



Lithuanian Free Market Institute

A Study on Economic Causes of Smuggling

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Introduction

Strategies for combating smuggling are usually designed to remove the symptoms of smuggling. Efforts are focused on identifying weaknesses of financing state institutions that are responsible for fighting smuggling or weaknesses in border control or oversight of corporate finances. Economic incentives for smuggling are not analysed. Economic causes of smuggling are considered to be unshakable axioms, so that the implications and the elimination of the economic causes are not even discussed.

The purpose of this study is to analyse economic causes and preconditions of smuggling and to offer proposals for eliminating them. This study looks at market forces behind smuggling and identifies and explores economic causes and preconditions of smuggling. Economic policy measures that would help to eliminate the causes and preconditions of smuggling are proposed.

Lithuania's border with Belarus and the Kaliningrad region of the Russian Federation is the external border of the European Union (EU). It makes up 902 km of the EU total external land border. The movement of goods that are taken across the EU external border inside the EU is much freer, therefore the security of the EU external borders is very important for those EU member states which administer them. Lithuania is not only a transit country or a country where goods are "unloaded." In Lithuania organized criminal groups are particularly active, while corrupt relationships with government officials, politicians and customs officers are deeply entrenched.

This study focuses on the economic causes of smuggling of the most popular contraband goods. These are cigarettes, ethyl alcohol and alcohol products and fuel. These goods were chosen on the basis of information about smuggling provided by state institutions and the media in Lithuania.¹

Another reason why cigarettes, ethyl alcohol and alcohol products and fuel are analysed in this study is that these goods are subject to excise taxation. Excise tax accounts for up to 70 percent of the final price of the goods in question. This makes state regulation an important economic factor affecting equilibrium that market forces create. Article 2 of the Law on Excise Duties states that excise duties are levied on ethyl alcohol and alcohol drinks, finished tobacco products and energy products. The categories of taxable commodities and minimum excise tax rates are set by the EU law.²

This study focuses on the smuggling of goods that are "normally" present in free and lawful trade. It does not explore contraband goods which are not allowed to be traded freely, such as firearms, ammunition, explosives, explosive and radioactive materials, other strategic goods, and poisonous and highly efficacious, psychotropic and narcotic

¹ According to press releases of the State Border Guard Service, 482,000 contraband cigarette packs had been detained on the Lithuanian border by 18 June 2004. <http://www.pasienis.lt/press/index.htm>
Data from press reports reviewed during the life of the project are used.

² The EU directives which were used for approximating the procedure for levying excise taxes are listed in Attachment I to the Law on Excise Duties.

substances. This is a relative choice because both firearms and various poisonous substances can be traded legitimately. Smuggling of both of these commodity groups shares one common trait, namely avoidance of existing rules. What matters in this case is not rules that have certain economic implications but a possibility to be on the market *per se*.

In this study smuggling is understood in accordance with the provisions of Article 199 of the Criminal Code and Article 210 of the Code of Violations of Administrative Rights of the Republic of Lithuania. Smuggling is understood as the carriage of goods for business purposes, not for personal consumption, through the state border in breach of established customs procedures and irrespective of the value of the goods. Some authors treat cross-border shopping, internet shopping and duty-free shopping also as ways of carrying goods through the state border with the view to avoiding taxation, but such cases are not covered in this study.

The causes of smuggling are the incentives that motivate people to engage in smuggling. Economic causes are understood as factors that determine the existence of smuggling. Economic preconditions are understood as factors that create favourable conditions for the economic causes of smuggling to manifest themselves.

It is a grounded belief that smuggling has a negative effect on the state and business. Contraband goods compete with legitimate goods and reduce the profits of law-abiding companies. They dodge taxes and lead to budget revenue losses. Some contraband is carried by organized criminal groups who use their profits to finance other activities. Smuggling incites corruption of state officials, customs and border control officers and politicians. By making it possible to obtain goods on a completely uncontrolled illegal market, smuggling also makes it impossible to limit the accessibility of tobacco and alcohol products to underage persons. However, smuggling has some advantages too: it allows people to obtain goods which they could not afford otherwise. By providing a source of subsistence, smuggling helps residents of the border regions of Lithuania and neighbouring countries solve their social problems.

The study argues that the business of smuggling is aimed to flout detailed, complicated and expensive regulations and that excise taxation drives up the prices of goods. The study looks at these regulatory measures and offers an economic analysis of the factors that affect smuggling. The purpose of this study is to identify, to analyse, to assess, and to draw public and official attention to, economic causes of smuggling and to emphasize them in developing effective anti-smuggling policies.

Chapter 1 of the study analyses general economic causes of smuggling and factors affecting them. Chapter 2 looks at the factors that contribute to the smuggling of the most popular contraband goods. The first part of Chapter 2 explores reasons for, and weaknesses of, state regulation of the markets under analysis. The second part discusses specific policies of non-tax market regulation. The third part presents data on the excise taxes in the European Union, Lithuania and neighbouring countries and evaluates the general problems of applying excise taxes and harmonizing them in the European Union. Conclusions and recommendations are offered at the end of the study.

I. ECONOMIC CAUSES AND UNDERLYING FACTORS OF SMUGGLING

In this chapter smuggling is treated as a market phenomenon affected by supply and demand. The contraband market functions alongside the legal market. The paths of buyers and sellers cross: buyers decide which goods to buy, while sellers look for ways to sell goods. In addition to the primary forces of supply and demand, smuggling is affected by other general factors. Some of them have a direct impact on goods and prices (excise duties, trade restrictions and customs duties), others provide additional incentives for underground activity (high taxes or strict employment regulations), while yet others facilitate smuggling (corruption). Identifying and analysing general causes of smuggling and its underlying factors are useful in general and in the prevention of smuggling of specific goods and investigation of the shadow economy in particular.

Smuggling and Its Economic Causes

Economic causes of smuggling are understood as economic factors that give rise to smuggling. A specific act of smuggling is a consequence of these causes.

Smuggling is understood as the carriage of goods for business purposes, not for personal consumption, through the state border in breach of established customs procedures and irrespective of the value of the carried goods. Smuggling is a conscious act.³ Economic causes of smuggling are factors that motivate people to engage in smuggling. These factors are understood individually, so individual perceptions of these factors differ. The causes of smuggling stem from a person's desire to satisfy his or her needs. People who use illicit goods satisfy their needs to obtain the goods they desire, while those who supply smuggled goods seek to satisfy their income needs.

Demand is determined by consumers' desire to obtain goods. The demand for cheaper goods is bigger than that for more expensive ones. A consumer wants a good that will satisfy his or her needs at the lowest price possible. In order to satisfy their needs consumers always have to choose between their various needs and between various goods that can be used to satisfy these needs. Consumers react to changes in prices and make decisions where to spend the resources they possess. Consumers have limited resources, so when the price of a good goes up, they have several alternatives: to buy the same but more expensive good, to forego this good and the needs it helps to satisfy or to switch from more expensive to cheaper supplies. Cheaper goods of the same kind can be legitimate (cheaper brands of cigarettes or alcohol products) and illegal, including home-made goods (moonshine, home-made spirits, etc.) or smuggled goods. An opinion poll conducted by LFMI confirms that consumers purchase goods that are acceptable for them in terms of price and quality. It also shows that people tolerate smuggled goods and illicit consumption. According to the opinion poll, more than half of those polled (61 percent) completely justify or tend to justify consumption of smuggled supplies.

³ Admittedly, carriers of contraband are not necessarily aware of the actual content of the freight they are carrying, therefore the treatment of smuggling as a conscious act is not absolute.

Satisfying consumers' demand is an activity which market participants undertake in order to satisfy their own income needs. The supply of goods reflects a response to the demand for goods. As was mentioned above, consumers desire goods of acceptable quality at the lowest possible price, and the demand for such goods is bigger as a rule. The demand for cheaper goods is not necessarily satisfied: no players on the market may happen to agree to exchange the commodity they possess at the price offered by the buyer. The seller has a possibility to satisfy the demand for cheaper goods by offering cheaper supplies of the same kind and by reducing the costs required to supply these goods. Costs inflicted by state regulations and taxes constitute a part of the price structure. In order to reduce the costs and to operate legitimately, traders seek to cut down the costs that are not related to state regulations, i.e. the costs of raw materials, labour force, management, etc. Costs can also be lowered by refusing to comply with the rules established by the state, i.e. by producing goods that do not comply with existing quality requirements, by paying "envelop" wages or by giving bribes to regulators, etc.

Smuggling is an activity that is used to earn income from carrying goods through the state border in violation of existing rules. Smugglers seek to generate income by avoiding state control and regulations and related costs.

A number of players are engaged in smuggling. Their motives, profits, legal status and responsibilities differ. Organized criminal groups, which are widely believed to stand behind smuggling and to seek maximizing their profits and financing other criminal activities, benefit from smuggling the most. Carriers of contraband can also be its organizers. As the opinion poll conducted by LFMI shows, a third of those polled see small-scale smuggling as an opportunity for people to earn income. Carriers of contraband can be hired by those who organize smuggling and can be related to them through some kind of labour relationships: they perform specific tasks and are remunerated for the accomplishment of these tasks. In response to recent amendments of the Criminal Code, carriers of contraband tend to carry goods not in excess of 250 times the minimum subsistence level so as to avoid criminal prosecution for smuggling. Distributors are usually private individuals, in fact salaried employees, who compete both over "employment" and the venue of sales and buyers. Customs officers or state border control officers who participate in smuggling can be both organizers of smuggling and aids for smugglers. Top politicians can also take part in smuggling by exerting influence on important, strategic policy decisions in favour of smuggling.⁴

Smuggling is aimed to avoid:

- ✓ Control in the case when carried goods do not comply with existing quality or safety requirements. For example, medicines from Russia or Belarus used to be imported legitimately prior to Lithuania's membership of the European Union. However, upon the coming into effect of the EU norms of the quality of medicines, these products no longer meet the existing requirements in the EU and are smuggled into the country.

⁴ On 15 July 2004 the *Respublika* daily published an article, "Pareigunus siutinantis istatymas – kontrabandininku rojus," about attempts of contraband organizers to have the provisions of the Criminal Code prescribing criminal responsibility for smuggling softened.

- ✓ Control in the case when certain goods are prohibited. This refers to guns, firearms, explosives, radioactive materials and psychotropic and narcotic substances.
- ✓ Tax-related costs. Smuggled goods evade customs duties, excise taxes and value added tax.
- ✓ Regulation-related costs. In most cases smuggled goods do not appear in the legal business environment,⁵ therefore smuggling of, and illegal trade in, these goods dodge taxes and costs that are inflicted by employment regulations, costs related to business licensing and costs inflicted by commodity-specific regulations.
- ✓ Customs-related costs. Customs procedures are costly because of both complicated customs regulations and changing rules of freight inspections.
- ✓ Regulations of intellectual ownership protection. Some categories of contraband violate intellectual property rights. This refers to bootleg audio and video records and fabricated industrial goods. Once smuggled, they are thrown onto the black market, the only place they can be sold.

The meaning of the word *contraband* confirms its origin, which is acting against rules. Contraband, or smuggling, is the carriage of goods through the state border and their supply on the market by violating and dodging established rules. Taxes and regulations are flouted in order to avoid the costs they inflict and to supply illicit goods that are in high demand.

Smugglers can satisfy the demand for cheaper goods because in other countries, separated by state borders, prices are lower. Distance considerations and legal restrictions that are applicable to the crossing of the state border prevent consumers from buying cheaper goods on these markets themselves. However, arithmetic price differences between countries should not be regarded as the driving force of smuggling. For example, retail selling prices can be similar on different markets, but tax evasion makes smuggled goods cheaper. So smugglers calculate and orient themselves to the price that will form once goods are smuggled into the market of destination. This price includes all costs that are related to the buying and carrying of the smuggled good. Given that every smuggled commodity competes not only with legal products but also with other smuggled goods, smugglers make an estimation of the future market price of their supplies both on the legal and illegal markets.

