

Illegal trade in tobacco in MERCOSUR countries

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Working Paper

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(...)

Conclusions

1. Results of our research do not point to tobacco multinationals currently being the major actors in the illicit cigarette trade that they were in the 1990s. Present operators appear to be part of criminal organizations, and this has ramifications not only for countries in the region but also internationally. Gangs dominate the market and have links with, or directly own, cigarette factories in Paraguay.
2. The illegal cigarette market is an enormous source of income but carries low penalties for criminals who are apprehended compared to drug and weapon

trafficking. Gangs linked to these other forms of illicit trade are therefore tempted to enter the cigarette business, while smugglers bring their expertise to other illegal businesses. Illegal networks are consequently created which share logistics, contacts and also resources for money laundering, and generally seek the extension and consolidation of their markets. Authorities are highly concerned about this development and are devoting closer attention to it which may in turn pave the way for more rapid and coordinated responses to cigarette smuggling in MERCOSUR countries.

3. In contrast to what is occurring in Member States of the European Union, where contraband mainly concerns counterfeit cigarette brands and hand-rolled tobacco (for example in the United Kingdom), illegal trade in low-priced little-known brands predominates in the MERCOSUR region. For its low-income smokers, price is the main determinant rather than the allure of well-known brands manufactured by multinational tobacco companies.
4. Although counterfeiting of international brands exists, market characteristics mean this is not the principal strategy of illegal cigarette manufacturers in the region. Tobacco companies mainly in Paraguay, but also to an extent in Brazil, produced forged products where they find markets exist. A more important problem seems to be the theft of brands whereby some Paraguayan companies openly start production of popular regional brands from multinationals. When taken to court, they take advantage of lengthy judicial processes and possibly corrupt judges.
5. Recently, another form of illegal or near-illegal cigarette trade has developed as a response to policy measures that have changed the structure of tobacco taxation, particularly in Brazil and Argentina. Companies are initiating litigation via administrative and judicial procedures to challenge policies they consider favour large companies. In some cases they obtain court protection and are consequently able to reduce, avoid or defer tax payments on cigarette sales. On the one hand, companies may be fighting for a higher share of the market. On the other hand, they are increasingly relying on dangerous on quasi-illegal tactics to do so. Some of them are being uncovered as being plainly illegal operators, and the estimated extent of illegal production in Brazil (some 9 billion cigarettes per year) implies that the problem has reached significant proportions. Given the relative weakness of controls and the slowness of the judicial procedure, companies may believe that the opportunity costs of illegal activities are not high.
6. Differences between retail and wholesale contraband are less distinct in the MERCOSUR region compared to other parts of the world. People who transport small volumes of illegal cigarettes by road and across isolated border crossing do so on a daily basis, and sometimes several times a day. But these activities form part of the strategy of organizations on both sides of the border, and frequently involve their employees. This form of smuggling functions closer to an actual wholesale market rather than the “family” operation typical of retail contraband in other parts of the world. There is also an economic reason for carrying small consignments as penalties mainly involve the seizure of the merchandise. The offender is either not apprehended or is quickly released.
7. The wholesale form of contraband trade, however, relies on containers via rivers and ports in the region and is presumably more important in volume and is less

visible. This form of smuggling benefits from the lack of controls on regional container movements and the solid growth in this type of regional trade through ports in Buenos Aires, Montevideo, Santos, Rio Grande, and others. In this situation, cigarettes originating mainly from Paraguay are hidden in containers with “in transit” documentation directing the cargo to free zones and ports. Often they are unloaded to serve the domestic markets of other MERCOSUR countries.

8. Paraguay is the largest illegal cigarette supplier in the region. There are commercial and tax benefits for locating factories in the country, such as loose controls and low wages, but the primary reason for the growth of the illegal supply of cigarettes in Paraguay can be traced to changes in Brazilian policies to fight contraband in the latter part of the 90's. Those policies, designed to control “export-reentry” devices by companies such as Souza Cruz (BAT) backfired. Some former managers and engineers relocated to Paraguay becoming owners of illegal trade factories. Traditional Paraguayan cigarette manufacturers also took advantage of the opportunity to expand their activities not only towards the clandestine market of Brazil but also to other countries in the region and, increasingly, the world.
9. The Paraguayan city of Ciudad del Este shares the Triple Border with Argentina and Brazil and is one of the more active worldwide centers of brand forgery and illegal trade in cigarettes, electronics, weapons, drugs, clothes, jewelry, spirits, and other articles. Illegal operators of dozens of nationalities congregate there where authorities exercise of low or zero control and there are high levels of corruption and violence. Most of the cigarette factories established in the past 10 years are in this area.
10. Quantifying the extent of the illegal market in the MERCOSUR region is no simple matter. Based on the potential cigarette production in Paraguay, we estimate that around 70 billion cigarettes could have transported illegally in 2007 through more than two dozen tobacco companies, subsidiaries and their associates. In the MERCOSUR region illegal cigarette trade is estimated at 45 billion units (sticks) per year, mostly coming from Paraguay, with Brazil absorbing 90% of this figure. Around 9 billion sticks could have originated from factories in Brazil. The rest of the illegal cigarettes leaving Paraguay that do not end up in Brazil and MERCOSUR countries is estimated in 30 billion sticks. These are smuggled to other Latin America countries, to Panama and Aruba which are major distribution centers for the rest of the world. Based on recent estimations of the worldwide illegal cigarette market (600 billion sticks), Paraguay would be the source of around 11% of this trade, with the MERCOSUR region accounting for 12,5%.
11. Fiscal losses due to illegal cigarette markets in the four countries of the MERCOSUR are estimated to be around USD 900 million per year, with Brazil accounting for 71% of this.
12. Governmental approaches to combating contraband in general, and cigarettes in particular, vary in MERCOSUR countries but are insufficient in all of them. Authorities frequently view the problem as a domestic issue and policy measures have proved inadequate in relation to the versatility and resources available to smuggling organizations that are increasingly regional and international in their nature, contacts and, presumably, their networks.

