Paradoxical increase in cigarette smuggling after the market opening in Taiwan
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Objective: To assess the magnitude of cigarette smuggling after the market opened in Taiwan.

Methods: Review of tobacco industry documents for references to smuggling activities related to Taiwan and government statistics on seizure of smuggled cigarettes.

Results: The market opening in 1987 led to an increase in smuggling. Contraband cigarettes became as available as legal ones, with only a small fraction (8%) being seized. Being specifically excluded from the market-opening, Japan entered the Taiwan market by setting up a Swiss plant as a legal cover for smuggling 10–20 times its legal quota of exports to Taiwan. Smuggling in Taiwan contributed to increased consumption of foreign brands, particularly by the young. Taiwan, not a member of the World Health Organization, was excluded from the East Asian 16-member “Project Crocodile”, a regional anti-smuggling collaborative effort to implement the Framework Convention on Tobacco Control.

Conclusions: Taiwan showed a sharp increase in smuggling after market liberalisation. Being excluded from the international community, Taiwan faces an uphill battle to fight smuggling alone. If Taiwan remained as its weakest link, global efforts to reduce tobacco use will be undermined, particularly for countries in the East Asian region.

RESULTS

Smuggling quantity
Before the market opening, a small amount of foreign cigarettes were legally imported under high tariffs. At the same time, smuggling existed, as evidenced by the amount seized in 1986–4800 cases, amounting to 9% of imported cigarettes in that year (table 1). Relative to the amount of imports consumed, this level of smuggling was not significant, and yet it was minimal compared with those in later years. Within two years after the market opened, when legal imports increased 10-fold, the seized amount of contraband, as shown in table 1, also rose nearly 10-fold. Internal industry documents estimated that the increase in smuggled volumes outpaced the increase in legal imports, as seized contrabands only represented a variable fraction of the total, and for at least three years, the smuggled volumes were found to surpass the legal imports. By aggregating and compiling industry estimates, supplemented by official seizure data between 1988 and 1995, smuggled cigarettes amounted to an average of 78% (ranging from 52–138%) of total legal imports. As a result, the smuggling-related loss in tax revenue was as much as the actual revenue gained from legal imports, with an average of 89% (52–138%) of the tax actually collected.
The proportion of smuggled versus legal imports varied among tobacco companies. For example, 14% of BAT products and 17% of Philip Morris products in Taiwan were illegal in 1993 by the industry’s own account, while the proportion from Japan Tobacco International (JTI) was several times higher, 92% in 1992, 86% in 1993 and 70% in 1994. Reasons for such a large proportion of smuggling by JTI will be explained later, but the ratio reflected smaller amounts of legal imports from JTI. Nevertheless, in one given year, JTI products reportedly contributed up to 90% of the total cigarette contraband in Taiwan.12 13

Price and preference of contraband
In Taiwan, some contraband cigarettes were reportedly able to fetch higher prices than their legal counterparts. A market survey from Philip Morris in 1995 stated prices for legal Mild Seven were NT$35–50, with the median at NT$40, while for smuggled Mild Seven, NT$50–70, with the median at NT$60, or 50% more expensive than legal cigarettes. Other contraband brands like BAT were sold at 11–22% above retail prices for legal products. This paradoxical or unthinkable phenomenon came about because “smuggled cigarettes were perceived by consumers as genuine imports and offering superior quality, and generally command a premium price”.14 15 By bypassing the custom, contrabands were believed by many smokers to be fresher than otherwise. One outcome of these higher priced cigarettes on top of the tax evaded was the much higher trade margins for the retailers than legal imports, with “market” margins from 15% to over 30% for the former but fixed at 8% for the latter by law.11 12 13 providing more incentives for contraband sales at the retail outlets.

Aided and abetted by the growing smuggling, a shift in smoker preferences and an increase in consumption for these smuggled brands occurred. Young adult smokers (aged 18–24) increasingly preferred foreign brands over domestic, from near zero before market opening to 64% by 1994, of which 34% preferred Mild Seven. Given the massive smuggling by JTI, the consumption of Mild Seven surged and led its attractiveness to becoming the leading brand smoked by the youth.16 Adult smoking rates increased by 14% and 52% among males and females, respectively, within three years of the market opening.17 Likewise, per capita cigarette consumption increased by 10%, from 1604 pieces to 1758 pieces, within one year of the market opening.18 19 By 1995, while the per capita consumption was 11% above pre-opening levels, Taiwan added one million smokers smoking foreign brands. These post-opening changes exceeded the estimate made by Chaloupka and Laixuthai, who reported an average of 10% consumption increase among the four Asian countries upon market opening.20

