating several blocks away) and drive it back here, stopping at the shops and the laundries and the restaurants and I guarantee you'll be empty by the time you reach here."*

Similarly, in California, several interviewed subjects who reside in less affluent areas of Los Angeles discussed the role of street gangs in the contraband tobacco market. They noted that several gangs run cigarettes into Los Angeles from Mexico.

In San Diego, three young males said there's a constant cross-border traffic in tobacco operated by the "Mexican Mafia." Three other youths in San Diego said that, in their lower-class neighborhood, purveyors of illegal cigarettes, alcohol, and prostitutes have no hesitation in selling cigarettes to anyone with the money.

In New York City, all sixteen- and seventeen-year-olds interviewed (a total of 11 individuals) said they knew criminals, including drug dealers and gamblers, who also sold tobacco and alcohol.

In upper Manhattan, an under-age smoker—a fifteen-year-old male—said all stores he patronized sold single and small quantities of loose cigarettes (20 to twenty-five cents each):

*"It's whatever he's got. He's got garbage bags full of loose packages."*

The boy illustrated, taking a five-dollar bill and going into a nearby store. He returned with three one-dollar bills, and a cigarette package. There was no cellophane on the package and no tax stamp, an indication that it was contraband.

The broken window effect intensifies when applied to under-age smokers. As one broken window is a green light to other vandalism, cigarette smuggling acts as a signal to teenagers that breaking the law is all right. This lowers communal barriers to crime among young people.

As one youth in Michigan, who earns an allowance helping his father smuggle cigarettes, told FIA:

*"My father says the government is making everything illegal so that there'll be a new generation of millionaires, like the guys who sold booze during Prohibition. He said if he ever catches me with dope, he'll kill me. But cigarettes aren't illegal, it's just another marketplace to make your money in."*

## SECTION 12: LESSONS FROM THE CANADIAN CRISIS

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### Overview

At the height of Canadian cigarette crisis, late in 1993, FIA professionals conservatively estimated that about 30 percent of the market in Canada was contraband and that lost tax revenues totaled about \$1 billion a year. In testimony before Congress in December 1997, the Royal Canadian Mounted Police, the national Canadian police agency also known as the RCMP, estimated that the contraband cigarette market was about 40 percent.<sup>98</sup>

The pattern was the same as had been seen in the United States. Back in 1985, it was difficult to find illicit tobacco in Canada. Then Canadian governments, federal and provincial, began increasing taxes in hopes of discouraging smoking while generating more tobacco tax revenue.<sup>99</sup>

In 1986, cigarette taxes rose to twice the levels of 1981. By 1991, they were more than six times the rate of a decade earlier.

Smokers rebelled and illicit cigarettes began to pour onto the black market. There were an estimated 9.8 million packs on the black market in 1986. This figure swelled to 25.7 million packs in 1988, 63.4 million in 1990 and an astonishing 770 million in 1993.

Profit margins were enormous. At the height of the crisis, a legal carton cost between \$45 and \$50 (Canadian), while the smuggled product could be obtained for as little as \$18 apiece. Smugglers even began to produce their own cigarettes. They were either copycat brands that mimicked brand names, or counterfeits.

An example of profits: When U.S. prosecutors charged a kingpin smuggler involved in the Canadian crisis they said he had laundered \$80 million and personally had been earning \$35 million USD a year from cigarette smuggling.<sup>100</sup>

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<sup>98</sup> Testimony of Sgt. Alain Giroux of the Royal Canadian Mounted Police, December 9, 1997.