13. Confiscations in the MERCOSUR region constitute only a small percentage of the estimated contraband trade in cigarettes, as is the case with confiscations of other illicit products. The strategies, routes, logistics and products plied by smugglers involved with contraband, in addition to the limited capacity for control and the corruption of civil servants in participating law enforcement agencies, facilitates the operations of a highly profitable illegal trade.
14. Apart from occasional exchanges in information, which are not always fluid, there is inadequate collaboration between enforcement agencies in MERCOSUR countries. Customs agencies in the region maintain intensive intelligence contact with each other and tend to cooperate effectively but coordination is not always sufficiently adequate to translate this into an increase in seizures.
15. Law enforcement agency operations to pursue smugglers' illegal trade networks involve long periods of intelligence work. Customs and police institutions in the MERCOSUR region are often eclipsed by the criminal gangs they fight against when it comes to resources, organization, systems and motivation. Agencies have problems in adequate coordination with judges and public prosecutors. Nonetheless, Brazil has been relatively successful in recent years in dismantling a number of high-scale illegal operations. Still, it remains the country which is most affected by the illegal cigarette trade.
16. The impulse given to regional and international trade promotion over recent years has unfortunately stimulated flows of contraband cigarettes and other products. Regional trade agreements among MERCOSUR Parties were from the beginning oriented towards facilitating the circulation of goods and the establishment of a customs union. Instruments for the development of regional commerce set up by MERCOSUR, via arrangements such as free trade zones, free ports and customs transit procedures, have, however, provided mechanisms which benefit activities by illegal traders. Considering the thousands of containers that circulate around the Parana-Paraguay river waterway, ports and transit zones, there are inadequate registries of importers and exporters and also inadequate customs controls on traffic zones and warehouses.
17. Argentina is progressively implementing satellite tracking of merchandise during transit operations, and a system of tracking and product location for the primary processing sector of cigarette industry. Brazil is implementing a track and tracing system in secondary processing and distribution of cigarettes. But for these initial efforts to be successful calls for a wider policy approach to smuggling control.
18. MERCOSUR countries have implemented criminal and fiscal legislation against contraband in general. Contraband legislation, however, is applied only partially or not at all or is not being applied effectively to combat illicit trade.
19. Throughout the MERCOSUR region dealing in contraband goods is considered as an offense punishable by imprisonment or restriction of liberty. However, participation in contraband activities in the four countries does not usually carry prison sentences except when other criminal components applied simultaneously increase the sanctions. These concern: a high market value of the goods, money laundering and conspiracy to commit an offense.
20. Even in such cases, however, a person often escapes imprisonment as the case is not forwarded to criminal authorities either for procedural or other reasons,

or proceedings are suspended, imprisonment is not applied, conditional sentences are given. And in many cases the criminal procedure is incomplete and the case is filed.

21. Some countries in the region (such as Argentina and Uruguay) regard contraband as a customs infringement when the value of the goods does not exceed a specified amount. In these cases, sanctions are of a general civil nature resulting in fines, costs, the payment of overdue taxes, and the seizure of goods and in some cases in Argentina and Uruguay result in destruction of the tobacco involved.
22. In Brazil, all custom's seizure proceedings go before the courts, but the result is the same in so far as there are very few judgments that result in prison sentences being imposed, except in cases involving large criminal organizations, of which there are few.
23. Legislation in some of the countries (excluding Argentina) does not distinguish between contraband tobacco and its by-products. Brazil distinguishes between the "re-routing", or illegal trafficking of legal products ("descaminho"), and contraband which refers to the illegal sale of illegal products. This leads to lower sanctions being applied in the case of, for example, contraband cigarettes concerning a brand which is legally sold in Paraguay, as opposed to that involving a forged brand of cigarettes.
24. Some countries in the region apply additional sanctions where a product arising from illegal commerce is forged, or when it is a dangerous drug. Nicotine and other substances contained in tobacco have not been classified as addictive or dangerous to health under legislation in MERCOSUR countries.
25. Impounded cigarettes are required to be burned or destroyed (except in Paraguay). At times, delays in legal procedures lead to a proportion of cigarettes re-entering the market as a result of corruption.
26. General fiscal and criminal legislation against contraband is in place.
27. Contraband goods are illegal in all MERCOSUR countries, resulting in imprisonment or other restriction of liberty, dependent upon circumstances.
28. Legislation covering money laundering is recent and there are insufficient resources to apply the regulations in full.
29. In the MERCOSUR region, the perception exists that criminal gangs are never actually identified and penalized as only rarely do matters come before criminal courts. Tobacco-related cases are regarded as being "light" offenses, of low priority, with imprisonment being unlikely. The goods involved are handed back and there is a general lack of any serious consequences.
30. In Argentina, Paraguay and Uruguay, the majority of proceedings involving contraband do not fall under criminal jurisdiction because the quantities involved are low and, accordingly, cases remain at the administrative level. In some countries, such as Argentina, cases concerning falsification are sent to criminal courts more often than those involving contraband. In the three countries mentioned it is unusual for judicial files to take into account previous offenses involving contraband or customs infringements. Nor are they combined with offenses regarding conspiracy to commit offenses, forgery of trademarks and fiscal stamps or money laundering. In summary, little or no serious consideration is given to the importance of matters that might lead to more significant penalties.