In most cases contraband is physically taken across the state border. The most popular way of smuggling is to hide goods from customs control.⁶ In 2003 a total of 58 criminal proceedings were instituted for this kind of violation. Document counterfeiting (15 cases) and lowering the value of goods at customs (two cases) are also used as means of smuggling. The carriage of goods through the state border is only a way to flout government control and regulation. The practice of leaving goods on the market where they are produced but avoiding regulations and taxes is an

⁵ According to an opinion poll conducted by LFMI, only 3.2 percent of those polled think that smuggled goods are bought in shops and kiosks. A total of 47.4 percent of the respondents think that illicit goods are purchased in the marketplace, while 45.9 percent say they are bought from private individuals.

⁶ Data from a presentation “Smuggling and Measures of Controlling it in Lithuania. Overview and Assessment” delivered by a representative of the Customs Department at LFMI’s conference “Economic Causes of Smuggling. Challenges for the New EU.”

illustration of this. For example, cigarettes that are produced in Great Britain and intended for export are taken out of the country but do not reach the export market: they are smuggled back to Great Britain. The same happens when only freight documents are “exported” abroad, while the contents do not leave the exporting (and the end-use) market. Paradoxically, customs control and bureaucratic procedures make this kind of violations possible as smuggled goods “get lost” amidst extensive regulations. One can only guess what other ways of smuggling are used. Government agencies have not disclosed, nor statistics captured, the “best” of them yet.

Smuggling is aimed to dodge competition that legal products present. The price of goods that are traded on the legitimate market reflects taxes and other costs of legitimate business, while smuggled goods become cheaper through avoidance of these costs. Smugglers compete among themselves too. This illegitimate business is not protected by law, so smugglers also have to deal on their own with “business” conflicts that are outside the law.

Underlying factors

A variety of factors affects the demand for, and supply of, smuggled goods. These factors create conditions for economic causes of contraband to manifest themselves. The impact that these factors have on the motives of smuggling differs depending on the type of smuggled goods. It depends on the extent to which specific markets are regulated, i.e. whether given commodities are subject to excise tax or customs duties or other regulations, etc. This part of the study analyses the main factors of smuggling, specifically a heavy tax burden, extensive legal regulation, the unpredictable, extensive and burdensome system of business licensing and permits, low quality of public services, strict employment regulations, entrenched corruption, complicated customs procedures, a low living standard in neighbouring countries, import formalities and non-tariff import regulations, organized crime and the infrastructure of contraband.

A heavy tax burden

The tax burden creates strong incentives to avoid legitimate business. Mandatory social security contributions make up 34 percent of the wage bill. Employment earnings are taxed at 33 percent, while other types of income are subject to a 15-percent tax. Sole proprietors pay 15 percent on their profits and another 15 percent on that part of income which they use for their own needs. A pollution tax on packages, enforced from the beginning of 2003, increased the tax burden. Excise taxes are growing rapidly due to Lithuania’s obligations to achieve the minimum EU level. The excise tax on tobacco is set to increase 156 percent by 2009. The excise tax on liquid gas has been raised by 20 percent in 2004. In 2003 the value added tax was levied on certain goods that previously had been exempt from taxation. Frequent changes of tax laws, numerous tax exemptions and a complicated tax collection system increase the indirect tax burden and lead to the expansion of the shadow economy. EU member states do not impose any customs duties or similar levies on the Single Market. The EU applies uniform customs duties to trade with third countries. Prior to membership of the EU Lithuania levied on average lower customs duties on trade with third countries, especially on industrial commodities, than the EU.

Excise taxes are directly reflected in prices. They increase the proportion of regulation-related costs in the final price. Excise tax and value added tax account for 60 percent of the retail selling price of tobacco products and up to 70 percent of the retail selling price of alcohol products. Given that illicit goods avoid tax-related costs, price increases that these factors cause encourage smuggling.

Abundant and unpredictable legal regulation

A complicated, inconsistent and unpredictable business environment is one of the causes of the shadow economy. Starting up a business (registration and licensing), employment relationships and the sale of goods are subject to special regulation. More than 70 government agencies are in charge of controlling business compliance with regulations. Laws and secondary legislation are imprecise, misleading, frequently changing and even retrospective. Regulations are unsystematic and dispersed among many legal acts. Upcoming new regulations are not communicated to the business community in advance. In many cases new regulations come as a surprise. This particularly hurts small and medium-sized business which lacks capacities to keep up with, and adjust to, a constantly changing legal environment. A regulatory practice like this has evolved because of a lack of horizontal coordination, information and administrative capacities in state institutions, overlapping functions and insufficient openness of state institutions, a lack of related public control and inadequate attitudes towards entrepreneurs and citizens as clients and recipients of public services. This increases uncertainty of business and diminish possibilities to plan business and adjust to future changes. Increased uncertainty and limited possibilities reduce incentives for legitimate business and create preconditions for smuggling.

An extensive and cumbersome system of business licensing and permits

The business community place business licensing and the issue of certificates and other business permits among the most serious barriers to doing business. Licenses are applied to more than 30 business activities, while many other types of business require other state permissions which go under different names. Licensing rules lack clarity and licensing procedures are complicated and lengthy. Various agreements, documents, inspection acts, permits, certificates and authorizations have to be submitted in order to obtain a business license. Official and unofficial payments for these documents inflict a heavy burden on starting entrepreneurs. State institutions responsible for issuing licenses have much discretion in applying additional requirements. In many cases companies are required to submit proof that they are ready not only to conduct a certain type of business activity but also to produce a certain type of product. Licensing institutions are left with much leeway to evaluate documentation and to adopt decisions regarding adherence to existing requirements and the issue of licenses. These procedures require large starting capital. They increase the dependence of business on decisions of government agencies and hinder the planning of, and adjustment to, future changes. This reduces incentives to engage in legitimate business and creates preconditions for smuggling.

Low quality of public services

Inadequate public services, i.e. the ensuring of business safety and an effective mechanism of contract fulfilment in court and through bailiffs, are another cause of

smuggling given that law-abiding businesses, whose advantage is to use available state services, do not take advantage of them. This reduces the attractiveness of legitimate business and motivates illegal undertakings to stay informal.

Strict employment regulations

Laws regulate employment relationships in great detail. Restrictions applicable to part-time employment and fixed-term employment plus a lack of tradition and incentives to use flexible forms of employment reduce the flexibility of the labour market. Firing is difficult and costly, especially in large enterprises. This makes hiring risky. Work hours are regulated, overtime is restricted and mandatory remuneration for overtime is high. This explains attractiveness of the shadow economy as being informal makes it possible to avoid detailed, costly and complicated employment regulations and increases the “benefits” of smuggling.

A high level of corruption caused by abundant regulation and wide authority of state institutions

Courts, customs offices, the traffic police, tax inspections, institutions issuing business licenses and other permits and public procurement executives are the most susceptible to corruption. The extensive regulatory system is particularly vulnerable. Protracted decision-making regarding the issue of business permits and licenses is a serious concern. Regulatory agencies exercise wide discretionary powers. Various controlling institutions have a right to inspect how companies adhere to employment, hygiene and fire prevention regulations. They are authorised to impose large fines and penalties without instituting court proceedings. Under such circumstances business people are forced to make unofficial payments in order to have state officials adopt favourable and fast decisions. Business people bear large costs of both implementing official requirements and unofficial purchases. Research into the causes of corruption conducted by LFMI shows that eliminating excessive restrictions and unjustified exemptions, reducing the opportunities for discretionary actions that public servants exercise and simplifying administrative procedures would be the most effective ways to counter corruption. A high level of corruption plus related business uncertainty and costs reduce incentives of legitimate business. On the other hand, corruption as we know it today stimulates smuggling by “communicating” to those interested that, with the aid of corrupt officials, illicit business is possible.

Complicated customs procedures

Despite the enforcement of a new customs code, customs procedures create much difficulty for legitimate business and foreign trade. The rights of importers and exporters are not properly secured. Customs valuation procedures, the filling of customs documents, customs inspections and the procedures for payment of customs duties are frequently unclear and unjustified. Customs officials exercise wide decision-making authority. This creates opportunity for abuse of official power. For example, the provision of information to a customs official that does not meet legislative requirements is prosecuted in Lithuania. A petty or technical problem, even if recognized by a carrier, may not be corrected and the carrier may not be relieved of responsibility.

According to market participants, particularly strict control of freight that was conducted at customs check points at the end of 1998 and at the beginning of 1999 reduced markedly legal flows of goods across the state border. In many cases detailed inspections made part of freight unsuitable for sale, stimulating illegal carriage of goods. Indeed, any strict procedures discourage legitimate operation. Later the practice under discussion was revoked and the incentives for illegal carriage diminished. Numerous exemptions reduce the transparency of customs procedures. For these reasons in fighting smuggling and applying overly tight requirements for legitimate business customs can become a factor that stimulates smuggling.

A low living standard in neighbouring countries

Lithuania's special geographical location is sometimes seen as a cause of smuggling. Lithuania is one of the most eastern EU member states. Lithuania has a border 902 km long with non-EU countries, the Kaliningrad region of the Russian Federation and Belarus. Upon joining the EU Lithuania became a transit country for large-scale contraband, because once brought into Lithuania goods can be taken across the EU with minimal inspections. The price and income levels in the neighbouring countries are lower than those in Lithuania. In 2003 the average wage was LTL 346 in Belarus and LTL 420 in Russia. In the Belarus-Lithuania border region the average wage was even lower, LTL 224 in the Grodno region and LTL 250 in the Brest region.⁷ Smuggling is caused by a high rate of unemployment, especially in the border regions. This encourages people to offer their services as carriers' or distributors of contraband. A low living standard also forces people to spend more time on finding cheaper commodities and to take the risk of buying illicit goods.

Import formalities and non-tariff import restrictions

Goods are smuggled in order to avoid customs duties, formalities and other non-tariff restrictions applicable to the import of goods. Upon joining the EU customs control of the external border is practically regulated at the EU level: a uniform level of customs duties is set for third countries, customs procedures are regulated and uniform non-tariff restrictions are applied to imports. EU regulation applies to the quality, safety and other characteristics of more than a half of all production. These requirements were adopted with allowance being made for a much higher living standard in the old member states, therefore some commodities do not comply with the high EU standards and cannot be supplied on the EU market and in the new member states. Consumers in the new member states tend to buy their usual goods that fit their desired quality level but do not meet EU requirements. This increases incentives for supplying such goods. For example, Lithuanian consumers are accustomed to using medicines from Russia, Ukraine and Belarus. However, these products no longer meet the established high quality requirements and therefore cannot be supplied legitimately. So they are smuggled into the country.

The infrastructure of smuggling and criminal structures

Smuggling is usually an organized form of activity that requires co-operation among separate persons and groups, competence of the players, organizational and financial

⁷ In Lithuania the average wage was LTL 1,146 in the first half of 2004.

resources and division of functions. Investing into and creating these organizational structures help to build the foundation for further illegal activity. This facilitates present and future smuggling, while profits generated from smuggling are used to finance other legitimate and illegitimate activities. Cigarette smuggling across the United States paved the way for smuggling of other goods and helped the mafia to establish itself.⁸ The creation of a distribution network depends on the degree of consumers' tolerance of the distributors and acceptability of the goods that consumers desire and buy in the marketplace. A lack of possibilities to establish distribution networks is mentioned as one of the causes of the absence of smuggling. The economy of smuggling revolves around infrastructure and the use of the economy of scale. It should be noted that this is a secondary factor of smuggling *per se* and one of its outcomes that ensures its further existence. However, the economy of smuggling is impossible without its primary determinants, i.e. the demand for cheap goods and incentives to avoid state control and related costs in satisfying this demand.