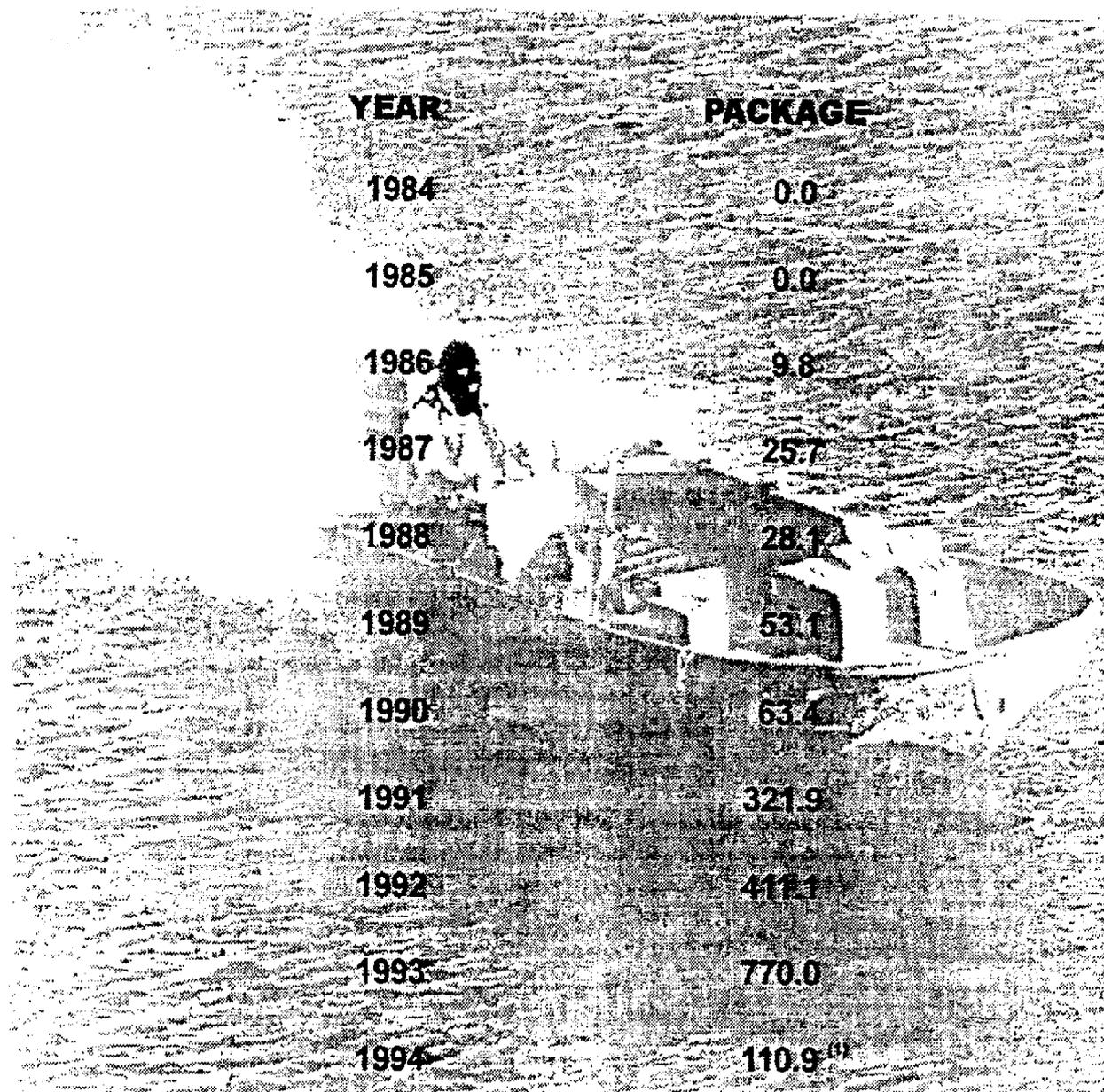
<sup>99</sup> General Accounting Office, *Tobacco*.

<sup>100</sup> "Illegal Gains Fall To Ashes," *The Post-Standard*, Syracuse, NY.

Figure - 6

# CANADIAN CONTRABAND ESTIMATE

(MILLIONS OF PACKAGES)



YEAR	PACKAGE
1984	0.0
1985	0.0
1986	9.8
1987	25.7
1988	28.1
1989	53.1
1990	63.4
1991	321.9
1992	417.1
1993	770.0
1994	110.9 <sup>(1)</sup>

Footnote:

(1) Based on data from January to May 1994. In February 1994, the Federal Government of Canada and four Provincial Governments significantly reduced their tobacco taxes.