31. The problem of obsolete or inadequate legislation is compounded by a lack, or absence, of specialized prosecutors and judges to confront drug trafficking and money-laundering. Offenses are often committed by gangs operating in several countries in the region, with international allies and contacts. This requires a high degree of specialization in the judicial field. The problem is compounded by the shortage of trained personnel in public prosecutors offices and courts who can address contraband, drug trafficking and money laundering. While there is legislation against money laundering, it is recent and there is a lack of qualified personnel who can extract maximum benefit from new regulations.
32. Management capacity for controlling illicit commerce is also limited. Technology is essential for stepped-up controls. For example, scans for inspecting containers and satellite control for tracking. Technology is incorporated too slowly due to budget limitations. Scanners recently installed in customs border controls and ports are clearly insufficient. Argentina, Paraguay and Uruguay lack adequate monitoring of flight movements, and there are insufficient radar installations. With the exception of Brazil, legislation does not authorize forcing down of aircraft which violate airspace. Brazil is the exception in being a country where contraband by air constitutes an aggravated crime and a radar system controls the country's airspace.
33. Problems in controlling smuggling also stem from cultural acceptance. Handling illicit merchandise is socially accepted in frontier areas such as the Triple Border between Argentina, Brazil and Paraguay as well as in other border regions such as the land borders between Uruguay and Brazil and between Paraguay and Argentina.
34. Governments may also be ambiguous in their view as to whether to intensify the fight against illegal commerce. Their efforts have been neither systematic nor sufficient, as evidenced by the slowness of approval of the MERCOSUR Customs Code and the elimination of chapters on illegal trade penalties from the agreement. One reason for this could be that contraband across land and river borders may be implicitly considered as a "traditional" kind of bootlegging activity and a significant factor in creating "employment" and the circulation of money in the region's economies. Governments may fear there are no clear formal alternative forms of employment in the short term.
35. Consequently, the perception remains throughout MERCOSUR countries that identifying and prosecuting criminal gangs involved in smuggling is the exception. Rarely do gang leaders appear before criminal courts. Contraband cases are mostly treated as low priority misdemeanors that end with the release of the prisoner and sometimes even include the restitution of goods and/or vehicles involved.

Chapter I

Introduction

This research stems from an initiative by the Research Center for Tobacco Epidemic (CIET, Uruguay) and the Associações de Controle do Tabagismo (ACT,

Brazil),¹ which saw the need to investigate and publicize the illicit tobacco trade in the region with the aim of ensuring tighter controls and reducing access to tobacco products.

The stimulus for this task lies in governments' ratification of the WHO Framework Convention on Tobacco Control by which, under Article 15, Parties pledge to act to tackle the illegal trade in tobacco.

Additional momentum in this direction was provided by the decision of the Second Conference of Parties to the Framework Convention (COP2), held in Bangkok in July 2007, to begin negotiations on a protocol to the Convention concerned specifically with the illicit trade in tobacco. This foresaw the need for greater information and intelligence on illicit trade, for an improved insight into its logistics in different regions, the legal framework and the success or otherwise of current strategies, and ways of improving national and regional control strategies.

Objective

Based on an analysis of the situation concerning illicit tobacco trade in MERCOSUR countries, the goal is to identify strategies for strengthening controls through the involvement of civil society and member governments.

Methodology and information sources

This study examines the background to the illicit trade in tobacco in each of the four MERCOSUR countries based on primary sources, such as interviews with law enforcement agents and customs agencies and, where possible, with participants and former participants in the illicit trade, and through secondary sources of information including journalistic, legal and institutional reports. The work was conducted in Argentina, Brazil, Paraguay and Uruguay. Studies in Argentina were coordinated by Lic. Mario Virgolini (Ministry of Health) with support from the World Bank. In Brazil, the work was undertaken by Roberto Iglesias (ACT Brazil). The author supervised the work in Paraguay and coordinated a small intelligence gathering team in Uruguay.

The report is structured as follows. First, a brief description is presented of MERCOSUR, its Customs Code and patterns of trade and treatment of tobacco control at a regional level.

By way of an analysis of illicit trade in the MERCOSUR there then (Chapters 2 and 3) follows a summary of intelligence compiled by teams in the four countries at the end of 2007. These studies were based on an in-depth review of the journalistic record over the past four years (10 years in Paraguay), on interviews with various actors and analysis of the legal framework and case law in each country conducted by experts on the issue.

The logistics of illicit trade (modalities, routes, agents, special features) are identified in each country and there is an analysis of existing information about counterfeit cigarettes, money laundering, corruption and the strengths and weaknesses of efforts to suppress the trade.

In Chapter 4 an estimate is made of the volume of illicitly traded tobacco in the region, mainly in response to the role of Paraguay but also considering data on

production and consumption in each country. Subsequently, the study examines the extent of fiscal losses due to smuggling in the four countries.

Chapter 5 is devoted to the analysis of legislation in each of the four countries related to smuggling, and a table compares the situation in regards of key juridical issues.

In Chapter 6, finally, the main findings of the report are drawn together and recommendations are proposed for engaging civil society and governments in the region.

Annex A presents case law collected by teams in each country regarding cases involving contraband cigarettes.