The table below presents an assessment of the factors under analysis from the perspective of smuggling and their oversight in the EU and Lithuania. The factors in question have a varying impact on smuggling and specific types of products.

- Importance: this criterion is used to assess the degree of impact that a given factor has on smuggling (on a 3-point scale with 3 being very important, 2 being important and 1 being minor).
- Oversight in the EU: this criterion is used to assess whether a given factor is being handled and eliminated through economic policy measures in the EU.
- Oversight in Lithuania: this criterion is used to assess whether a given factor is handled and eliminated through economic policy measures in Lithuania.
- The relation of a factor with smuggling:
 - A directly related factor. This refers to factors which have a direct impact on the presence of specific goods on the market: rules regulating the presence of these goods on the market and taxes applicable to them. In many cases business people or smugglers consider these factors to be the most important and the most decisive in making a decision to engage in smuggling because these factors are, albeit not necessarily, the most obvious and the most “visible;”
 - An additional incentive. This refers to factors which are not directly related to the regulation of goods but affect the business and market conditions in question and motivate market participants to act either legitimately or illegitimately. Given that smuggling is a form of the shadow economy, market participants can choose other ways of avoiding government-adopted rules, such as double book-keeping, “envelop wages,” etc.
 - A facilitating factor. This refers to factors that are completely dependent on primary causes of smuggling and should not be treated as causes of smuggling themselves. These factors reduce the costs of smuggling.

Individual business people and smugglers treat different causes of smuggling differently. So their weight on individual decisions to engage in smuggling differs.

⁸ For more see Patrick Fleenor “Cigarette Taxes, Black Markets, and Crime. Lessons from the New York’s 50-year losing battle.” <http://www.cato.org/pubs/pas/pa-468es.html>

This depends on specific goods, regulation and popularity of these goods, the ease of transportation and other possibilities to flout and adjust to applicable regulations.

	Oversight in the EU	Oversight in Lithuania	Relation to smuggling	Importance
<i>Heavy tax burden:</i>				
• <i>Customs duties;</i>	Yes	No	Related factor	3
• <i>Personal income tax;</i>	No	Yes	Additional incentive	1
• <i>Corporate income tax;</i>	No	yes	Additional incentive	1
• <i>Excise tax;</i>	Yes	partial	Related factor	3
• <i>VAT.</i>	No	Yes	Related factor	2
<i>Abundant and unpredictable legal regulation</i>	Yes	Yes	Additional incentive	1
<i>Extensive and cumbersome business licensing and permit system</i>	Partial	Yes	Additional incentive	1
<i>Low-quality public services</i>	Yes	Yes	Additional incentive	1
<i>Strict employment regulation</i>	Yes	Yes	Additional incentive	1
<i>High level of corruption</i>	No	Yes	Facilitating factor	2
<i>Complicated customs procedures</i>	Yes	Yes	Related factor	3
<i>Low living standard in neighbouring countries</i>	No	No	Related factor	3
<i>Import formalities and non-tariff import restrictions</i>	Yes	No	Related factor	3
<i>Criminal infrastructure of smuggling and criminal structures</i>	Partial	yes	Facilitating factor	3

Conclusions

1. Smuggling is the carrying of goods across the state border and supplying them on the market in violation of existing rules with the view to avoiding state control and related regulation and/or taxes. Taxes and rules are flouted in order to avoid related costs and to supply prohibited goods that are in demand on the domestic market. Smuggling is aimed to avoid state control because goods do not comply with existing quality and safety requirements or the circulation of given goods is prohibited or the costs inflicted by taxes, regulations and

customs procedures and regulations of intellectual ownership protection make legal operation unacceptable.

2. The causes of smuggling stem from people's desire to satisfy their needs. People who use smuggled goods satisfy their need to purchase desired goods, while those who supply illicit goods seek to satisfy their income needs. Consumers choose acceptable goods in terms of price and quality and tolerate contraband goods and consumption thereof. Traders can satisfy the demand for cheaper goods by reducing the costs of supplying these good on the market. Costs that are inflicted by government regulations and taxes constitute a part of the price structure and can be cut down by refusing to obey government-adopted rules.
3. Factors that are directly related to a given good and factors that present additional incentives for smuggling affect prices and drive them up, thus providing incentives to circumvent government regulation and avoid related costs. Business people and smugglers make an evaluation and are aware of the impact that every factor has on the smuggling of a specific commodity.
4. A tax burden imposed on goods through value added tax, excise taxes and customs duties shows what proportion of the price is directly affected by government regulation and makes it possible to assess what costs can be avoided by way of smuggling. The avoidance of taxes which account for up to 70 percent of the retail selling price is a serious incentive to dodge state control and regulation.
5. Factors that present additional incentives for smuggling are also the causes of the shadow economy which avoids state control. Therefore simpler and easier employment regulations, higher quality of public services, the abolition of business licensing and a reduction of business permits, consistent and clear legal regulation and low personal and corporate income taxes would provide strong incentives to keep away from smuggling and other illegal business undertakings.

II. REGULATION OF THE TOBACCO, ALCOHOL AND FUEL INDUSTRIES, EXCISE TAXES AND IMPLICATIONS FOR SMUGGLING

Tobacco, alcohol and oil products are then most widespread contraband goods in Lithuania. The burden of government regulation inflicted by excise taxes accounts for up to 70 percent of the retail selling prices of the goods in question. This provides strong incentives to avoid state control. In addition to that, these commodities are traditionally subject to numerous business restrictions, such as licensing, advertising and selling restrictions. The purpose of this chapter is to analyse the main regulatory and tax-related factors of the tobacco, alcohol and fuel markets and their implications for smuggling.

This chapter draws on the conclusions made in the first chapter that smuggling is determined by the demand for cheaper goods that are not present on the market and possibilities to satisfy this demand by supplying smuggled goods on the market. This chapter provides an illustration and validation of the earlier conclusions on the preconditions of smuggling.

The first part of this chapter provides an overview of the rationale for government regulation of the markets under discussion and disadvantages of this regulation. The second part analyses specific regulatory policies that are not related to taxation. The third part presents data about excise taxes in the EU, Lithuania and neighbouring countries and discusses general problems of applying and harmonizing excise taxes in the EU.

The rationale and disadvantages of regulation

This part analyses the rationale for government regulation of the tobacco, alcohol and fuel markets and identifies disadvantages of this regulation. An overview of general objectives and shortcomings of the regulation of the said markets helps to make a comprehensive analysis of applicable policy measures and to evaluate them from the perspective of the objectives they are designed to achieve.

Most of the analysed factors of smuggling include economic policy measures that are designed to help regulate the market. These are excise taxes and customs duties, the system of business licenses and permits, employment regulations and the like. Business regulation is a set of legal, administrative and economic policies directed towards the accomplishment of certain objectives. Information asymmetry and neutralization of externalities are the main motives of the regulation of the tobacco, alcohol and fuel markets.

The problem of information asymmetry is first of all solved with the help of a principle of civil law stating that parties to a contract are obligated to provide each other with essential information about the contract. Parties to a contract are obligated to provide each other with information in accordance with the principles of prudence, justice and honesty. If such information has not been communicated, a contract can be deemed invalid and the party concerned will have to return everything it has obtained during the fulfilment of the contract, to cover the costs and to compensate for the non-material harm incurred by the other party.⁹ Suppression by one of the parties to the contract of the information that would have prevented the other part from concluding the contract, provided it had to be communicated in compliance with the above-mentioned principles, is deemed to be deception. So the general legal principles of contract provide an adequate protection against from information asymmetry for both parties.

State regulation designed to alleviate the consequences of information asymmetry is applied on the basis of considerations of how strong parties to a contract are. For example, regulations may be adopted to protect consumer rights or recognition being made for the object of a contract, for example goods that are detrimental to the consumer's health in the case under analysis in this study.

Externalities, or the external effect, are a situation when the costs that an individual market participant bears differ from the general social costs. For example, consumption of fuel satisfies a consumer's need to use a car, but at the same time it causes damage to the environment. Or consumption of tobacco satisfies the needs of a tobacco consumer, but at the same time it inflicts costs on the health care system and

⁹ Article 1.91 of the Civil Code of the Republic of Lithuania.

injures the health of the surrounding people. Externalities are usually neutralized by means of taxes: if consumption of certain goods brings about negative consequences (or creates negative externalities), these goods are subjected to taxation. Such goods include tobacco and alcohol products, hazardous wastes, fuel and others. It is argued that making these goods more expensive is beneficial not only for the state (from the perspective of budget revenues), but also for the society and the consumers of these goods alike. Higher prices diminish consumption and consequently negative consequences it brings. In addition to that, consumers of goods which entail negative effects pay themselves the price of neutralizing these effects. In many cases the rationale for excise taxes is not economic (budget revenues) but related to health, environmental and moral considerations.

In practice however regulation has serious disadvantages. Governments adopt rules in the belief that they possess and make allowance for all available information on the market. Yet, they encounter even greater information asymmetry than the market does. On the market it is prices that transmit information, whereas governments can never have sufficient information about consumers' needs. So as governments take to regulating the market and prices, they are invariably faced with the problem of valuation. As a result, in trying to correct "market failures" governments can and do bring about still bigger failures. The very impulse to amend market defects often has its roots in previous government actions. The correction of market failures creates privileges for some market participants at the expense of others, while governments, in spite of their proper and often declared role of representing the interests of the whole society, finally end up defending narrow group interests. Corruption is another disadvantage of market regulation. It is the role governments assume in specific areas that is first to create incentives for corruption. The more restrictions are imposed on a certain sector, the more incentives they create to "buy" permits in unlawful ways. And the more complicated regulation is, the more incentives they create and the more accessible "permits" are. Admittedly, the level of corruption depends not only on the degree of interventionism but also on the level of citizens' consciousness. If regulation is applied to one chain of supply, there is inevitably a need to regulate others as well.

Leaving aside the question about the rationale and proportionality of regulation, every government-adopted rule inflicts costs on business and creates additional costs for goods. For this reason growing costs force price increases. Yet, market prices are determined by the ratio of supply and demand. State regulations create costs that have to be covered by the consumer. Consumers will either be ready to accept the regulation and cover these costs and or they will try to avoid them by all possible means: they may choose some substitutes or switch to cheaper or smuggled goods. Buyers can also forego such goods and make them disappear from the market altogether. As a result, these goods will not longer be produced or supplied.

It is difficult to determine precisely the price of regulation and the share it constitutes in the final product. For one thing, companies choose different ways of implementing regulations. Second, the costs of implementing the same regulation differ over time. Therefore calculating and comparing what proportion of the final price regulations account for is inexpedient. Government regulators do not calculate these costs either.

The effectiveness and legitimacy of regulations also depends on how clear the objectives of regulation are, whether the measures chosen to accomplish these objectives are proportional to the objectives and whether these measures are not overly restrictive. Impact assessment analysis before and after adopting a regulation can also help improve the quality and effectiveness of regulation. According to the existing rules of drafting legislative proposals in Lithuania,¹⁰ the authors of legislative proposals have to identify possible negative consequences of their proposal and evaluate the impact that it will have on corruption. However, these requirements have been viewed formally so far.

Alcohol and tobacco regulation is also based on demonstratively guardian-like attitudes of the lawmakers towards alcohol and tobacco production, selling and consumption. The belief is that entrepreneurs profit from people's weaknesses and misfortunes, therefore groundless and disproportionate measures can be taken to restrain them. Penalties are widely recognized as the most effective way to reduce tobacco and alcohol consumption.¹¹ The popularity of these measures can also be explained by the state's paternalistic attitudes towards people's health. It is believed that it is the duty of the government to take care of citizens' health and to protect them from all kinds of vices. Tobacco and alcohol regulation is also dictated by aesthetic perceptions of public space and human body. Public areas are protected from those who smoke and people's health is safeguarded from the bad influence of alcohol and tobacco. The lawmakers seem not to notice other vices, such as insufficient mobility, overeating, stresses and the like, that may cause damage to health. Regulations in these areas would be seen as too big interventions into private life, so the lawmakers do not dare to introduce it. Yet, the idea of taxing fast food in order to compensate for the costs that obesity inflicts on the health care system has already been articulated.¹²

It is important to note that with the development of private medical insurance people will increasingly pay for their treatment themselves and so the need to neutralise negative consequences born by the state health care system through excise taxation will be considerably reduced.