(Photograph reproduced with the permission of *The Toronto Sun*.)

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Stated O'Riordan, the senior official of Revenue Canada:

*"From 1991 to 1994, the smuggling problem grew to alarming proportions. In scope, it quickly developed from a local, to a regional, to a national problem. The effects of tobacco smuggling were not only felt in fiscal and economic terms, from a significant loss in government tax revenues and a drop in sales by legitimate wholesalers and retailers, they were also felt in the areas of justice and social policy."<sup>101</sup>*

Canada is a country that prides itself in being a nation forged in compromise without violence. Respect for the law is a key underpinning of that society. The disrespect for the law and the violence that came with the cigarette crisis was a shock to many.

In 1994, the then Solicitor General of Canada, Herb Gray, stated:

*"Organized crime has become a major player in the contraband market. What we are facing is a frightening growth in criminal activity. We are seeing a breakdown in respect for Canadian law. Canadian society is the victim."*

Stated O'Riordan:

*"Effects in these areas included: a growth in violent and organized crime; the establishment of smuggling channels which were also used to transport liquor and, to a lesser extent, drugs and weapons; a growing disrespect for the law."<sup>102</sup>*

The Canadian Government wasn't able to stop the problems immediately. More enforcement resources didn't work. Neither did supply-side efforts such as the short-lived export tax. The country seemed to be slipping deeper into the grip of organized crime.

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<sup>101</sup> O'Riordan, "The Federal Perspective," p. 2.

<sup>102</sup> O'Riordan, "The Federal Perspective," p. 2.

## The River of Contraband

The center of the Canadian crisis was a stretch of the St. Lawrence River dividing the provinces of Ontario and Quebec and the State of New York. The two main towns in the area are Cornwall, Ontario and Massena, New York.

The St. Lawrence River is narrow there and there are many islands and small channels. It also flows through an Indian reservation whose territory straddles the international border and is apportioned among New York and the two Canadian provinces. The geography of the area and the fact that reservation residents can purchase as much tax-free tobacco as they wish combined to make an ideal situation for smugglers to exploit.

Cigarettes were easily moved by speedboat in summer, snowmobile in winter. At the height of the Canadian contraband crisis, police estimated that seven of every 10 contraband cigarettes smoked in Canada came through this route.<sup>103</sup>

All types of organized crime groups were involved. But just like in Prohibition when street criminals gained strength and organization from alcohol, new crime groups developed and strengthened through cigarettes.

It was a classic case of undeveloped criminal potential emerging through opportunity provided by government taxation policies.

The flow of cigarettes was so large that it was impossible for law enforcement to control. In 1993, a senior police officer, Detective Inspector Chris Lewis of the Ontario Provincial Police, testified before a committee of Ontario lawmakers that in one month they seized only 30,000 cartons of illegal cigarettes in the Cornwall area along the busy smuggling corridor. He estimated that 50,000 cartons were getting through undetected every day.

Lewis told the committee:

*"It's a very big problem and we're barely touching the tip of the iceberg."<sup>104</sup>*

With the smuggling came violence unprecedented for Canada. The sound of automatic gunfire echoed along the river almost nightly as rival smugglers fought

<sup>103</sup> "Expect line-ups at U.S. border," *Toronto Star*, February 9, 1995.

<sup>104</sup> "Hearings of the Standing Committee on Finance and Economic Affairs," *Legislative Assembly of Ontario*, Toronto, November 25, 1993.

for control. They dressed in camouflage battle gear and obtained expensive night vision gear and AK-47 assault rifles. Death threats were made against the then mayor of Cornwall and he was forced into hiding.

