

# Case Studies in Illicit Tobacco Trade: Colombia

## Background

Large price differentials that result from high taxation in one jurisdiction relative to others create economic incentives for illicit trade. However, illicit trade depends on other factors, such as the availability of illicit products, which is a function of the strength of the customs and tax administrations and the industry's motivation to supply the market via illicit trade channels. In a nutshell, illicit trade is the result of a combination of forces that includes governance, price differentials between jurisdictions, and industry behavior.

The risk of illicit trade can be mitigated when governments exercise greater border control and adopt policies that enhance law enforcement. There are a number of effective measures to deal with illicit trade that can be taken alongside an increase in taxes. This case study shares the recent experience of Colombia in mitigating the risk of illicit trade while successfully increasing tobacco and alcohol taxes.

## Colombia's Efforts to Reduce Illicit Trade

Prior to significantly increasing tobacco taxes in 2016, the Colombian government presented a bill and Congress enacted legislation on illicit trade. Law 1762 of 2015 (better known as the Anti-smuggling law) reformed the criminal code and adopted measures to fight illicit trade in a more effective way. The law characterized illicit trade as a source crime of money laundering (both illicit trade and money laundering now have the same penalties) and gave the Financial Intelligence Unit legal instruments to investigate activities related to illicit trade. In particular, the

reform increased prison sentences to 4-12 years (from 3-5 years) for illicit trade (including not just "open" contraband, but also the "technical" version that involves altering the information presented to the customs authority).<sup>1</sup> Persons who favor and facilitate illicit trade within the administration are now subject to prison terms that range from 4-15 years. Individuals involved in transportation or retail services of smuggled goods are subject to prison terms that range from 3-10 years. Vehicles used for transporting smuggled goods can also be seized. In addition, accounting auditors who fail to disclose evidence of illicit trade are sanctioned. Penalties are increased for illicit trade by firms or individuals

<sup>1</sup>Technical contraband typically comes through legal ports with documents that misrepresent what actually is being imported (for example, more items than the number that is declared, or items of more value than the ones declared, or declaring items subject to lower tariffs, etc.). Open contraband refers to smuggling that takes place without leaving any trace in terms of documentation or pretense of being a legal import. Typically, it takes place outside the official ports in areas where there is no border control.

operating in areas with customs privileges, such as special economic zones. The law also establishes that illicit trade aggravates other crimes.

Of course, the effectiveness of these reforms in reducing illicit trade depends on enforcement outcomes, such as the probability of capture, trial, and conviction. Recognizing this, policy makers acted to strengthen the coordination of legal enforcement agencies to increase the likelihood of capture and increased prison terms. A high-level Interagency Commission was created to share information (including from the private sector) and plan activities. It was also decided that the head of the Customs Police (POLFA) and its members must come from the National Police, which has the ability to coordinate interagency operatives.

In addition, the law created new sanctions related to liquor and tobacco excise tax evasion, such as seizure of goods, fines, closures at the retail level, and the suspension or cancellation of licenses, authorizations, or registries. This was an important step because previously, retailers

selling contraband products were not considered smugglers and, therefore, not subject to criminal prosecution. At most, they were considered tax evaders, which at the time was not considered a crime.

## Tobacco Taxes and Illicit Trade in Colombia

After the enactment of the Anti-Smuggling Law, tobacco taxes were significantly increased. The specific excise tax increased from COP\$ 700 per pack in 2016 to COP\$ 1,400 in 2017, and then to COP\$ 2,100 in 2018 (and to COP\$ 2,253 in 2019). The law also established a 4-percentage point annual increase on top of inflation after 2018. Data from the Ministry of Finance indicate that sales decreased by 33 percent in 2018 relative to 2016, while tobacco tax revenues increased by 92 percent (Figure 1). Another reform in 2016 increased taxes on alcohol, adopting a combination of a 25 percent ad valorem tax and a specific tax based on alcohol content. The reform increased revenues from these taxes by 17 percent in 2017 compared to 2016.

**Figure 1**

### Packs Sold and Tobacco Tax Revenue Before and After-Tax Increase, Colombia, 2016-2018



Source: Ministry of Finance

The authorities report that since the enactment of the Anti-smuggling law five criminal organizations have been dismantled, 53 individuals have been apprehended, and 72 assets have been confiscated. In addition, between 2016 and 2018, 2,236 individuals were apprehended, and 503 vehicles transporting smuggled goods were confiscated as transport of smuggled goods is now also considered a crime as a result of the law. According to a Tax Administration (DIAN) internal report, the interagency commission met four times in 2017 to set anti-smuggling operation policies. In that year, seizures of tobacco products represented 3.2 percent of total seizures (by value).<sup>1</sup>

In a 2018 DIAN report, despite the increase in domestic prices resulting from higher taxes, tobacco products continue to be identified as products that do not have significant values in terms of smuggling.<sup>1</sup> Estimations using triangulation methods (which DIAN routinely provides comparing COMTRADE data on exports and domestic records for imports) report very low values of tobacco smuggling.

The tobacco industry, using surveys conducted directly with smokers, has traditionally reported much higher figures. However, independent survey-based estimations of illicit trade for Colombia by Maldonado and colleagues find that nine months after the initial tax increase of 100

percent, illicit cigarettes represented 6.4 percent of consumption in five Colombian cities, a much lower estimate than the industry estimate of 18 percent.<sup>2</sup> There are significant differences across cities, with Bogotá at the bottom (1.65 percent) and Cúcuta (on the border with Venezuela) at the top (29.37 percent). The situation in Cúcuta can be explained by cross-border trade driven by the strength of the Colombia peso relative to the Venezuelan bolivar. The low estimate for the other Colombian cities where the survey was conducted confirms illicit trade estimates derived through triangulation methods and, more importantly, suggests that smuggling did not become a significant problem after the tax increase.

## Conclusion

What the experience of Colombia shows is that inaction in raising taxes, due to the fear of illicit trade, should not be the course of action. The evidence suggests that taxes can be increased without having to face a surge in illicit trade, and Colombia is an example of how efforts to address smuggling can be successful. The argument that higher taxes lead to a loss of tax revenues, as a result of illicit trade is exaggerated, and more importantly, generally wrong.

## References

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