Regulation of tobacco, alcohol and oil industries

Extensive regulation

Alcohol, tobacco and oil industries are among the most regulated sectors of the economy. Laws regulate manufacturing of alcohol, tobacco and oil products. Manufacturing of is subject to quality, safety and other requirements that are applied through licensing procedures. Although the production of home-made spirits is widespread in the country, the opposition of the producers and difficulties that

¹⁰ Article 183 of the Seimas Statute; Decree No 277 of the Minister of Justice of the Republic of Lithuania of 29 December 2001 "On the approval of the methodology of the preparation of conceptual frameworks of laws."

¹¹ According to a public opinion poll, 30.1 percent of society thinks that sanctions for traders are the most effective way to fight youth drinking. The opinion poll shows 20.2 percent of the respondents in favour of sanctions for persons who engage the underage in alcohol consumption and 15.5 percent in favour of sanctions for parents and the underage themselves. A public opinion poll: "Penalties are the most effective way of combating youth drinking."

<http://www.delfi.lt/archive/index.php?id=4400283&ndate=25.05.2004&categoryID=3939742>

¹² For more see "The shape of things to come." *The Economist*, 13-19 December 2003.

controlling the quality of home-made production entails have so far prevented legalization thereof. Wholesale trade is regulated by means of licenses. Wholesalers are allowed to sell products only to retailers and wholesalers and are prohibited from selling them to consumers. Regulation is applied to marketing: tobacco advertising is banned and alcohol advertising is restricted. The rules are not clear. The practice of recent years is getting to be more restrictive towards marketing. Restrictions have been applied to advertising campaigns and sponsorship. Retail trade is regulated. Detailed requirements are imposed on trade in bulk oil products. Restrictions on opening hours for the sale of alcohol products and on trade in gas stations have been abolished only recently. The buying of alcohol and tobacco products is restricted. Consumption is also subject to regulation, including limitations on the circle of consumers and the places of consumption and the like.

The abundance of regulation causes a lack of clarity and increases opportunities for discretionary decision-making in state institutions. Every new regulation boosts business costs and undermines incentives for doing legitimate business.

Proportionality of regulation

In order to neutralize the externalities that tobacco, alcohol and oil products create, lawmakers fail to consistently apply the criterion of proportionality of regulation. This means that undertaken regulatory measures are not always adequate to the objective that is set to be achieved. Lawmakers seem to believe they have a duty to take care of citizens' health and can take any measures, even beyond the limits of proportionality, in order to fulfil this duty. Governments set to clamp down on businesses that profit from people's weaknesses and introduce various prohibitions with the view to protecting people from consumption of harmful goods.

The Constitutional Court found a provision of the Law on Alcohol Control stating that companies incur a fine in the amount of LTL 10,000 for breaches laid down in the law and a fine of LTL 20,000 for repeated breaches to be in violation of the constitutional principles of justice and rule of law, stressing that "there must be a rightful equilibrium (proportion) between the objective sought and the measures taken to achieve this objective and between breaches of law and penalties envisaged for them."¹³ The Law on Alcohol Control prescribes an absolute amount of penalty for several legal offences that differ in their nature and damage caused and does not differentiate between penalties. These provisions rule out a possibility to determine the size of penalties in accordance with the nature of breaches and other circumstances. With allowance being made for their right to take care of people's health and to delineate certain restrictions, the lawmakers are still bound by the constitutional principles of justice and legitimacy.

¹³ Del Lietuvos Respublikos alkoholio kontroles istatymo 1 straipsnio 4 dalies (1997 m. liepos 2 d. redakcija), 2 straipsnio 1 dalies (1995 m. balandžio 18 d. redakcija), 3 straipsnio 1 dalies 2 punkto (1995 m. balandžio 18 d. redakcija), 4 straipsnio 2 dalies (1998 m. gruodžio 10 d. redakcija), 13 straipsnio (2000 m. liepos 18 d. redakcija), 30 straipsnio 1 dalies (1997 m. liepos 2 d. redakcija) bei 44 straipsnio 4 dalies (2002 m. birželio 20 d. redakcija) ir Lietuvos Respublikos Vyriausybės 2001 m. sausio 22 d. nutarimu Nr. 67 "Del alkoholio produktu gamybos licencijavimo taisykliu patvirtinimo" patvirtintu alkoholio produktu gamybos licencijavimo taisykliu 7 bei 9 punktu (2001 m. sausio 22 d. redakcija) atitikties Lietuvos Respublikos Konstitucijai. The official gazette "Valstybes žinios," 2004, No 15-465.

The Law on Alcohol Control and the Law on Tobacco Control provide for a one-year suspension of licenses for trade in tobacco or alcohol products as a sanction for repeated violations of the laws in questions. These provisions raise doubts concerning proportionality of regulation. The revoking of a license can be tantamount to a company's bankruptcy, which is a maximum penalty for a company as a business entity. Following the principle that a penalty has to be proportional to a committed violation of law, the revoking of a license, say, for keeping home-made alcohol products (Article 17 Part 2 Point 7) or for unintentional violations of law is disproportionate. This penalty is not effective from the point of view of prevention either, because it can be dodged by re-registering the company or through a formal transfer of ownership or the company's management to other persons. The revoking of a license for minor violations provides favourable conditions for unfair competition, as some companies may be interested in their competitors losing their licenses.

In 2004 the state monopoly of strong alcohol production was abolished. The Constitutional Court ruled that the monopoly contradicted Article 46 of the constitution providing that the Lithuanian economy is based on private ownership rights and forbids market monopolisation by law. The state monopoly had been maintained to preserve the manufacturing of strong alcoholic products in state ownership and thus achieve a reduction of alcohol consumption. The ruling of the Constitutional Court emphasised that regulation of an economic activity may not result in monopolization of production or the market and has to safeguard free competition and freedom of economic activity.

Disproportionate measures undermine incentives to engage in legitimate business as they increase the risk of legitimate business and make it impossible to foresee disproportionate decisions. Such business conditions create additional preconditions for smuggling of the goods under discussion.

Compliance costs

Every regulation inflicts additional costs on companies and creates pressure on final prices.

The Law on State Reserves of Oil Products and Oil provides that manufacturers and importers of oil products as well as companies transporting oil products into the country have to accumulate reserves of motor petrol, aviation petrol and petrol-like reactive fuel, diesel oil, gasoline, kerosene, kerosene-type reactive fuel and fuel oil. Companies that are obligated to accumulate reserves have to cover all costs of accumulating and maintaining reserves with their own funds. The law states that these expenses are reflected in the costs of the goods and services these companies sell. Companies have to invest in fuel tanks and safety measures and to "freeze" a necessary amount of fuel. The law also lays down requirements for the equipment of warehouses (terminals) to ensure that oil products could be taken and transported to the location of utilisation by road or railway or through pipes.

The Ministry of the Economy carried out an assessment of the impact that these requirements will have on business entities. It was concluded that the implementation

of the provisions in question will have cost companies about LTL 173 million by 2009, the year set for complete implementation of the requirements.

Given that smugglers seek to take advantage of existing price differences and to supply goods that are in high demand, the costs that additional requirements impose on businesses and goods encourage smuggling. Additional regulations augment the costs of legitimate goods and by doing so they widen price differentials and increase profits from smuggling. All this bolsters incentives for smuggling.

Information requirements

In labelling tobacco products, tobacco manufacturers are required to include, in addition to the information required by legal acts, health warnings about harmful effects of tobacco products on cigarette packets intended for sale and any outside packets of tobacco products. The warnings have to indicate the amount of tar, nicotine and carbon monoxide contained in cigarettes. It is also required that health warnings occupy up to 40 percent of a cigarette pack.

Every year manufacturers and importers of tobacco products have to submit written reports detailing the composition of tobacco products intended for sale in the Republic of Lithuania. Information has to be provided for every brand, trade mark or type of tobacco products and it has to detail all ingredients of tobacco products and the amount, categories and functions of these ingredients, the reasons why tobacco products contain these elements, available toxicological data and methods by which these data are obtained and health implications of the ingredients, including the effect of addiction. Compiling these reports requires an effort of scientific research that the manufacturers have to carry out at their own expense. Such obligations burden business entities with responsibilities that are untypical of them. They also require additional costs that create pressure on the final price of a product.

Information requirements augment costs and force price increases. This bolsters demand of cheaper illicit goods.

A lack of clarity and unpredictability of implementation

Legal regulation lacks clarity. The contents of legal norms raise doubts for persons who are supposed to fulfil them and for state agencies that are charged with their enforcement. Business entities are forced to run the risk of making mistakes in implementing ambiguous legal provisions plus the risk of malicious actions on the part of state institutions. The Constitutional Court investigated compliance of the provision of the Law on Alcohol Control delineating the definition of alcohol advertising with the constitution. The court ruled¹⁴ that the said provision was consistent with Article 24 of the constitution protecting freedom of expression but the Law on Alcohol Control was being applied inadequately as state institutions and courts interpreted the contents of the aforesaid provision too broadly. The Constitutional Court ruled that “legal certainty and clarity were essential elements of rule of law that are enshrined in the constitution: legal regulation has to be clear and consistent, while legal norms have to be formulated precisely and explicitly.” State

¹⁴ Ibid.

institutions considered any information about alcohol consumption to be alcohol advertising, but the Constitutional Court emphasised that an advertisement is commercial information that is aimed to influence consumer choice or purchase of certain products and to stimulate a certain kind of consumer behaviour. The Court recognized that the legal provision in question was applied too broadly. It should be noted that a lack of clarity in the contents of legal norms impedes the implementation of the principle of legitimacy by state institutions. Applying this principle requires a clear and explicit formulation of legal norms, i.e. legal norms have to define clearly and explicitly the rights and duties of individuals and state institutions. In this particular case state institutions treated the provision of the law inappropriately for several reasons: the legal norm in question was not clearly defined or state officials abused their official powers.

A lack of clarity and unpredictability of implementation of legal norms affect the operation of business enterprises and pose additional obstacles to legitimate business.

A multitude of regulatory institutions

Article 34 of the Law on Alcohol Control and Article 26 of the Law on Tobacco Control lay down economic sanctions for violations of these laws. Fines for various types of breaches range from LTL 1,000 to LTL 80,000. Eight non-judiciary institutions are authorised to impose fines. To begin with, if decisions are to be taken impartially and transparently, fines as high as this need to be imposed by courts. Second, although these fines are levied for administrative violations of law, they are as high as criminal penalties in size. When criminal punishment is imposed by court, criminals are entitled to all kinds of procedural guarantees that ensure their right to impartial investigation. When such fines are imposed through administrative proceedings by non-court institutions, suspected offenders can receive fines that will be equal to those envisaged for criminal offences in the Criminal Code but will not be entitled to procedural guarantees prescribed for criminal proceedings. It is therefore advisable that such fines for administrative breaches are imposed only by courts and guarantees of impartial and transparent legal proceedings are provided.

The factors under discussion increase the risk of legitimate business and incentives for illegal undertakings because business interests are not properly protected in terms of judiciary matters from inadequate actions of state institutions and.

Advertising restrictions

Advertising of tobacco products is prohibited, while advertising of alcohol products is restricted. Article 29 of the Law on Alcohol Control lists detailed restrictions applicable to alcohol advertising. These restrictions are defined very vaguely (for example, a favourable treatment of immoderate consumption of alcohol products or a negative treatment of abstinence and moderation) and raise doubts regarding their expediency (for example, restrictions applicable to advertisements that are placed on title pages of newspapers or independent supplements of newspapers, journals and books).