MERCOSUR

1. Background

The Southern Common Market (MERCOSUR) was established in March 1991, via the Treaty of Asuncion, by Argentina, the Federal Republic of Brazil, the Republic of Paraguay and the Republic of Uruguay. All Parties have a voice and a vote, with decisions being reached by consensus decision of all four countries.

MERCOSUR covers an area of 11,863,000 km² and has a total population of 246 million people.

(...)

MERCOSUR is an intergovernmental institution having a distinct legal entity under international law and independent of its member countries; a status that allows it to negotiate with third countries or sub regions. It can exercise its powers to pursue efforts required in achieving its objectives, in particular by concluding contracts, acquiring assets and real estate, appearing in court, and establishing and transferring funds.

The main objective of the block is the integration of the four States via the free circulation of goods, services and the means of production among countries. Other objectives include the establishment of common external tariffs and the the adoption of a common trade policy in relation to third countries, or groups of countries, coordination of macroeconomic and sector policies between State Parties, as well as the harmonization of legislation in relevant areas to ensure the strengthening of the integration process.

Since January 1995, MERCOSUR has been a free trade area covering all goods circulating in the region. It has also established a customs union—whose details are not yet finalized—with a common external tariff (AEC).

In 2000, a new step in the regional integration process was decided (the “Relaunching of MERCOSUR”) not only to enhance its economic strength, but also to give priority to important issues including: employment and social security; environmental protection; education; and technological development. Some of these issues had already been implemented to a lesser extent, though lower priority had been given to the pace of development.

A key feature of MERCOSUR is the marked difference that exists between members on geographical and commercial levels and in their size and population. This has led to weakness and fragility in the process of integration. Advances have also been slow due to economic crises and for political, legislative and infrastructural reasons.

Factors such as these have led to the lack of effective cooperation on objectives, strategies and activities to control illicit trade.

2. MERCOSUR Customs Code (CAM)

Following a transition period, once general guidelines and instruments for the functioning of the customs union were in place, MERCOSUR decided to ensure full operation of the Customs Code by its four members. The process has been slow, however, and is not yet entirely complete.²

Recently, a set of definitions and guidelines to be used in drafting the MERCOSUR Customs Code (CAM) were accepted via Resolution No. 40/06 of the Common Market Group (GMC). An *ad hoc* group of experts worked intensively during 2007 and 2008 but outstanding differences between Parties have prevented adoption of the CAM.

Consequently, despite efforts over a number of years, the Code had not been approved as of July 2008.

Points of contention preventing adoption of an earlier version, and which have still not been addressed in the final document, include customs offenses, fines, the definition of actions for demanding payment and the tax liability of foreign trade operators.

Irrespective of any final approval, it is clear that up to now governments in the MERCOSUR region have avoided applying the Customs Code as an instrument for harmonizing financial penalties associated with breaches of tax liability or illegal customs operations. This problem has its roots in the asymmetries of the block and differences in national legislation in the four countries.

Governments' lack of background in, and sensitivity to, these issues has led to discussion of these specific points being postponed.

3. Intergovernmental Commission for Control of Tobacco in the MERCOSUR

Aiming to expand and set priorities for the initial MERCOSUR Working Group for the Control of Tobacco, formed in 2003, health Ministers set up the Intergovernmental Commission for Control of Tobacco (CREST) to promote an integrated tobacco control policy in the region and implement agreed regional strategy.

Still pending is progress in other areas such as coordinated national and international policies concerning pricing and taxation and regulatory measures against illicit tobacco trade which the FCTC sees as major elements in reducing access to tobacco products at the regional level.

Chapter II

The tobacco industry in MERCOSUR countries

1. The tobacco industry in Paraguay

(...)

Employment statistics from Paraguayan tobacco companies can serve to differentiate between firms engaged in industrial activity versus those in commercial trade, or entities created for tax purposes. Of the 35 tobacco companies registered with the Ministry of Industry and Commerce in 2007, only 11 firms were recorded

as having employees or workers. And 86% of the workforce was concentrated in only 4 companies.

However, this could point to a large section of cigarette manufacturing in Paraguay being clandestine, with no industrial activities being reported to the authorities.

Official data for the tobacco sector are sketchy in Paraguay. Particularly lacking are precise figures on domestic production of cigarettes.

Tobacco leaf production is officially recognized as being around 15,000 tons per year, harvested from 7,000 hectares. The level of production is small by international standards and does not point to Paraguay being as important a tobacco leaf producer as Argentina or Brazil.

Regarding industrial production of cigarettes, the situation is more complicated since most of the industry produces or operates illegally. There are no official figures for domestic production of cigarettes, so the extent of the industry has to be indirectly evaluated via data for the number of primary and secondary level cigarette manufacturing firms, sectoral value added, labor employed, foreign trade and consumption. This data, in turn, reveals some conflicting evidence.

Nonetheless, based on various assumptions estimations are made later in this report regarding the size of legal and illegal markets.

Number of firms

(...)

Value added in cigarette manufacturing

(...)

The tobacco sector is an important commercial and industrial activity in the country (refer to Chapter IV, below). According to estimates, it produces around 70 billion cigarettes a year and in 2006 generated around USD 612.5 million. (Calculated from 70 billion cigarettes, or 3.5 billion packs, at an average factory price of USD 0.175). This compares to an estimate of USD 588 million, based on production of 41 billion cigarettes, arrived at by consultants in 2003.