## Legitimate Businesses Were Hurt

At the height of the crisis nearly one of every three cigarettes was contraband. Businesses that sold tobacco were hit hard and some never did recover. The Canadian Association of Chain Drug Stores estimated that tobacco sales dropped 60 to 75 percent at many of their member stores.<sup>105</sup>

Sales dropped drastically and some stores faced bankruptcy. It was a simply matter of legal sellers and distributors refusing to enter the contraband market but unable to compete.

Owners of convenience stores, donut shops and other places that sell cigarettes were also pushed toward the illegal market for competitive reasons. Some did not sell contraband cigarettes but others felt they had to, despite not wanting to.

The Ontario legislature held hearings on the underground economy in December 1993. One of the witnesses was Geoffrey Pottow, president of a major convenience store chain in Ontario. His company had closed 100 stores in the previous two years, he told the legislators. He predicted the closing rate would increase because of the cigarette smuggling killing tobacco sales. As Pottow told the committee:

*"My purchase price for a carton of cigarettes is around \$40 a carton ... How do I compete now when a man comes up in a van and says 'How many cartons would you like at \$25?' I put it to you that if you're an independent businessman going bankrupt, that's an awful hard thing to walk away from."<sup>106</sup>*

## The Corruption of Society

The Canadian crisis in many ways was a protest against government and taxation. Citizens were chafing after the introduction of a seven percent general sales tax.

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<sup>105</sup> Hearings of the Standing Committee (Toronto: December 2, 1993).

<sup>106</sup> Hearings of the Standing Committee (Toronto: December 2, 1993).

It was a period when tax and government fees seemed to increase at every turn. People were fed up.

For many participating in a contraband market that offered cigarettes at 20 to 50 percent below retail price was just another way of protesting to government. Canadians who would report to police any deals on drugs or stolen goods, saw nothing wrong with cigarette smuggling. They felt much the same way that Americans did during Prohibition.

Few could see the harm in buying contraband cigarettes, few could see the huge drain on government revenues that were needed to support social and other services.

But as Prime Minister Jean Chrétien said in 1994:

*"When you are buying contraband cartons of cigarettes, you aren't just saving a few dollars for yourself, you are directly supporting organized crime."*

When people started seeing their friends and neighbors involved in the black market they were less concerned about joining in. People who saw the low risk and high benefits began practicing other forms of tax evasion, such as not remitting sales taxes.

Finally, a breaking point came when Chrétien visited an old friend in his hometown, who bragged about buying black market cigarettes and liquor. A government insider told a major Canadian news magazine that, at that point, Chrétien, "realized that smuggling had acquired social acceptance, so that police action alone would not be enough."<sup>107</sup>

In the end, organized crime had become so powerful that the only solution was to cut taxes—thereby reducing the demand and taking the profits out of the trade.

In announcing the tax cuts in February 1994, the prime minister stated:

*"Smuggling is threatening the safety of communities and the livelihood of law-abiding merchants. It is a threat to the very fabric of Canadian society."*

<sup>107</sup> "Pack of Trouble," *Maclean's*, February 21, 1994.

Not only was respect for the law being corrupted, but also there were cases of organized cigarette smugglers corrupting or threatening government officials. The effects of that corruption linger remain today.<sup>108</sup>

## Policies Undermined

Cigarette taxes were ostensibly increased to reduce smoking, especially among young people. It was thought that higher taxes would make cigarettes far less affordable to under-age smokers.

The reality, states O’Riordan, was much different:

*“Ironically, through the ready availability of cheap contraband tobacco with no questions asked, [there was] an undermining of government initiatives to reduce smoking, particularly among young people, for which purpose the taxes had ostensibly been increased in the first place.”<sup>109</sup>*

Consumers shifted from the legal to the illegal market. That is, high taxes invited consumers to seek a cheaper substitute—i.e. the smuggled product—rather than cease smoking altogether. As Murray Kaiserman, an analyst with Health Canada, stated at the height of the contraband crisis in late 1993:

*“It’s classic economics. Given the cheaper [smuggled] product on the market, people are continuing to smoke.”<sup>110</sup>*

When taxes were lowered in Canada, consumers returned to the legal market. Overall, the size of the market remained roughly the same.