Research shows¹⁵ that under a complete prohibition of advertising of tobacco products manufacturers sometimes resort to smuggling as a marketing policy. New brands of cigarettes are first brought onto the market as cheap contraband cigarettes. If advertising is banned, introducing new types of cigarettes is costly and lengthy. Later these cigarettes are “legalized” and are supplied legitimately. Smuggling is a way to supply new cheap cigarettes whose introduction on the market by means of advertising would be very costly or, under a complete prohibition of advertising, lengthy.

Business licensing

In Lithuania licenses are required for growing tobacco, for the manufacturing of, and retail and wholesale trade in, tobacco products, for the manufacturing and import of, and retail and wholesale trade in, alcohol products and for retail trade in oil products.

Trade is subject to extensive licensing. Six types of licenses are issued for trade in oil products. In order to obtain them, it is necessary to fulfil licensing requirements and to pay a state levy. Eleven licenses are applied to the manufacturing of alcohol products. These licenses differ depending on the type of trade (retail and wholesale), the types of alcoholic drinks (beer or other types of alcoholic drinks), the actual alcoholic strength by volume of alcoholic drinks (with actual alcoholic strength of ethyl alcohol not exceeding 22% vol. and exceeding 22% vol.), seasonality and the like.

Fulfilling licensing requirements prior to the receipt of a license is costly and complicated for starting enterprises. In order to obtain a license for the manufacturing of alcoholic drinks, it is necessary to submit documents showing that the qualifications of the personnel of the quality laboratories and production personnel comply with the requirements prescribed by the State Food and Veterinary Service, a certification of the alcohol quality test laboratory carried out in accordance with the procedures approved by the State Food and Veterinary Service, a document showing that technical conditions (equipment) and facilities for the manufacturing of alcohol products and the equipment and facilities of the quality laboratory meet the requirements laid down in normative documents and legal acts, and a certificate of a food maintenance company issued in accordance with the procedures established by the State Food and Veterinary Service.

Other areas of manufacturing and trade are also subject to quality and safety requirements. Compliance with these requirements is ensured, not through licensing procedures, but by controlling the quality and safety of products and business activity. Levies charged on the issue of licenses definitely exceed the costs of issuing licenses. They are charged as a tax on a given type of business activity and duplicate other taxes imposed on business. License dues erect a serious barrier to market entry for new companies and by doing so they restrict competition. Splitting licenses for the manufacturing of alcoholic drinks by the alcoholic strength of ethyl alcohol undermines competition between different brands of alcoholic drinks.

¹⁵ Luk Joossens, Martin Raw. “Cigarette smuggling in Europe: who really benefits?” <http://tc.bmjournals.com/cgi/content/full/7/1/66#B1>

Additional control of business activity that is carried out by means of licensing increases business costs and reinforces incentives to supply cheaper contraband goods.

Market regulation through excise taxes: an overview and problems

The application of excise duties, unlike other taxes (personal and corporate income taxes and the value added tax), is usually validated not only by budget revenue needs but also other “important public” needs. Excise taxation is levied mainly on goods whose consumption entails negative consequences and when costs that an individual market participant bears differ from the general social costs. This means that the consumption of excisable goods creates negative externalities. Excise taxes are harmonized in the European Union. The reasons for the harmonization of excise taxation are twofold: (i) to converge price levels in the common economic area and (ii) to prevent a reduction of the income incidence in high-tax countries caused by the consumption of a given good in countries other than those for which the good is intended or by smuggling. This part of the study provides an overview of the excise tax rates in the European Union and discusses the main problems of applying and harmonizing excise taxation.

The Law on Excise Duties in Lithuania provides that excise duties are levied on:

- 1) ethyl alcohol and alcoholic drinks;
- 2) finished tobacco products;
- 3) energy products; and
- 4) electrical energy.

The Lithuanian Law on Excise Duties has been brought in line with the legal acts in the EU which prescribe goods chargeable with excise taxes, the minimum rates of excise taxes, the rules of administering excise taxes and exemptions.

Excise tax rates on cigarettes, alcoholic drinks and fuel

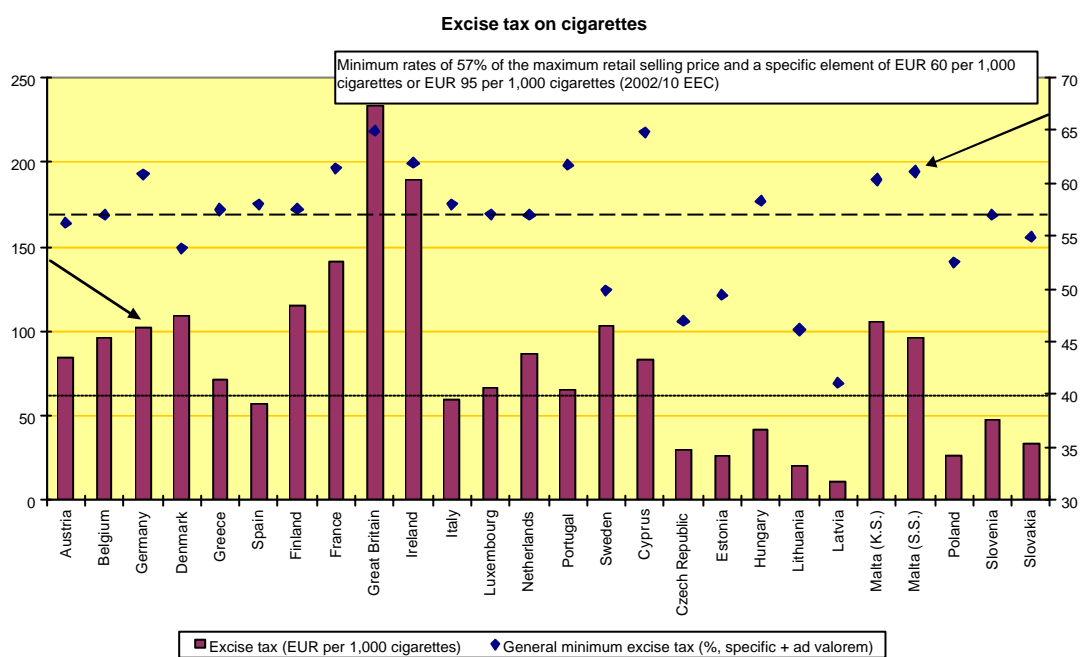
This part of the study presents excise tax rates and compares them with the rates of excise taxes applicable in the EU member states, Russia and Belarus.

Excise tax on finished tobacco products

Excise tax is charged on all kinds of tobacco products: cigars, cigarillos, smoking tobacco and cigarettes. The following analyses taxation of cigarettes, which are a popular consumer and contraband product.

Pursuant to Directive 2002/10 of the EU, member states can apply a minimum excise burden on cigarettes of (i) 57 percent of the retail selling price of the Most Popular Price Category and EUR 60 per 1,000 cigarettes or (ii) EUR 95 per 1,000 cigarettes. Starting from 1 July 2006 the directive requires that member states raise the excise tax from EUR 60 to EUR 64 and from EUR 95 to EUR 101 per 1,000 cigarettes. The directive also requires that the taxation contains an *ad valorem* element, expressed as a percentage of the maximum retail selling price, and a specific element, expressed in euros or national currency per 1,000 cigarettes.

Compliance with the minimum excise burden requirements (57 percent and EUR 60 or EUR 95) is assessed by calculating the general excise tax burden, including the *ad valorem* and specific elements. This tax burden best reflects the excise tax differentials across member states. Of all of the old member states, only Spain has not achieved the rate of EUR 60 per 1,000 cigarettes, but the excise tax applied in Spain meets the 57-percent incidence requirement. The highest excise taxes are applied by Great Britain, EUR 233.38,¹⁶ Ireland, EUR 189.45, and France, EUR 141.22. In Scandinavian countries excise taxes on cigarettes range from EUR 102 to EUR 115. Excise duties make up EUR 20.38 in Lithuania, EUR 11.39 in Latvia, Poland and the Czech Republic and EUR 26 to 29 in Estonia. Of all the new member states, only Malta and Cyprus have exceeded the minimum rates.



In the old EU member states taxes (VAT and excise duties) account for 69 to 79 percent of the total retail selling price of cigarettes.

Excise duties in Belarus and Russia, the main suppliers of contraband cigarettes,¹⁷ are lower: in Russia the general excise burden on filter cigarettes comprises EUR 2.385 and is almost nine times lower than that in Lithuania and a hundred times lower than that in Great Britain. The retail selling prices of the most popular cigarettes, expressed in litas, are LTL 3.04 in Lithuania, LTL 24.8 in Great Britain and LTL 0.97 in Russia.

¹⁶ The data about the excise tax rates and the most popular price categories in EU member states as presented in the text and the tables are drawn from the European Commission's Internal Market and Tax Directorate General http://europa.eu.int/comm/taxation_customs/publications/info_doc/info_doc.htm and reflect the data of 17 December 2003.

¹⁷ According to the data of the State Border Guard Service, 71 percent of the detained cigarette contraband was carried from the Kaliningrad region of the Russian Federation and 20 percent from Belarus.

Excise cigarette taxation in EU member states, Russia and Belarus

Country	<i>Ad valorem</i> element	Specific element, EUR per 1,000 cigarettes	General excise burden, EUR per 1,000 cigarettes	MPPC, EUR per 1,000 cigarettes
EU minimum	- 57 percent of the Most Popular Price Category and the general burden of EUR 60 per 1,000 cigarettes; or the general burden of EUR 95 per 1,000 cigarettes.			
Finland	50	15.13	115,20	200.14
Germany	24.23	61.7	102,51	168.42
Great Britain	22	154.34	233,38	359.25
Spain	54	3.91	56,56	97.50
Lithuania	15	13.76	20,38	44.17
Latvia	6.1	9.7	11,39	27.71
Estonia	24	13.42	26,08	57.23
Poland	25	14	50,86	50.86
Belarus		1.8 (filter cigarettes) 0.8 (non-filtre cigarettes)		6.08
Russia	5	1.67* (filter cigarettes), 0.64 (non-filtre cigarettes)	2,385 (filter cigarettes) 1,355 (non-filtre cigarettes)	14.3

Sources: Belarus statistical data,¹⁸ Tax Code of the Russian Federation

* The exchange rate of Russian ruble and euro is 35.9953, as set by the central bank of the Russian Federation on 15 July 2004

The data show that the retail cigarette prices and the excise tax burden differ markedly in Lithuania, its neighbouring countries and EU member states. In the old EU member states the excise tax accounts for up to 79 percent of the retail selling price of cigarettes. It is the main factor of high cigarette prices. Wide price differences caused by excise taxation are a strong incentive for cigarette smuggling.