Contraband distribution system
To be successful in smuggling, contraband cigarettes need a distribution system for retailing.21 Upon market opening, foreign tobacco companies took advantage of the fledgling betel quid vending kiosks at that time, and asked them to sell imported cigarettes, hitherto limited to licensed vendors. Quite a few smokers purchased their cigarettes from these betel quid kiosks, growing all over the island (27.5%). The business of these stalls or kiosks22 was boosted by the addition of foreign cigarettes sales and led to a rapid increase in its number. These betel quid vendors soon became the distribution venues for smuggled cigarettes.23 24 As much as 90% of retail outlets openly displayed smuggled cigarettes,25 particularly favoured by young adults (56%), aged 18–34.26 As these kiosks provided a fertile ground for Japanese cigarettes, US trade representatives expressed specific concerns to Taiwan, in regards to allowing unlicensed vendors selling cigarettes, both legal and illegal, as one major issue during the 1992 trade negotiations.11 17

Contraband confiscation rates
Between 1988 and 1995 an estimated average of 8% of contraband was intercepted by law enforcement (table 1). This meant that 92% of smuggled product successfully penetrated the market. During these years, smuggling cost Taiwan $1.68 billion dollars from foregone tax revenue, an amount almost equal to the actually collected tax revenue from cigarettes. To alleviate smuggling losses, government launched a series of auctioning for these confiscated cigarettes.2 Such an action triggered repeated protests by the US, as these auctions were tantamount to promoting smuggled products from Japan.17 23 25 After 1993, the Monopoly Bureau responded by destroying the seized products instead. As soon as the destruction started, however, the amount of confiscations sharply decreased to less than one half while levels of smuggling remained (table 1).

Smuggling in other Super 301 countries
Four countries (Japan, South Korea, Thailand and Taiwan), known as Super 301 countries,20 opened their cigarette markets in the late 1980s.2 All four countries saw their market shares of foreign cigarettes increase, but the largest increase occurred in Taiwan (table 2). From opening to 2000, the market share jumped from 2% to 48% in Taiwan, while in Japan, South Korea and Thailand the increases were much smaller, from 5% to 24%, from 0.1% to 9%, and from 2% to

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Table 1 The legal and smuggled cigarette market in Taiwan

<table>
<thead>
<tr>
<th>Year</th>
<th>Legal market (%)</th>
<th>Legal imports (%)</th>
<th>Smuggled estimates (%)</th>
<th>Amount seized (%)</th>
<th>Estimated tax revenue lost (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td>3119</td>
<td>52(2%)</td>
<td>NA</td>
<td>4.8</td>
<td>17</td>
</tr>
<tr>
<td>1987</td>
<td>4327</td>
<td>580(17%)</td>
<td>NA</td>
<td>1.7</td>
<td>17</td>
</tr>
<tr>
<td>1988</td>
<td>3678</td>
<td>576(20%)</td>
<td>553(96%)</td>
<td>45.1%</td>
<td>96% ($168 million)</td>
</tr>
<tr>
<td>1989</td>
<td>3487</td>
<td>526(18%)</td>
<td>570(108%)</td>
<td>36.5%</td>
<td>108% ($187 million)</td>
</tr>
<tr>
<td>1990</td>
<td>3506</td>
<td>573(16%)</td>
<td>791(138%)</td>
<td>57.4%</td>
<td>138% ($249 million)</td>
</tr>
<tr>
<td>1991</td>
<td>3556</td>
<td>505(14%)</td>
<td>660(131%)</td>
<td>1.4%</td>
<td>8% ($242 million)</td>
</tr>
<tr>
<td>1992</td>
<td>3570</td>
<td>114(28%)</td>
<td>708(62%)</td>
<td>129.7%</td>
<td>62% ($241 million)</td>
</tr>
<tr>
<td>1993</td>
<td>4375</td>
<td>143(31%)</td>
<td>760(52%)</td>
<td>67.4%</td>
<td>52% ($248 million)</td>
</tr>
<tr>
<td>1994</td>
<td>3672</td>
<td>814(22%)</td>
<td>588(72%)</td>
<td>38.16%</td>
<td>72% ($192 million)</td>
</tr>
<tr>
<td>1995</td>
<td>3971</td>
<td>1019(27%)</td>
<td>545(23%)</td>
<td>27(5%)</td>
<td>53% ($172 million)</td>
</tr>
<tr>
<td>Average</td>
<td>3704</td>
<td>827(22%)</td>
<td>647(78%)</td>
<td>50(8%)</td>
<td>89%</td>
</tr>
</tbody>
</table>