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In 2006, Paraguay imported nearly 40 million kilos of tobacco leaf and raw tobacco and waste, from which no less than 60 billion cigarettes could be produced. This amount is in line with the primary manufacturing capacity indicated above.

Output capacity from primary processing is compatible with a high use of domestically produced leaf tobacco (equivalent to around 9 million sticks per year) and imported raw tobacco for cigarette manufacturing amounting to around 70 billion cigarettes per year. (Chapter IV outlines how this figure is calculated).

However, the 26 factories listed as cigarette producers would, according to the Ministry of Industry and Trade, have production capacity far exceeding the combined sum of primary processing plus imported cut tobacco. In fact, the above figure for reported cigarette production capacity is close to the cigarette consumption of Brazil over an entire year.

This is inconsistent, unless a significant amount of unused production capacity exists for cigarette manufacturing in Paraguay, which is unlikely.

However, the above Table [not included in this excerpt] implicitly points to a huge gap between production capacity, domestic consumption and legal exports. This difference is, namely, due to illicit production and trade.

Even were some of these figures to be overstated, conservative estimates still indicate huge levels of clandestine cigarette production in Paraguay. (See Chapter IV, Quantifying legal and illegal markets)

Quantification of size and extent of illegal cigarette production has to be tentative, given the limited information available.

Estimate of the legal market for cigarettes in Paraguay

In 2006, a typical tobacco firm in Paraguay would have incurred estimated total factory costs of around USD 0.05 per pack of 20 cigarettes (based on export prices averaging USD 0.11 in 2006, considering that this is a high margin industry) and would sell the same pack on the domestic legal market for a profit of USD 0.32. (i.e. the sum of the retail price USD 0.60 less USD 0.05 in unit cost, less tax of USD 0.086 and a retail and distribution margin of USD 0.15). This huge profit margin of 86.5% (before income tax) makes the domestic market highly attractive. But the size of the market is very small.

As the government has not imposed higher taxes, it can be assumed that at current prices for stamped cigarettes in Paraguay (average price of around USD 0.60 in 2006) the industry is “collecting” a total profit of around USD 0.32 per pack, or USD 48 million per year.

Considering the above assumptions and calculations, the total size of the legal cigarette market in Paraguay, based on annual sales of 150 million packs containing 20 cigarettes at an average price of around USD 0.60 per pack, amounted to USD 78 million, excluding tobacco tax and value added tax. The total amount of taxes on tobacco in 2006 is estimated at around USD 15 million. When nominal tax rates on tobacco products are compared in relation to the final retail value of sales, the effective rate of tax is an average of 14%. This is far below the effective rate of tax in relation to the retail price of tobacco which is over 65% in the other three MERCOSUR countries.

Estimate of the illegal market for cigarettes in Paraguay

Not unexpectedly, the illegal market offers less profit per pack but in turn an unlimited potential for growth.

A first approach to estimating the size of the illegal market starts with the estimated volume of illegal manufacturing by Paraguayan firms of 70 billion cigarettes (i.e. 3.5 billion packs of 20 sticks, see Chapter IV for details).

Considering a factory cost per pack of USD 0.05 and a retail street price in neighboring countries of USD 0.50, a factory selling cigarettes to a smuggler would charge a price (per pack) of at least USD 0.10 in order to make an immediate almost risk-free 100% cash profit. The cost may rise to USD 0.25 for small orders to cover the smuggler's profit and costs of the operation (bribing Customs and police agents,

transportation costs, retail margin, etc.). This then averages USD 0.175 per pack, so the value of Paraguay's illegal cigarette market would be around USD 612.5 million per year.

The industrial value-added of the illegal cigarette industry in Paraguay is at least around 88.6% of gross sales (15.5/17.5), meaning USD 542.5 million, or 13 times the "official" value-added as estimated in the National Accounts of the Central Bank.

2. The tobacco industry in Brazil

The total volume of the domestic Brazilian cigarette market (both legal and illegal) is estimated at 7,000 million packs of 20 sticks (140,000 million cigarettes). Souza Cruz (BAT) has a 78% share and PM 13% of the market for "legal" Brazilian cigarettes. Between them the two multinational subsidiaries dominate 91% of the legal market. In 2006, there were also 14 other local tobacco manufacturing companies that controlled 9% of the legal market and had an undetermined stake in the country's illegal market. The size of the illegal market is hard to evaluate; some observers put it at a 30% of total sales.

This significant proportion of illicit trade prompted authorities into action in the mid-1990s. Changes in the Brazilian domestic market in recent years have in part resulted from efforts by the tax authority (Receita Federal) and changes in the supply of illegal cigarettes.

Many lessons can be learned from Brazil's experience in controlling the illicit tobacco trade.

For most of the '90's, Souza Cruz (BAT) was the main beneficiary from a triangular trade involving cigarettes produced in its factories in Brazil being legally exported to neighboring countries, especially to Paraguay, and then reintroduced illegally into Brazil, thus avoiding paying taxes in the domestic market.

Another illegal tax evasion scheme involved diverting cigarettes intended for export back into the Brazilian domestic market. To combat this, the government approved a decree, in December 1998, placing a 150% tax on exports of cigarettes to Latin America and the Caribbean.

The government changed the tax system from an *ad valorem* to a specific type of tax (a fixed sum per pack) which taxed lower-priced cigarettes relatively more heavily.