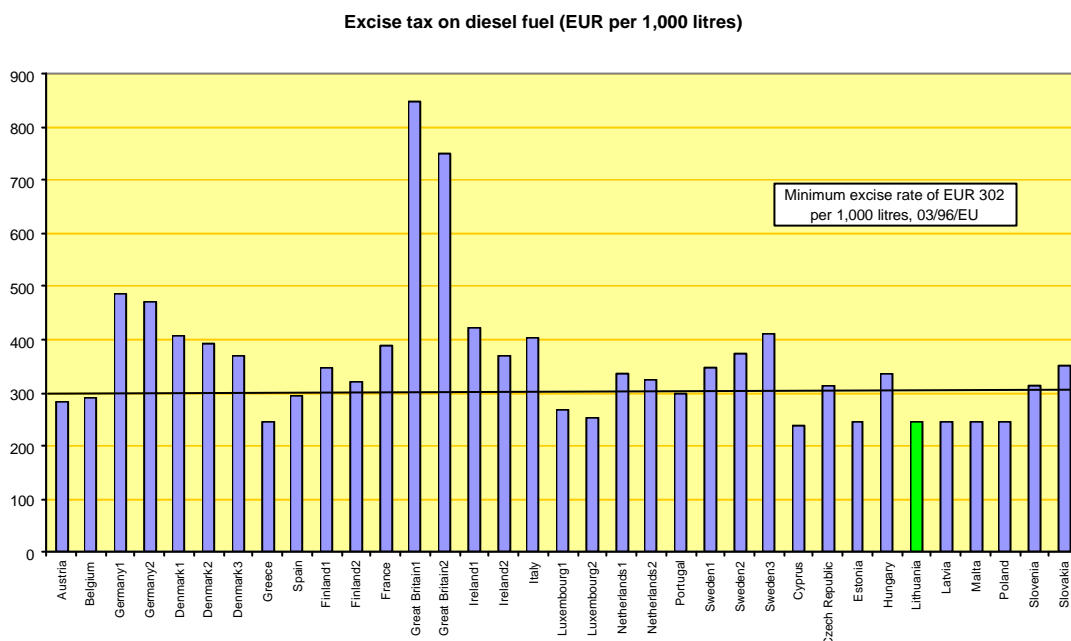
Excise taxes on fuel

Excise tax is levied on lead-free petrol, leaded petrol, kerosene, diesel fuel, fuel oil, orimulsion, oil gas and gas carbohydrates. This part presents an overview of the excise tax rates charged on petrol, gasoline (diesel fuel) and liquid gas.

¹⁸ The data about the excise taxes in Belarus are drawn from Jaroslav Romanciuk's presentation „The Economic and Political Situation in Belarus: Implications for Smuggling in Lithuania,” delivered at LFMI's conference „Economic Causes of Smuggling. Challenges for the New EU.”

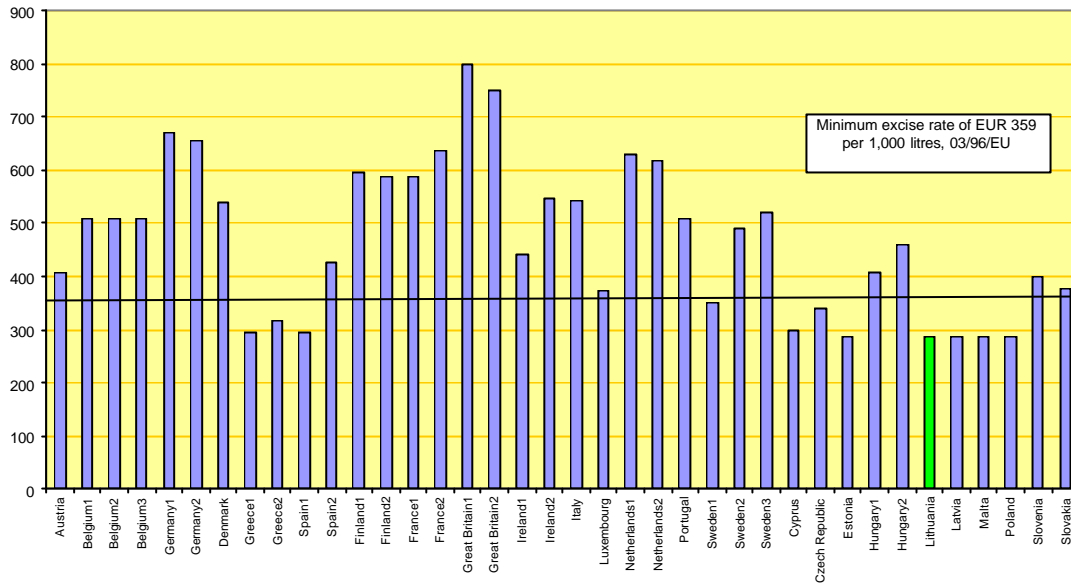
The excise tax rates on fuel are laid down in EU Directive 2003/96 of 27 October 2003. This directive changed the composition of taxes on energy products and electrical energy and replaced Directives 92/81 and 92/82.

The minimum excise duty on diesel fuel is EUR 302 per 1,000 litres (EUR 330 starting from 2010). In the old member states excise taxes on diesel fuel are higher. They range from EUR 253 (in Luxembourg) to EUR 848 (in Great Britain) per 1,000 litres. In most of the EU member states excise taxes are from EUR 300 to EUR 400 per 1,000 litres. This group contains some of the new member states (Hungary, the Czech Republic, Slovenia and Slovakia). Starting from 1 May 2004 Lithuania applies a rate of EUR 245, but a transition has been allowed to achieve the minimum EU level: the rate will be EUR 274 starting from 2008, EUR 302 from 2011 and EUR 330 from 2013.

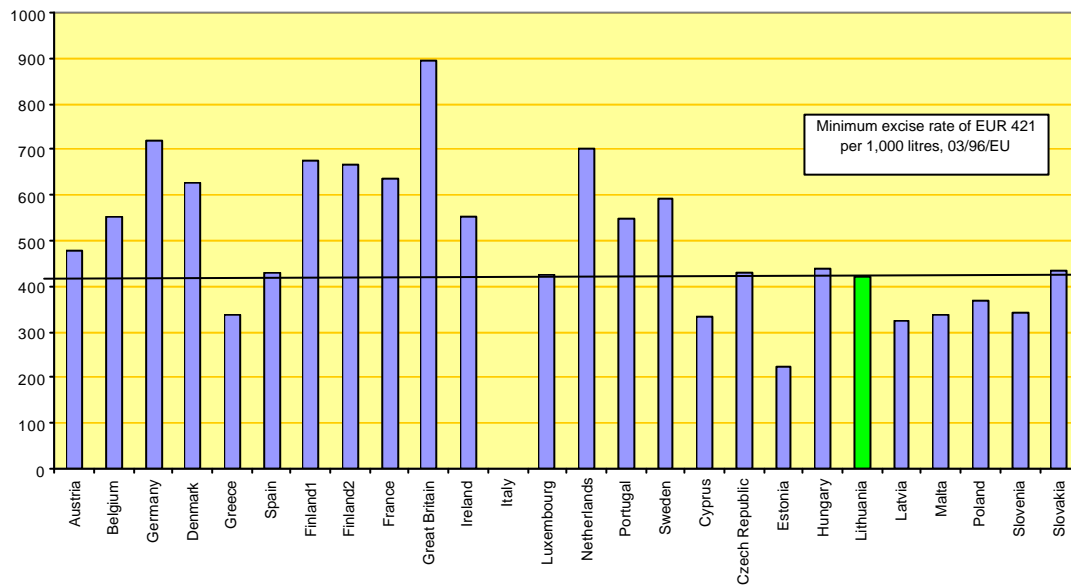


The minimum excise tax rate is EUR 359 per 1,000 litres charged on lead-free petrol and EUR 421 per 1,000 litres on leaded petrol. The new EU member states charge the lowest excise duties on lead-free petrol. They range between EUR 400 to EUR 450 in Hungary and EUR 223 in Estonia. Great Britain charges the highest excise tax on lead-free petrol (EUR 900) and Greece applies the lowest (EUR 337). In Lithuania, excise duties on lead-free petrol and leaded petrol differ. They are EUR 421 and EUR 287 per 1,000 litres respectively. Lithuania has been allowed a transitional period to meet the minimum excise tax rate on lead-free petrol: the rate will be EUR 323 from 2008 and EUR 359 from 2011. The Lithuanian excise duty on leaded petrol complies with the EU requirements.

Excise tax on lead-free petrol (EUR per 1,000 litres)



Excise tax on leaded petrol (EUR per 1,000 litres)



Of the four types of vehicle fuel, the excise tax charged on liquid gas is the lowest. Belgium, Finland and Cyprus apply a zero rate. The highest excise taxes are in Denmark (EUR 469 per ton), Italy (EUR 285), Hungary and Slovakia (EUR 189) and Bulgaria (EUR 175). Lithuania charges EUR 125 per ton. The minimum excise duty on ethyl gas is EUR 125 per ton (03/96/EU), so quite a few EU member states have not reached the minimum level yet.

Excise duties on fuel in EU member states, Russia and Belarus

Country	Leaded petrol, EUR per 1,000 litres	Lead-free petrol, EUR per 1,000 litres	Diesel fuel, EUR per 1,000 litres	Gas, EUR per 1,000 kg
EU minimum	421	359	302	125
Finland	676.2	596.5	345.9	0
Germany	721	669.8	485.7	161
Great Britain	895.33	799.59	848.65	143.38
Spain	428.79	395.69	293.86	125
Lithuania (data as of 1 May 2004)	421	286	244	125
Latvia	323.33	246.34	153.96	76.98
Estonia	223.69	223.69	162.97	95.87
Poland	369.72	331.22	249.62	99.54
Belarus	80.1* 101.18** 113.83***		50.59	N/A
Russia	51.36 ⁱ 70.18 ⁱⁱ		23.42	No tax

* except for 1991, 1992, 1993, 1995, 1996 and 1998.

** for 1991, 1992 and 1993.

*** for 1995, 1996 and 1998.

ⁱ for petrol with octane number not exceeding 80.

ⁱⁱ for petrol with octane number not exceeding 80.

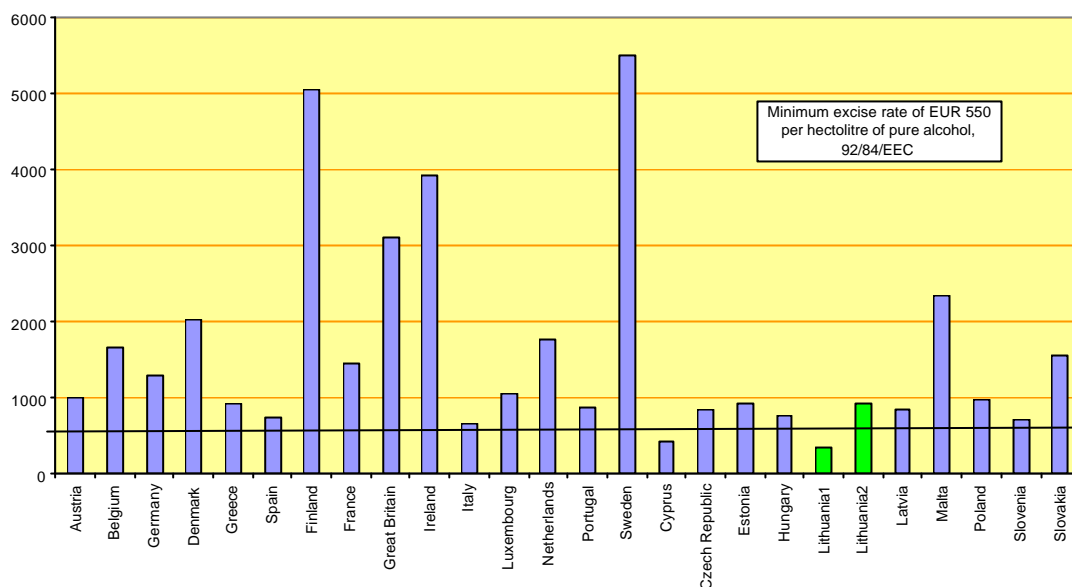
Excise taxes in Lithuania and neighbouring non-EU states differ three to six times. Retail fuel prices in Lithuania are approximately double those in the Kaliningrad region of the Russian Federation and Belarus.

Excise taxes on ethyl alcohol and alcoholic drinks

The minimum excise tax on ethyl alcohol¹⁹ is EUR 550 per hectolitre of pure alcohol (92/84/EEC). The lowest excise taxes on ethyl alcohol are in the new EU member states of Central Europe and Italy and Portugal, where they are lower than EUR 1,000. The lowest rates are in Cyprus, Italy and Slovenia (EUR 348), while the highest levels are in the Scandinavian countries, Great Britain and Ireland (from EUR 2,000 to EUR 5,500 per hectolitre. Lithuania applies a higher rate (EUR 927), except for the excise tax on mead (EUR 348), than that required by EU Directive 92/84/EEC.