Source: British American Tobacco12 13 Monopoly Bureau2
Unit: 1000 cases (1 case = 500 packs = 10000 cigarettes)

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18%, respectively. One reason for this 2–5 times larger market share of foreign imports in Taiwan came from the result of massive smuggling. Although data on other Super 301 countries are sketchy, the level of smuggling reported in the industry documents seemed to have paralleled the amount of legal imports.11–26 Taiwan, caught off guard and lacking a comprehensive tobacco control policy, had earned the unenviable position of having the largest smuggled cigarette market among them, constituting an average of 78% of the legal imports and 17% of the total market.

**Complicity of tobacco companies in their roles in smuggling**

Smuggling was extensively discussed as part of the business plans of tobacco companies. Quotes were selected from the internal documents and shown in table 3, arranged according to the 4 Ps of social marketing: price, place, product, and promotion.11 These quotes provided strong evidence that tobacco companies were directly involved in aiding and abetting in the various phases of the smuggling process, with some having business units specifically responsible for this “transit” operation.11–28–30 In addition, because of the unique situation of Taiwan in selectively opening the market to the US and European tobacco companies, such restriction promoted the smuggling phenomenon. Due to an unfavourable trade imbalance, Japan was excluded from the cigarette market opening.11 In desperation, JTI resorted to smuggling to gain a competitive position with other foreign companies.11 JTI set up a small manufacturing plant in Switzerland as a legal cover for importing to Taiwan,11 and smuggled between 10–20 times the legal quota of their main product Mild Seven, as estimated by competitors of JTI.11,12 It would be inconceivable to smuggle such a large quantity for a number of years without the direct involvement of JTI. This type of smuggling operation is characteristic of an extended version of the “umbrella operation”, as described by Collin et al.,13 where “a token legal presence [in Switzerland] enabled marketing and promotional activities to be undertaken in support of contraband [in Taiwan]”. In other words, JTI set up production in European facilities, first in Switzerland and later in Manchester, UK,14 serving as legal cover for justifying the large presence of smuggled cigarettes, which would otherwise be faced with prohibition in the market place. Because of the geographic distance, only a small amount of European-made cigarettes could be produced and shipped to Taiwan. The bulk of the products, as expected, were logistically more efficient to come either directly from Japan or locations in closer vicinity, by way of smuggling. The fact that over 80% of Mild Seven, the leading foreign brand in Taiwan, was smuggled product provided strong evidence that JTI had to be involved in the process.11

**DISCUSSION**

This study is the first to document one of the unexpected effects of market opening: the extent of smuggling and the complicity of tobacco companies in a country during transition from a governmental monopoly to a liberalised and competitive market. This paper unveils the massive smuggling that occurred after foreign cigarettes became legally available, an unthinkable phenomenon. Although smuggling was also encountered in other Super 301 countries,11–13 its magnitude in Taiwan was by far the largest, once referred to as the “smuggler’s paradise”.11 The effect of smuggling lingered on far beyond the immediate period of market opening and, as of 2002, or 15 years later, more than half of the import-smoking young smokers purchased smuggled products.24 The impact of smuggling on the youth was devastating as it affected preference and increased consumption of the foreign brands. Evidence, shown in table 3, has been compelling that tobacco companies were intimately involved, aided and abetted, or directed smuggling activities, in order to circumvent legal quotas, to increase their immediate profits, and to expand their long-term market share.4–12,14–21,22,34,36 The success of JTI experience attested to the fact that these objectives have been largely achieved, resulting in extraordinary financial gains and market domination by this tobacco company for an extended period of time.11–17

To the general public, it seems counter-intuitive to see massive smuggling upon liberalisation of the market. Market opening lowered the tariffs and the price of foreign cigarettes, and, along with competition, low cigarette price was maintained.3 Smokers in Taiwan, having easier access to these products, gradually developed their taste and preference for the imports. When the demand for imports grew, with more smokers seeking these products, so grew the market for smuggled ones.11–13,16,27 This seemed to be a fundamental reason for the smuggling increase, as expanding market would attract more contraband business, a highly profitable endeavour. However, additional reasons accelerated the smuggling increase, and produced a magnitude of smuggling as large as the one seen in Taiwan.