Brazil's cigarette market (and tax administration and collection) began to increase in complexity with different strategies being adopted by small tobacco companies operating in the market:

- Some companies took Receita to court for having introduced the new tobacco tax rate (IPI). The companies continued to pay taxes based on the more favorable previous *ad valorem* tax rate;
- Other firms continued to pay the IPI but started administrative litigation against the tax authority. This may have led the Receita to cancel the special registration allowing companies to manufacture cigarettes. But some of the small tobacco companies affected challenged the administrative decision by the Receita through the courts. Judgments are still awaited following several years of litigation;
- Some companies that refused to pay the tax, or were in arrears with respect to the new specific tobacco tax, then proceeded to file an administrative

complaint against the Receita and obtained a judicial injunction permitting them to continue operations. The Receita lost its case for revoking production permits.

In this context of litigation, with small companies and a significant illegal market, Brazil's tax authorities have had great difficulty in raising taxes on cigarettes. This has hampered achieving health policy objectives which depend on higher taxes and prices. In recent years, the Receita has tended to reduce the real burden of IPI, as demonstrated by an uneven response of the specific level of tax to variations in inflation in Brazil.

Another rapid change that followed the adoption of controls and export taxes in Brazil in the late '90's was the remarkable export of entire factory machinery and qualified personnel to Paraguay. At first, the new export tax affected only cigarettes in order to combat the triangular scheme. Then, in 2000, the Brazilian government extended the export tax to tobacco leaf. However, the growing tobacco industry in Paraguay sourced its tobacco from elsewhere, particularly Argentina.

The impact of export taxes introduced by the Brazilian government probably led to substantial changes in the organization of the tobacco industry in the region, and accounts for what is an unexpected and complicated situation.

A Uruguayan tobacco company successfully sued the Brazilian government through a MERCOSUR court alleging a breach of free trade regulations in the custom union. Brazil reversed its policy of taxing tobacco exports to neighboring countries in 2003. Nonetheless, the triangular system and tobacco leaf exports to Paraguay have not re-emerged.

The illegal market is well established in Brazil. Competition for lower-priced segments is fierce and the confused legal situation regarding small companies is driving new schemes for avoiding paying taxes on at least a portion of production. For instance, some companies (an example being the well-known situation of a company named SUDAMAX) that own factories in Paraguay and Brazil manufacture in Brazil but label the product as Paraguayan, pretending it had been introduced illegally by other agents in Brazil. The Federal Police uncovered this operation but it is believed that other companies may be involved in similar activities.

3. The tobacco industry in Argentina

Argentina has a domestic market of 2,000 million packs a year (40 billion cigarettes) which is shared mainly between two multinationals with factories in Argentina: Philip Morris (Massalin Particulares) and BAT (Nobleza Piccardo). Together they have 96% of the Argentinean market; approximately 70% and 26%, respectively. The remaining 4% is shared between nine small start-ups. The setting up of new small local firms in Argentina became important after 2002, a year of severe economic crisis with significant decreases in real household spending. This drove the market towards low-priced cigarettes, and some new operations quickly expanded.

Coimexpor S.A., for example, opened its doors in January 2004 with only 20 employees and now has 200 personnel; 110 being factory workers. According to company statements, it is presently producing 2 million packs of cigarettes per month which are sold nationally.

Some of these companies sell the same brands that are produced in Paraguay, for example Rodeo, which is the main brand smuggled from Paraguay. A scheme similar to that by SUDAMAX, in Brazil, could be operating in Argentina. In reaction to market changes, the two multinational tobacco companies, PM and BAT, have, since 2000, renewed agreements with Argentina's Ministry of Economy regarding minimum tax payments. This scheme establishes a target floor for tax payments by means of a cigarette tax rate of 75% on the retail price of the best-selling brands. The latest of these agreements, signed in 2007 and in force until 30 September 2008, included an increase in floor tax payments and targets. These agreements were endorsed by government decrees and so became mandatory for the entire tobacco sector, placing a burden on small companies selling cheaper cigarettes. The latter complain they are unable to "cross subsidize" lower-priced cigarettes as they do not produce more expensive brands on which more tax would be paid.

The position of small cigarette manufacturers was strengthened after 2001 by favorable court decisions that overturned their obligation to comply with the agreement between tobacco multinationals and the government. To confront this threat, tobacco multinational companies launched cheap-priced brands in an attempt to recover market share which had fallen from 13 to 4%.

The situation of small firms in Argentina is similar in some respects to their Brazilian counterparts. In both countries, small firms are owned by domestic operators and capital; they are active in the market for low-priced cigarettes, are verging on illegality and attempt to persuade courts to rule in their favor concerning non-payment, or reduced payment, of taxes.

In both Argentina and Brazil, a number of small firms may also be linked to contraband tobacco from Paraguay, which suggests that there are agreements that allow businesses to confuse the country of origin of cigarettes and exploit weaknesses in governmental control systems.

4. The tobacco industry in Uruguay

The Uruguayan tobacco market is in a distinctly different situation compared to most other MERCOSUR countries. The Uruguayan-owned and operated company *Compañía Industrial de Tabacos Montepaz S.A.* long ago established a position as the leading firm compared to the two other operators, the multinationals *Phillip Morris* (operating locally under the name of *Abal Hnos. SA*) and *British American Tobacco (BAT)*.

Montepaz S.A holds a 70% share of the domestic market for legal cigarettes. It is also responsible for a lucrative triangular scheme supplying Brazil through cigarette exports to Paraguay, and also owns a factory in Paraguay to export cut tobacco produced at its primary processing plant in Uruguay. The two brands owned by *Montepaz* and exported to Paraguay are *Calvert* and *Broadway*; they are not sold in Uruguay.