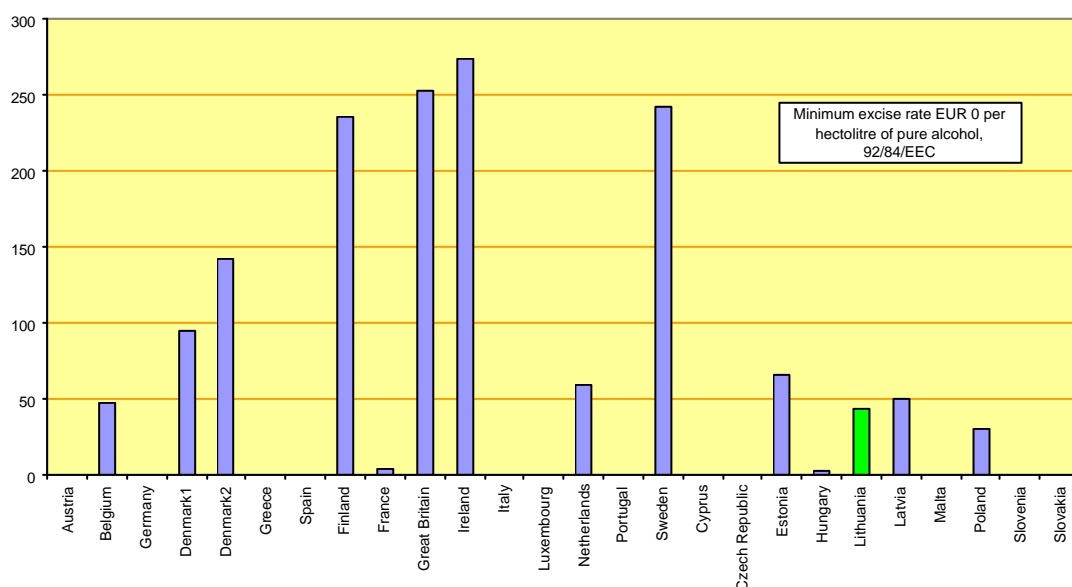
¹⁹ This category includes alcoholic drinks with the actual alcoholic strength by volume exceeding 22% vol.

Excise tax on ethyl alcohol (EUR per hectolitre of pure alcohol)



Pursuant to EU Directive 92/84/EEC, the minimum excise tax on wine is zero. However, EU member states apply different excise tax rates on still and sparkling wine. Excise taxes on still wine range from zero (in Austria, Germany, Greece, Spain, Luxembourg, Italy, Portugal, Cyprus, the Czech Republic, Malta, Slovenia and Slovakia) to EUR 240 per degree of actual alcoholic strength in hectolitre in Sweden. In other Scandinavian countries excise taxes on still wine are high as well: they are EUR 235 in Sweden and up to EUR 142 per degree of actual alcoholic strength in hectolitre in Denmark. Great Britain and Ireland also charge high excise taxes on still wine, EUR 253 and EUR 273 respectively. In other countries excise tax rates range from EUR 30 to EUR 60 per hectolitre.

Excise tax on wine (EUR per degree of actual alcoholic strength in hectolitre)



Excise taxes on sparkling wine are somewhat higher. A zero-tax rate is charged in Greece, Spain, Italy, Luxembourg, Portugal, Bulgaria, Malta and Slovenia. In Belgium, Austria and Denmark the excise duties range between EUR 140 and EUR 190 per alcohol degree in hectolitre. In Sweden, Finland and the Netherlands excise duties on sparkling wine range from EUR 200 to EUR 250 per hectolitre. Great Britain and Ireland charge the highest rates, EUR 351 and EUR 546 respectively. In other countries excise taxes on sparkling wine range between EUR 30 and EUR 70 per hectolitre.

In this context Lithuania belongs to a group of 13 countries which tax still wine. Shielding the Lithuanian beer market from international wine competition is ostensibly one of the main motives of taxation. It should be noted that the Czech Republic, Germany and Slovakia - countries famous for their long-standing brewery traditions – do not charge excise taxes on still wine. The experience of these countries shows that such policy does not injure the beer industry.²⁰

Country	Ethyl alcohol, EUR per hectolitre of pure alcohol	Beer, EUR per degree of actual alcoholic strength in hectolitre	Still wine, EUR per hectolitre
EU minimum	550	1.87	0
Finland	5046	28.59	235.46
Germany	1303	1.97	0
Great Britain	3,116.14	19.47	252.81
Spain	739.97	2	0
Lithuania	926.89	2.03	43.45
Latvia	846.1	4.7-8.1*	50.41
Estonia	926.2	3.52	66.47
Poland	962.9	6.25	29.75
Belarus	390	0.8**	15
Russia	375	0.86**	6,11

* In Latvia the excise tax rate depends on the alcoholic strength of beer. The table presents excise tax rates charged on beer with an actual alcoholic strength by volume ranging from 2.8% to 7% vol. Beer having an actual alcoholic strength of 7% vol. is taxed at a rate of EUR 64.67.

** In Russia beer with an actual alcoholic strength of 0.5% to 8.6% vol. is taxed at a rate of EUR 4.3 per hectolitre. Belarus charges a general excise tax of EUR 4 per hectolitre. The table presents a comparative rate showing what rate of excise tax, expressed in euros per degree of actual alcohol strength in hectolitre, would be charged on beer with an actual alcoholic strength by volume of 5% vol. per hectolitre.

Problems of applying excise taxes

Excise taxes entail certain problems which should not be ignored or neglected when the application and rates of excise taxes are being contemplated. The following presents a brief overview of these problems.

²⁰ For more see “Study on the competition between alcoholic drinks. Final report. February 2001.”

1. The problems of applying excise taxation are related with negative externalities that consumption of excisable goods causes. To begin with, if a certain externality is to be minimized and neutralized by making consumption of a given commodity more expensive (provided doing so is expedient and meaningful), the externality in question should be serious indeed. Second, this externality should be caused by consumption of any quantity of a given commodity, but not by excessive or inappropriate consumption (excise tax is charged on every first item consumed, but not on additional items whose consumption creates the externality). Third, there are many commodities whose consumption creates (or can create) negative externalities, but they are not subject to excise tax. This raises questions about the consistency of the arguments. Fat food increases the risk of heart breaks, cars entail the risk of accidents, aerosols widen the ozone hole, etc. So if the criteria of neutralizing and minimizing externalities were applied consistently, many goods would have to be taxed (it should be borne in mind that all goods are already taxed with value added tax).

It is difficult, or most probably impossible, to determine what creates the biggest negative consequences and should therefore be subjected to excise taxation. The application of excise taxes is no longer based on the argument of identifying, evaluating and neutralizing negative externalities. This tradition has not been questioned for some time now. No proof or confirmation that “reducing and neutralizing externalities” bring desired results is required. Quite the contrary, there is indirect proof that even governments that seek to do it do not believe their policies can be successful. Additional direct prohibitions that are being used, such as a prohibition for the underage to buy alcoholic drinks or prohibition of smoking in public places or a complete ban on drug consumption, are a good illustration of the failure of excise tax objectives (minimization of externalities). Attempts to warn consumers against consumption of the goods in question in some other ways have a similar effect. Informing consumers about detrimental effects of consumption is one of them. The requirement that health warnings occupy a considerable amount of space on a cigarette pack provides a good example. This also shows that the price factor fails to fulfil the restrictive function assigned to it. As a result, other measures are being sought to accomplish it and these measures may well become overriding policies in achieving the objectives that are currently being pursued through excise taxation..

2. The setting of excise taxes raises many unanswered questions. If excise taxes are designed to neutralize negative consequences of consumption of a given product, the excise tax rate should be linked to the costs of eliminating these consequences. To put it bluntly, excise tax on tobacco should be such as to generate sufficient revenues for the treatment of lung cancer (the so-called Pigouvian level). However, the normal practice in Lithuania has been to set excise tax rates with the view to fulfilling obligations imposed by future membership of the European Union, rather than assessing and validating them in terms of neutralization of externalities. It would also be inexpedient to calculate a general tax rate in this way, while calculating an individual rate would be utterly impossible. The impossibility of implementing this principle raises doubts about the effectiveness and expediency of applying it. In practice

excise tax revenues are not linked to the neutralization of negative consequences.

3. Applying excise taxation with the view to neutralizing externalities brings about negative consequences itself:
 - Relatively more expensive excisable goods force people to switch to equally harmful substitutes. For example, when excise taxes are raised, a smoking person may switch to lower-quality cigarettes that are in line with his or her purchasing power.
 - Excise duties create particularly strong incentives to avoid them by means of smuggling, illegal production and illegal trade. Attempts to reduce these excise-related threats are costly and frequently ineffective. In many cases people do not support such policies because illegal production allows them to satisfy their needs in a cheaper way.
 - Excise tax administration is getting increasingly costly. The rules are becoming more and more complicated, while ensuring compliance with these rules (and a desired proportion of excise tax revenues) requires continuous interventions and active supervision on the part of tax administration agencies.
 - Experts on excise taxation often indicate negative implications that excise taxes have on low-income groups of society. In other words, excise taxes are regressive and discriminatory. The least educated members of society are the ones who pay the lion's share of excise duties. This dictates another alternative to excise taxation, namely education.
 - Experts also emphasize disastrous moral and psychological consequences of excise taxation, such as the shifting of responsibility and crippled motivations.

Problems of harmonization of excise taxation in the European Union

Excise taxes are harmonized in the European Union. The reasons behind harmonization of excise taxes are twofold: (i) achieving convergence of price levels in the common economic area and (ii) preventing a reduction of the income incidence in high-tax countries that is caused either by consumption of a given excisable good in countries other than those for which the good is intended or by smuggling. The main problems of harmonization of excise taxes are as follows:

1. Although excise duties are harmonized at the present moment, the excise tax burden differs markedly across EU member states. In Great Britain the excise tax burden (EUR 233.38 per 1,000 cigarettes) is double that in Finland (EUR 115.2 per 1,000 cigarettes) and four times that in Spain (EUR 56.56 per 1,000 cigarettes). Retail selling prices also range between EUR 359.25 per 1,000 cigarettes in Great Britain to EUR 97.5 per 1,000 cigarettes in Spain. The existing differentials are being tolerated and convergence in price levels is not being achieved.
2. Excise taxes have a major influence on the operation of the market and distort competition within and between commodity groups and between countries. Although this problem is inherent in the very application of excise taxes, it is manifestly obvious on the EU scale. Excisable goods and the rates of excise taxes are political decisions that weigh heavily on prices and consumer choice. It is therefore inevitable that both EU member states, which are protecting their national interests and dominant businesses, and companies whose business is directly affected by excise taxation applicable to their products and

the products of their competitors are trying to exert influence on policy-making regarding excise taxation. A zero-tax rate on wine which the member states producing wine have achieved is the best example of such attempts. Member states are allowed to levy different excise tax rates on sparkling and still wine. Austria and Germany, which do not produce sparkling wine, charge EUR 144 and EUR 136 per hectolitre respectively, while still wine produced in these countries is subject to a zero-tax rate. This is not in line with the declared objectives of excise policy, namely a reduction of general alcohol consumption and compensation of the social costs that consumption of alcohol products inflicts.

Directive 2003/96 regulating taxation of energy products is an example of exemptions and inconsistencies of the EU tax policy. The directive provides a number of exemptions for, or partial applications of, excise taxation. To begin with, the directive allows differentiating tax rates by consumption purposes (for example, Article 2 provides that the directive is not applicable to energy products used for purposes other than vehicle fuel or heating fuel).²¹ Second, the directive provides that member states may apply differentiated tax rates if they adopt fiscal control measures. Third, in certain conditions member states may revoke or reduce the tax rates prescribed by the directive. Fourth, the directive differentiates between the use of fuel for economic and non-economic purposes and for other purposes.