In this regard, it is worth noting a series of four surveys conducted by Health Canada, the federal health department, following the February 1994 tax reduction. It wanted to determine whether the overall prevalence in Canada—i.e. the proportion of Canadians aged 15 or over whom smoked—would rise following the tax cut. That is, it wanted to determine whether the size of the overall market would increase as taxes—and thus legal prices—fell.

<sup>108</sup> “Organized Crime Activity in Canada, 1998: Results of a Pilot Survey of 16 Police Services,” Canadian Centre for Justice Statistics.

<sup>109</sup> O’Riordan, “The Federal Perspective,” p. 2.

<sup>110</sup> “Rise in Smuggling Blamed for First Hike in Smoking Since ’82,” *Toronto Star*, December 21, 1993.

The four surveys found that prevalence remained stable after the tax decrease, and was at about the same level as had been observed in surveys in 1986 and 1991. The first Health Canada survey showed that the prevalence in April-May 1994—just after the tax cuts—was 31 percent, unchanged from 1991 and about the same as in 1986 (32 percent). The three subsequent surveys found that prevalence remained about the same or fell in the post-tax-cut period: 30 percent in a survey conducted in August-September 1994; 30 percent in a survey conducted in November-December 1994; and 27.4 percent in a survey conducted in February-March 1995.

### Canadian Situation Today

The dramatic tobacco tax of February 1994 by the federal government and major provinces like Ontario and Quebec took most of the profit potential out of smuggling cigarettes into Canada. The cross-border smuggling crisis was ended.

Smuggling, did not stop, however. Criminal organizations simply used the infrastructure and systems in place for tobacco to smuggle alcohol, firearms, illegal aliens, drugs—anything that would turn a reasonable profit.

Tobacco smuggling continued in some provinces like British Columbia, the western-most Canadian province, which declined to reduce its tobacco tax. The criminal organizations supplying British Columbia and other high-tax provinces switched from international to inter-provincial smuggling of cigarettes. Much as in the U.S., they now illegally ship cigarettes to high-tax provinces from low-tax ones.

At the end of 1998, the RCMP warned that this inter-provincial smuggling is a growing menace that has reached “epidemic proportions” in some areas. An RCMP briefing note said illegal cigarettes represent as much as 35 percent of the legal market in high-tax jurisdictions such as the provinces of Newfoundland and British Columbia, and up to 20 percent in Saskatchewan, Manitoba and Nova Scotia.<sup>111</sup>

The cigarette smuggling heydays not only promoted the growth of organized. The RCMP has warned that virtually every criminal group in Canada now is active in smuggling a wide variety of goods. Some of the systems and infrastructures were put into place originally to service cigarette smuggling.

<sup>111</sup> “Up to 35% of Tobacco in B.C. Smuggled,” *Globe and Mail*, December 24, 1998.

According to an RCMP report:

*"Most of the criminal groups in Canada are involved, both separately and co-operatively, in smuggling operations. The range of commodities being handled is constantly increasing, with the only consideration being the potential of the commodity to command maximum profit."<sup>112</sup>*

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<sup>112</sup> "Mafia smugglers 'out of control,' Mounties warn," *The Ottawa Citizen*, July 21, 1997.

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## SECTION 13: THE CONCLUSION

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Demand for smuggled cigarettes is mounting in the United States.

After a moderate rise in 1998, preliminary data indicates significant growth in the first five months of 1999. What has sparked this increase has been a sharp rise in the economic factors that create this demand.

Indeed, the incentive for organized crime to smuggle cigarettes—and conversely for consumers to acquire the cheaper, untaxed product—has now reached a critically high level in many parts of the United States. So much so that the ability of the federal government and many state administrations to further increase tobacco taxes without either exacerbating an existing contraband problem—or creating a new one—is severely limited.