The scheme involves import and production of these two brands, selling them via Paraguay's retail market, where their market share is insignificant, and selling to "operators" who introduce the two brands into Brazil, where they are well-known in the southern states and also extend to Brazil's northern states. This operation is unique: foreign trade statistics from Paraguay show these cigarettes imports from Uruguay to be practically the only cigarettes imported by Paraguay from MERCOSUR countries.

Montepaz's exports, mostly to Paraguay, amounted to around 2.5 billion sticks in 2006, together with cut, leaf and other tobacco raw materials (about 3 million kilograms this year). This represented twice the volume of the company's sales in Uruguay.

Philip Morris entered the Uruguayan market in 1979 by buying a local company (Abal Hnos.SA). It owns a cigarette factory and imports some of its international brands. Its market share is around 25% of the domestic market for cigarettes. There are virtually no exports.

British American Tobacco (BAT) began manufacturing cigarettes in Uruguay in 1997. Unable to increase its low market share of 6%, it ceased manufacturing in 2003. It serves its current market share of under 4% by importing brands from Argentina.

In Uruguay, a small firm named Eurolíder, ran a cigarette factory at Rivera on the border with Brazil between 1996 and 2004. It produced its own branded cigarettes which were mainly exported to Paraguay.

The cigarettes were sold mostly in the free zone near to Rivera. The company's owners sold the cigarettes illegally to Brazil through a scheme that nominally sent the goods to Chile by truck.

Once Uruguayan authorities uncovered the operation the zone's owners were arrested, or fled. Affected by the loss of its primary client, Eurolíder dismantled its factory and moved it to Paraguay in 2003.

Eurolíder's Brazilian factory had previously been closed in 1996 and relocated to Rivera. As with Brazilian factories that set up shop in Paraguay after 1999, it shows that small factories in the region can be highly mobile and take advantage of opportunities often created by changes in government policy to combat illicit trade.

Presently, no evidence exists of illegal cigarette production in Uruguay which instead suffers from smuggling from Paraguay that accounts for around 12% of the domestic market.

For many years, a regime of cigarette sales to free shops located in various towns bordering Brazil acted as a means for the re-entry of cigarettes through illegal sales. Legislation permitting sales in these shops allows for reduced taxes exclusively on sales to foreigners, as is the case in many other parts of the world. Most of these cigarettes—the leading brands smoked by Uruguayans—are reintroduced into the country.

Another scheme providing a form of legal status to dubious or plainly illegal operations is the “entrepot” system by which tobacco companies can sell duty suspended cigarettes to the crews of ships operating in the area or based in Uruguayan seaports. The amounts sold, and the lack of controls, point to yet another scheme used to circumvent internal taxes on cigarette sales since most of these cigarettes find their way back to the Uruguayan territory.

Situation of the multinational tobacco industry with regard to tobacco smuggling

Both Phillip Morris (Argentina) and BAT (Argentina and Brazil) have significant shares of domestic markets in the region, except in Uruguay and Paraguay where the largest domestic market shares are held by the locally-owned firms Tabacalera del Este and Boquerón, in Paraguay, and Montepaz, in Uruguay.

In recent years, multinational tobacco firms operating in the region have publicly “lobbied” against smuggling and the illicit trade of cigarettes, which has been consistently highlighted as an obstacle to the consolidation of legal industries, permanent jobs and above all, payment of taxes.

This lobbying strategy places distance between multinationals and illicit trade and has a dual purpose: for the majors to appear as socially responsible firms in the eyes of the public and governments, but also to place the blame for the illicit trade on a lack of adequate government controls, while also accusing smaller national competitors of breaking the rules.

As discussed above, however, Souza Cruz (a subsidiary of BAT in Brazil) has been accused by independent observers of being the main beneficiary of a system of tax evasion that functioned until 1998 by which cigarettes were exported to neighboring countries and which “distributors” then illegally reintroduced into Brazil.

More recently, multinationals have faced greater competition from new manufacturers, especially from Paraguay, and from the increasing trend towards “control” of the illegal market. Particularly damaging for multinationals is brand falsification or even brand theft.

By way of response, multinational tobacco concerns in the region changed their strategy towards supporting agreements with national Customs authorities concerning combating smuggling and the illegal market.

Growth in the volume of illicit trade of cigarettes from Paraguay has been so significant that even the powerful Souza Cruz company, the BAT subsidiary in Brazil, has been affected and has promoted an “ethics committee” together with companies in other business sectors that are also affected by smuggling, such as the brewer AMBEV.

Smuggling in MERCOSUR countries as the main mode of illegal trade in tobacco

Smuggling is the most comprehensive and oldest form of illegal trade. Traditionally, it has been separated into “bootlegging”, or small-scale smuggling, and wholesale smuggling.

The defining element is the involvement of gangs, whether organized or not. Bootlegging is conducted by individuals or families not forming part of a network. It generally involves tax-paid cigarettes being conveyed across a border. Profits are generated by differences in retail prices between two or more countries.

MERCOSUR countries do experience smuggling that approximates to bootlegging. Primarily young people who live in towns close to national borders serve as drivers for transporting cigarettes.

Generally, though, this young and low-paid workforce of smugglers is part of a criminal network. The product is not purchased legally, as in traditional bootlegging, but it is bought “wholesale” from the factory without domestic taxes being paid.

An illegal product bought in one country is then shipped illegally for illegal sale in another.