First, these tobacco companies (such as JTI and BAT), in direct competition with one another for profit and market share, resorted to smuggling in order to gain an advantage over each other. BAT, in its business report, considered smuggling as a primary “profit contributor.”30 JTI smuggled for expanding market share. By applying the “umbrella operation”, Mild Seven came from behind and overtook all others27 and became the preferred brand for the young.16 In retrospect, smuggling may not have been so rampant in Taiwan if the Taiwan market were not selectively opened. Once the market was opened to Japan in 1995, “JTI shifted products to legal channel.”11–14

Second, when the market opened, foreign tobacco companies created nationwide retail outlets for the distribution of their products.11,12,27–37 The fledging betel quid stalls received a big boost in business when they were asked to sell cigarettes, a 10-fold larger business than selling betel quid.38 These retail outlets became the hot bed for contraband sale, with over 90% selling smuggled cigarettes.35 These betel quid kiosks, a product of market opening, continued to act as the prime distribution networks for the smuggled products.24 With the higher trade margins,11 street sellers selectively promoted contraband over the legal products.

Third, the market opening provided a legitimate legal front for smuggling.28 By presenting an assortment of cigarettes, contraband took cover under legal products in retail shops, hitherto unavailable. As noticed by BAT in Thailand, “Since market liberalization, the transit business (smuggling) has expanded tremendously under the legal cover front.”35

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**Table 2** Comparison of market share changes among the four Asian Super 301 countries after market opening

<table>
<thead>
<tr>
<th>Year market opened</th>
<th>Japan</th>
<th>Taiwan</th>
<th>South Korea</th>
<th>Thailand</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>5%</td>
<td>2%</td>
<td>1%</td>
<td>13%</td>
</tr>
<tr>
<td>1991</td>
<td>13%</td>
<td>16%</td>
<td>5%</td>
<td>3%</td>
</tr>
<tr>
<td>1992</td>
<td>18%</td>
<td>27%</td>
<td>14%</td>
<td>13%</td>
</tr>
<tr>
<td>1993</td>
<td>24%</td>
<td>48%</td>
<td>9%</td>
<td>18%</td>
</tr>
<tr>
<td>2000</td>
<td>24%</td>
<td>48%</td>
<td>9%</td>
<td>18%</td>
</tr>
</tbody>
</table>

Sources: Annual Statistical Report of the Monopoly Bureau (Taiwan data); British American Tobacco (Japan and Korea in 1993); Tobacco Control British American Tobacco (Japan and Korea in 1995); BATUKE (Thailand).
ment may seem innocent and reasonable on the surface, but, auctioning at below-market prices not only promoted the best bidders and sold back to the market to recover the financial loss. This is particularly difficult as trafficking contraband cigarettes cannot be viewed as a major crime. The effect of a major crackdown ordered by the prime minister in early 1990s was disastrous. Without the goal as a means for preventing tax loss, would only be short-lived. The practice of auctioning off contraband by the government may seem innocent and reasonable on the surface, but, in fact, it was counterproductive to tobacco control. Auctioning at below-market prices not only promoted the market share of that particular foreign brand, but also stimulated their consumption. The increased consumption of the particular brand attracted more smuggling of that brand. On the other hand, auctioning generated significant revenue, which not only made up for part of the loss in excise tax, but was also able to provide financial incentives for the law enforcers. When auctioning ceased and contraband started to be destroyed, confiscation rates dropped sharply in the wake of disappearance of incentives, in turn encouraging more smuggling to occur. In retrospect, destruction of seized products should be pursued in lieu of auctioning, but the incentive programme should also be continued to encourage seizure, with funding sources from placing penalties on the smugglers and the associated tobacco companies.

The 10–22% of the proportion of smuggling on the entire cigarette market witnessed in Taiwan in the 1990s were two to three times higher than the 6–8.5% estimated smuggling rate worldwide by Merriman et al. This massive smuggling occurred despite the fact that cigarette prices in Taiwan have been rated as one of the lowest in the world, particularly taking into account the cost of living. This apparent
paradox is supportive of the belief that an increase in cigarette prices or the amount of tax is not necessarily a major factor in its relationship with the extent of smuggling. Many countries with higher-priced cigarettes saw very little smuggling, while some lower-priced countries had more smuggling. The transparency of the governmental policy, or the lack thereof, and the commitment to cracking down on smuggling have been more important in determining the extent of smuggling.