In examining this issue, it is worth recalling the challenges faced by law enforcement agencies battling drug trafficking. The billions of dollars expended in this regard have produced large seizures and major prosecutions. But the problem remains because organized criminals have largely countered law enforcement initiatives by improving their ability to profitably service their markets.

As long as it remains lucrative to smuggle cigarettes, a similar fate awaits supply-side initiatives to combat the contraband tobacco market—especially in view of the increasing prevalence of international smuggling.

There are so many international sources of supply. There are more than 200 independent, foreign-owned manufacturers around the globe. Many produce American brand names under license. All in all, they make billions of cigarettes each year, and supply about 57 percent of the world market. It would be easy to set up offshore entities to legally acquire cigarettes from foreign producers at the cheap, international wholesale price and then funnel them into U.S. smuggling networks.

Internationally, there are also producers of counterfeit copies of major U.S. brands. Counterfeiters have proved themselves extremely capable of creating fake tax stamps and government seals.

The bottom line: Using supply-side mechanisms to control cigarette smuggling—whether through tougher regulations or enhanced law enforcement—is like trying to squeeze air in a balloon. The air simply pops out somewhere else.

## **APPENDIX A: FIA'S METHODOLOGY**

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### **Quantification Methodology**

The FIA methodology of quantifying contraband activity relies on public opinion surveys that measure the prevalence (the proportion of the population that smokes) and the intensity (the average amount that smokers say that they consume on a daily basis).

This approach differs from that employed in other studies which have attempted to quantify contraband markets. Those studies rely on regression analysis—a statistical analytical technique that permits the quantification of the relationship between two or more variables. This analysis generates a demand function for cigarettes. This demand function is the relationship between cigarette sales (dependent variables) and all quantifiable factors that are deemed to influence cigarette sales. These are referred as independent variables.

While we recognize that this kind of analysis is widely used to derive the demand functions for various commodities, we question its validity in deriving a demand function for a product like cigarettes. This is because Government sales data for cigarettes is not a true reflection of real consumption. It measures only actual taxed sales and, as such, cannot include sales of contraband. While some studies attempt to take into account inter-state smuggling, international smuggling is not accounted for. As a result, this shortcoming causes the parameters of the demand function to be unreliable.

The FIA methodology, on the other hand, relies on on-going surveys that attempt to measure, among other things, the prevalence and incidence in a representative sample of between 16,000 and 30,000 respondents who are 18 years and over. These types of surveys have long been used by health officials to determine levels of smoking in a given population. They are also used for marketing purposes by all consumer products manufacturers.

However, a wide range of research has shown that smokers underestimate the amount that they consume. This may be due to a number of factors, including the lessening social acceptance of smoking and negative societal attitudes towards smokers.

In analyzing this under-reporting, health economist Kenneth E. Warner has stated in the Journal of American Statistical Association:

*"It is well established that the 'reporting of an event is likely to be distorted in a socially desirable direction' (Cannell, Oksenberg and Converse, 1977). Events or behaviors perceived to be desirable are often over-reported (Ferber et al. 1969; Lansing and Blood 1964; Parry and Crossley 1950), while those perceived to be socially undesirable or personally sensitive or threatening are often under-reported (Cannell, Fisher and Bakker 1965; Cobb and Cannell 1966; and Lamale 1959)."*<sup>113</sup>

A number of health researchers have compensated for this under-reporting. In a 1989 article in the Journal of the American Medical Association, for example, researchers estimating the external costs of smoking adjusted their data to take into account the under-reporting factor. They stated:

*"Because people under-report their consumption, we have corrected for the difference between actual and reported use. The reported number of packs per day was multiplied by 1.5 ..."*<sup>114</sup>

Other researchers have similarly adjusted for under-reporting but they have postulated a different under-reporting factor. In another article in the Journal of the American Medical Association, Dr. Joseph DiFranza, stated:

*"Self-reports of cigarette consumption reliably underestimate actual consumption, accounting for only 72% of the cigarettes sold in this country. The self-reporting consumption rates for children were therefore multiplied by a factor of 1.30 to correct for this under-reporting."*<sup>115</sup>

FIA uses the prevalence and intensity figures from the samples, as well as the population that is 18 years of age and over, to calculate claimed consumption. Because of the under-reporting discussed above, FIA has found that claimed consumption in years when there is little or no smuggling is much lower than the amount that official tax sales figures would indicate. To measure the under-reporting factor, FIA examines years in which there is evidence of little or no smuggling, based on field studies and media/law enforcement reports. Dividing the national claimed consumption figure by the official figures for sales of

<sup>113</sup> Warner, "Possible Increases in the Under-Reporting of Cigarette Consumption"

<sup>114</sup> Willard G. Manning, Emmett B. Keeler, Joseph P. Newhouse, Elizabeth M. Sloss, Jeffrey Wasserman, *The Taxes of Sin: Do Smokers and Drinkers Pay Their Way*, JAMA (March 17, 1989).

<sup>115</sup> Dr. Joseph DiFranza, *Who Profits from Tobacco Sales to Children?* JAMA (May 23, 1990).

cigarettes in each of those years generates this under-reporting factor. These yearly under-reporting factors are used to calculate the average under-reporting factor, which we postulate is an estimate for the under-reporting in the general population. FIA assumes that the underestimation factor remains constant over time. This is likely to be a conservative assumption because over time social acceptance towards smokers is lessening and thus one of the pressures to underestimate may be increasing. As Kenneth Warner has observed:

*"In the present instance, both the social undesirability and the perceived personal threat associated with smoking have increased steadily ... Consistent with the findings in the literature, this growing undesirability of smoking could be expected a priori<sup>116</sup> to lead to concurrent increases in under-reporting."<sup>117</sup>*

Moreover, the fact that there might have been some smuggling in those years where we thought none or very little took place, would cause our methodology to err on the conservative side.

This average under-reporting is then used to calculate estimated consumption for a period where field studies, intelligence and other evidence point to the existence of smuggling. This is done by calculating the amount of reported consumption (estimated prevalence, times rate per day, times population) and dividing it by the under-reporting factor to arrive at the total estimated consumption. When we subtract total taxed sales from estimated consumption, we arrive at the smuggled volume of cigarettes.

### **International vs. Inter-State Smuggling**

International smuggling involves cigarettes that evade federal and state taxes. These cigarettes are the product of international smuggling because they violate the key requirement for any product to gain access to the U.S. national market—i.e. payment of the appropriate federal taxes. To calculate the extent of international smuggling, we determined total estimated consumption, as outlined above, for the United States as a whole. We then subtracted from this total estimated consumption, total federal taxed sales. This produced the national

<sup>116</sup> This Latin term is defined in Webster's New Dictionary as "of knowledge gained without actual experience; of reasoning from cause to effect. [L. a, from, *priori*, preceding]".

<sup>117</sup> Kenneth E. Warner, "Possible Increases in the Under-Reporting of Cigarette Consumption," *Journal of the American Statistical Association*, June 1978.

contraband total—i.e. the amount that evades federal tax and, thus, is smuggled internationally.

We then analyzed the situation in specific states and calculated the volume of cigarettes that evaded state taxes by relying on prevalence, incidence and population data in each of those states. We examined all states in which there might be even a minimal level of smuggling. These were states where the tax rate was at, or above the flash point, and where there had been some indications of smuggling, though field studies. State contraband totals were generated using the same methodology outlined above to determine the national contraband total. To prevent double-counting, we were mindful of the fact that cigarettes that evade state taxes may, or may not, also evade federal taxes. Thus, we subtracted from the sum of all individual state contraband totals, the national contraband total. This produced the volume of cigarettes that are evading state taxes only—i.e. the product of inter-state smuggling. The state contraband total also measures the total number of smuggled cigarettes consumed by Americans, as that figure includes the products of both international and inter-state smuggling, but avoids double-counting.

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