The regulation in question has serious disadvantages:

- Although exemptions provide some flexibility and opportunity to make allowance for specific conditions, they also deny the very essence of harmonization and reveal its shortcomings.
 - Exemptions that are prescribed for specific types of fuel create favourable opportunities for smuggling and fraud. Goods are declared as non-taxable goods, etc.
 - Differentiating excise tax rates by uses of fuel negates the purpose of applying excise taxation, complicates control and tax collection and undermines competition.
3. Economic implications that approximation of excise taxes have differ across EU member states. Income and price levels differ markedly across the European Union, especially in the new member states.

Upon harmonization of excise taxes, especially if these are expressed in absolute terms, countries have to pay approximately the same amount of excise tax regardless of income differentials. This means that some countries have to carry a heavier tax burden, considerably exceeding the cost of neutralizing the mentioned externality. Here regressiveness of the excise tax manifests itself at the level of a less well-off country.

²¹ Neutralization of negative implications for roads and their depreciation is one of the objectives of excise taxation of fuel. Differentiation of taxes on energy products fails to achieve the objectives because the excise tax rate is not linked to expenses necessary for road building and maintenance.

Harmonization of excise taxation was intended to protect the interests of member states with high excise taxes at the expense of the consumers in low-excise countries (who receive lower income than the EU average as a rule). A practice like this is acceptable for the governments in small countries because it implies growing budget revenues.

The level of excise taxes was set without allowance being made for the living standards in the new member states. The existing minimum rate was established for countries whose GDP is almost double that in Lithuania. At present tobacco products are much more affordable in the old member states than in the new ones. According to findings of research that was conducted to evaluate the affordability of 1,000 cigarettes in terms of personal income in various member states,²² the affordability of cigarettes in the EU is almost double that in Lithuania and Poland and almost three times that in Estonia. By the end of 2009 the retail cigarette price will have grown by 156 percent in Lithuania. The excise tax on cigarettes is set to increase by 26 percent. If the income level fails to grow as fast, the affordability of cigarettes will diminish and incentives to buy cheaper goods will increase.

High excise taxes injure Lithuania and other new member states disproportionately because of the costs of administering the long external EU border and wide price differentials on the domestic and neighbouring markets. New member states administer 45 percent of the total external land border of the EU.²³

4. It is not equal taxes but internal competition and free movement of goods that are the tenets of the common EU market. A common market is “commoner,” i.e. more tightly bound, when incentives exist to operate across member states. Differentiation of excise taxes is useful for the common EU market because market participants benefit when differences are wider and make it possible to better satisfy the needs of consumers.

An argument that lowering the minimum excise tax rate will invite unfair competition for countries that maintain higher rates is not conclusive. Although excise taxes are harmonized, the excise tax burden differs sizeably across member states. The excise tax burden in Great Britain (EUR 233.38 per 1,000 cigarettes) is double that in Finland (EUR 115.2 per 1,000 cigarettes) and four times that in Spain (EUR 56.56 per 1,000 cigarettes). The retail selling prices range between EUR 359.24 per 1,000 cigarettes in Great Britain to EUR 97.5 per 1,000 in Spain. So the existing differences are being tolerated and are not viewed as restrictive in terms of competition between member states. The existing minimum excise tax allows member states to raise it without any applicable ceiling, therefore some countries have real possibilities to increase excise tax and consequently widen relative differentials between member states. If legal and political possibilities to increase excise taxes and consequently to widen tax and price differentials are in place, countries should be allowed to reduce excise taxes so that allowance is made for the economic situation in the new member states.

²² The International Tax and Investment Centre, “Cigarette Taxation. Issues for EU Accession countries.” November 2003.

²³ The border with Norway, a country that is not likely to be a source of smuggling due to its high living standard and high excise duties, accounts for 26 percent of the remaining land border of the EU.

Directive 2004/74 of the European Council of 29 April 2004, which replaced Directive 2003/96, provides that new entrants to the European Union may be granted temporary exemption from excise taxes or allowed to reduce them. This directive states that the minimum tax requirements for energy products as prescribed in Directive 2003/96 may bring about serious economic and social difficulties for acceding countries. Difficulties may be by existing relatively low excise taxes on energy products, the economic reforms that these countries are pursuing, relatively low income levels and limited possibilities to cut down other taxes and converge the general tax burden. The preamble has it that, if excise duties were raised as required by Directive 2003/96, the economies and inhabitants of the new member states would experience negative consequences, while a particularly heavy burden would fall on small and medium-sized enterprises. For this reason the directive provides exemptions to minimum excise tax rates. At the same time it is stated that the nature of such exemptions and specific tax rates “shall not be detrimental to the proper functioning of the internal market nor cause distortions of competition.”²⁴

These statements and the excise tax rates chargeable in EU member states validate a conclusion that differences in excise taxes across member states are being tolerated and are possible, that they neither distort competition nor jeopardize the operation of the common market.

Conclusions

1. The tobacco, alcohol and oil industries are subject to detailed regulation which is not always proportional and clear. The abundance of controlling institutions and regulatory rules create favourable conditions for corrupt decision-making. Large direct compliance costs have a major influence on final prices of goods and increase incentives for smuggling.
2. Excise tax rates in Lithuania and neighbouring non-EU countries differ three to six times. Retail fuel prices in Lithuania are approximately double those in the neighbouring non-EU countries. In Russia, which is the main supplier of smuggled cigarettes, the general excise burden on filter cigarettes is EUR 2.385. It is almost nine times lower than that in Lithuania and a hundred times lower than that in Great Britain. The retail selling price of the most popular cigarettes is LTL 3.04 in Lithuania, LTL 24.8 in Great Britain and LTL 0.97 in Russia. Consequently differences in the retail cigarette prices and the excise tax burdens in Lithuania's neighbouring countries, Lithuania and other EU member states create preconditions for smuggling.
3. Excise taxes have been established in breach of the declared objective of reducing negative effects that consumption of the most harmful goods produce. Taxable goods are chosen on the basis of tradition rather than objective valuation. Excise tax rates are not based on objective data about negative consequences that consumption of excisable goods brings, because it is impossible to measure the overall effect experienced by every person individually. Excise taxes intended to neutralize externalities entail negative consequences themselves. They force price increases, encourage smuggling and make consumers buy cheaper but equally harmful goods. In addition to that, excise tax administration is costly and complicated.

²⁴ Preface Part 3.

4. Although excise taxes are harmonized, the excise tax burden differs markedly across EU member states. The existing differences are being tolerated and are not considered to restrict competition among member states. Economic implications of excise taxation differ across EU member states. Excise taxes have a strong influence on the operation of the market and distort competition within and between commodity groups and between countries. Excise tax rates have been set without allowance being made for the living standard in the new member states. The existing minimum level has been established for those countries whose GDP is almost double that in Lithuania. Taxable goods and excise tax rates are political decisions that have a major impact on prices and consumer choice.

III. EXECUTIVE SUMMARY AND RECOMMENDATIONS

1. Smuggling is the carriage of goods through the state border and their supply on the market in breach of existing rules with the view to avoiding state control and related regulation and/or taxes. Taxes and rules are dodged in order to avoid the costs they inflict and to supply prohibited goods that are in high demand.
2. Smuggling is intended to avoid government control when goods do not meet applicable quality and safety requirements, when the circulation of certain goods is prohibited and when costs inflicted by taxes, regulations and customs procedures and regulations of intellectual ownership protection are unacceptable.
3. The causes of smuggling have their roots in people's desire to satisfy their needs. Consumers use smuggled goods to satisfy their needs, while suppliers of contraband satisfy their income needs. Consumers choose acceptable goods in terms of price and quality and tolerate illicit goods and illicit consumption. Traders can satisfy the demand for cheaper goods by reducing the costs that are related to supplying desired goods on the market. Costs inflicted by government regulations and taxes constitute a part of the price structure of a given good. They can be cut down by refusing to obey government-adopted rules.
4. Factors that are directly linked to a given good and factors that present additional incentives for smuggling affect price and force price increases, thus providing incentives to flout government regulation and to avoid regulation-related costs. Business people and smugglers make an evaluation and are aware of the impact that every factor has on the smuggling of a specific commodity.
5. Taxes charged on goods, including value added tax, excise taxes and customs duties, are the most important factor of smuggling. They show what share of the price depends directly on government regulation. Consequently they make it possible to estimate what costs can be avoided through smuggling. Evading taxes that account for up to 70 percent of the retail selling price of a product is a serious incentive to circumvent government control and regulation.
6. Factors that present additional incentives for smuggling are also determinants of the shadow economy. Consequently simpler and looser employment regulations, higher quality of public services, the abolition

of business licensing and a reduction of business permits, consistent and clear legal regulation and low personal and corporate income taxes would be positive incentives to avoid smuggling and other informal undertakings.

7. The tobacco, alcohol and oil industries are subject to detailed regulation which is not always proportional and clear. The abundance of controlling institutions and regulatory rules create favourable conditions for corrupt decision-making. High direct compliance costs have a major impact on final prices and increase incentives for smuggling.
8. Excise tax rates in Lithuania and its neighbouring non-EU countries differ three to six times. Retail fuel prices in Lithuania are approximately twice as high. In Russia, which is the main supplier of smuggled cigarettes, the general excise burden on filter cigarettes is EUR 2.385. It is almost nine times lower than that in Lithuania and a hundred times lower than that in Great Britain. The retail selling price of the most popular cigarettes is LTL 3.04 in Lithuania, LTL 24.8 in Great Britain and LTL 0.97 in Russia. As a result, differences in retail cigarette prices and the excise tax burdens in Lithuania's neighbouring countries, Lithuania and other EU member states create preconditions for smuggling.
9. Excise taxes have been set in breach of the declared objective of reducing negative consequences that consumption of the most harmful goods bring about. Taxable goods are chosen on the basis of tradition rather than objective valuation. Excise tax rates are not based on objective data about the said negative consequences, because it is impossible to measure the overall effect experienced by every person individually. Excise taxes intended to neutralize externalities entail negative consequences themselves. They boost prices, encourage smuggling and force consumers to switch to cheaper but equally harmful goods. In addition to that, excise tax administration is costly and complicated.
10. Although excise taxes are harmonized, the excise tax burden differs markedly across EU member states. The existing differences are being tolerated and are not considered to restrict competition between member states. Economic implications of excise taxation differ across EU member states. Excise taxes have a profound influence on the operation of the market and create distortions of competition within commodity and between commodity groups and between countries. Excise tax rates have been set without allowance being made for the living standards in the new member states. The applicable minimum level has been established for countries whose GDP is almost twice as high as in Lithuania. Taxable goods and excise tax rates are political decisions that have a considerable impact on prices and consumer choice.

Recommendations

1. To make an evaluation of over-extensive regulation as one of the reasons why legitimate business is difficult and costly. To emphasise and eliminate

economic causes of smuggling in developing new methods of fighting smuggling.

2. To eliminate factors that present additional incentives for smuggling and by doing so to reduce incentives for shadow activity. To achieve this, it is necessary to simplify employment regulation, to improve the quality of public services, to abolish business licensing and to reduce the number of business permits, to adopt consistent and clear-cut legal regulation and to lower personal and corporate income tax rates.
3. Given that excise taxes have a strong influence on the functioning of the market, distort competition within and between commodity groups, force price increases and encourage smuggling, to lower excise taxes in Lithuania within the limits allowed by EU directives.
4. Given that the approximation of excise taxes does not help to achieve convergence in the prices of excisable goods in the European Union, while expensive excisable goods hurt hard consumers in the new, not so well-off EU member states, to propose lowering minimum excise tax rates in the European Union. Reducing the minimum excise levels would also be advisable in that increased smuggling injures the most new member states, which administer the majority of the EU external border with less economically advanced countries and suppliers of smuggling.