The smuggling data in this paper came from internal industry documents. Actual smuggling data are notoriously difficult to obtain, let alone verify. This is because of the illicit nature of smuggling; such data are generally considered to be clandestine. Official statistics from seizure represent only that which was intercepted, usually a relatively small portion of the total amount. The industry, by being involved as the supplier, kept statistics for business reasons. Accuracy was required for internal planning, manufacturing and marketing considerations, and for projecting company’s revenue. Some of the data used in this paper were corroborated among several companies, making this conceivably the reasonable source of smuggling statistics.

While governmental commitment is essential, the nature of enforcement efforts against tobacco smuggling requires an extensive transnational coordination. This is one of the most important reasons why the World Health Organization (WHO) worked toward a treaty-like convention (Framework Convention on Tobacco Control, FCTC), fostering international collaboration for an issue traditionally viewed as a domestic programme within individual countries. Taiwan, not a member of WHO, was excluded from the East Asian 16-member “Project Crocodile”, a regional anti-smuggling effort to embrace the spirit of FCTC. As its stated goal, setting up an improved communication system to monitor suspicious shipments crossing borders is essential to control transnational smuggling syndicates, which may use other jurisdictions as a safe harbour. The international community working to fulfill the FCTC requirements could be adversely impacted if Taiwan continued to be excluded from the international collaboration. For global anti-smuggling efforts to be successful, all countries must collaborate, share information and work in concert. An effective counter-smuggling strategy will only be as successful as its weakest link. If Taiwan were to become a “smuggler’s paradise”, global efforts to reduce smuggling and to reduce tobacco use will be undermined, particularly for countries in the East Asian region.

There are at least two limitations of this study. First, the internal documents came mainly from American and British companies, and not from JTI. JTI, being the main perpetrator of smuggling in Taiwan, has not yet disclosed its internal documents. Our data and documents were compiled from its competitors, a potentially biased source. However, the evidence on smuggling by JTI was overwhelming and consistently observed from different companies, including the collaboration of the industry data with the official statistics. Secondly, the public release of the documents as the result of litigation, particularly after the Master Settlement Agreement, made tobacco companies aware that their internal documents would be open to legal and public scrutiny. This may have led to a more discrete handling and gradual disappearance of documents related to smuggling after 1997. Perhaps this is why our smuggling information was largely limited to the first half of the decade.

One approach to control smuggling is to follow the European experience of enlisting the collaboration of tobacco companies. In the 1990s this was resolved in the European Union’s favour; Philip Morris agreed to finance anti-smuggling efforts with US$1.2 billion over 12 years, to implement stricter controls on distribution, and to be liable if its products were discovered in future smuggling confiscations. By holding tobacco companies responsible, the agreement may help reduce industry-directed smuggling, as the company’s intimate knowledge of smuggling will likely assist the overall tobacco control efforts.

Conclusion
The need to expand market share and increase profits by foreign tobacco companies, the availability of retail networks, the legal cover provided by the market opening, and the lax law enforcement were the main forces that led to a sharp increase in smuggling after the market was opened, contrary to an expected decrease. Smuggling increased consumption of cigarettes in general and foreign brands in particular, especially by the young. Smuggling also undermined global tobacco control efforts. Confronting tobacco companies for their liabilities and involving them in reducing future smuggling activities would be a worthwhile pursuit. Further, being excluded from the international community, Taiwan faces an uphill battle to fight smuggling alone. For global anti-smuggling efforts to be successful, all countries must collaborate, share information, and work in concert. An effective counter-smuggling strategy will only be as successful as its weakest link. If Taiwan were to become a “smuggler’s paradise”, global efforts to reduce smuggling and to reduce tobacco use will be undermined, particularly for countries in the East Asian region.

What this paper adds
In theory, opening markets for imported cigarettes should make foreign cigarettes more readily available and reduce the number of smuggled cigarettes. However, the validity of such an assumption has not been fully researched with an actual case study.

Taiwan experienced massive cigarette smuggling after their market was opened in 1987. Contraband cigarettes flooded the market and nearly equaled the volume of legal imports, with tobacco companies directing or facilitating the smuggling process. Smuggling persisted ever since, even though cigarette prices had been low in Taiwan. Cigarette smuggling has been widely used by tobacco companies to increase their market share, to circumvent legal quotas, and to increase profits. Illicit trade is a transnational activity and will undermine global tobacco control efforts. To prevent Taiwan from becoming a smuggler’s paradise, the establishment of regional and global anti-smuggling collaboration under the Framework Convention on Tobacco Control is urgently needed.

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