Two elements implicit to traditional bootlegging are missing in the region:

- a) Operators do not buy tax-paid cigarettes in one country to carry them to another country;

- b) The small-scale operation involving young people is the final link in a chain of “sales”. The system is mainly used by gangs to thwart official checks as quantities smuggled are typically too small for an offender to be sent to prison. Terming this “small-scale” is often misleading: having passed border controls, cigarettes are stored in secret warehouses in the destination country prior to subsequent distribution and retail sale. Even though the small-scale operators transporting cigarettes across borders may be “freelance”, they actually have a closer relationship to their vendors than do retailers to wholesalers in the legal market.
- c) The traditional bootlegger can generally no longer operate truly independently in the region, as they did until a few years ago, for risk of being assaulted or robbed by gangs. Small-scale operators used to travel to Paraguay and buy cigarettes directly from factories there. But larger-scale operators and criminal activity along the borders made it increasingly dangerous to travel long distances carrying money and merchandise. Small groups and families therefore remained in business by becoming part of large networks.

Thus, larger-scale land-based smuggling operations crowded out smaller operators. Larger organizations are also apt to be more efficient in terms of purchasing, transportation and identifying and paying corrupt customs officials and police to prevent confiscations.

From the conceptual point of view, it therefore seems more useful to dispense with the traditional definitions of bootlegging and wholesale smuggling and use a different approach. This is to simply distinguish between patterns of smuggling based on: i.) the use of land and river borders between two or more countries (typically by bus, truck, boat, or car) versus, ii.) smuggling that relies on seaports and overseas trade facilities in MERCOSUR countries, under agreements promoting international trade, such as free port areas, processing zones and with special transit permits. The latter makes extensive use of the rapidly expanding use of container shipping in international trade.

Port facilities are a convenient additional means for smuggling cigarettes and other goods since thousands of containers enter and leave every month.

Customs procedures involving opening containers are not routine. There are few resources for this and it implies further delays and higher port costs which are strongly resisted by private operators such as importers and forwarders. Scanners which check the contents of containers could offer a solution but few of them are used in regional ports.

There are clear differences between these forms of smuggling. Smuggling operations which take advantage of trade-promotion clauses in treaties and domestic legislation in MERCOSUR countries generally move wares by ship. Containers of cigarettes have the necessary documentation for international cargo movements but there are a variety of ways of hiding that they are contraband cigarettes.

In the case of illegal trade across land or river borders (including the use of light aircraft), the common feature is to avoid being subjected to customs controls. Goods are hidden when crossing border posts, and carry either no valid documentation or circumvent controls via corrupt officials. Intelligence collected in border towns points to corruption of officials as the main way of reducing the risk of an operation

since there are few roads and most are highly controlled. Avoiding possible confiscation depends on an organization which can move smuggled cigarettes. Gangs in border areas have highly-organized and sophisticated means of communication, operate using a wide variety of forms of transport and vary both routes and smuggled products, as needed. Sometimes they will transport cigarettes, at other times consumer electronics, medicines, or prohibited products such as agricultural chemicals or illicit drugs. In conclusion, it appears that smuggling operations in border areas continually respond to changing policies and improved controls by mobilizing more resources, improving upon technology and organization and by corrupting officials at different levels. The old days of bootlegging activities are long gone.

Chapter III

Types of illegal trade in cigarettes in MERCOSUR countries

Illegal trade in tobacco products, as set out under Article 15 of the FCTC, comprises illicit manufacturing, smuggling and counterfeiting. Illegal trade means operators do not pay taxes on retail sales of cigarettes. Illegal operators benefit from the realities of international trade which are characterized by a lack of adequate regulation.

Governments are chiefly interested in promoting trade and attracting investors. These objectives are framed in a range of treaties and policy instruments. Treaties, agreements between countries and domestic legislation serve to promote intra-regional and international trade through customs transit facilities, free trade zones and free port areas, and duty free shops, for instance.

On the other hand, border controls are weak, there are instances of corrupt officials, and it is often difficult to formally prove the existence of an illegal operation or activity concerning international trade.

Illegal trade does not necessarily involve cross-border movements. There are manufacturers who operate outside the legal framework within a given country, especially regarding non-payment of domestic tobacco and other taxes. Cigarettes may or may not be counterfeit in these situations. In both Argentina and Brazil there are examples of illegal cigarette production in which the manufactured items could be counterfeit versions of well-known brands but where, for reasons of profiting from lower-priced segments in the domestic market, they are instead counterfeits of a Paraguayan convenience brand and marked “Paraguayan made”. The intention is to divert the attention of the authorities away from illegal manufacturing by presenting this as another case of smuggling from Paraguay. Legally established operators in the domestic market are sometimes involved in such activities.

Intelligence information collected by the analysis team and compiled by CIET in Paraguay established how “closed factories” can engage in clandestine production. Companies produce cigarettes legally during normal working hours but outside of these times manufacture cigarettes illegally using trusted workers and staff. This form of operation has been recorded in Brazil.

The three main forms of illegal trade in cigarettes—illicit manufacturing, smuggling and counterfeiting—are to be found in MERCOSUR countries. In

Argentina, Brazil Paraguay all three forms have been recorded. In Uruguay, there appears to be no illegal manufacturing or counterfeiting by local manufacturers.

1) Forms of “wholesale smuggling” through ports and regional and international trade facilities

The following section describes the more common procedures for illegal cigarette operations via international trade. It is based on information uncovered by enforcement agencies:

- Alteration of certificates of origin and forgery of public documents

This mechanism is widely used in smuggling various goods including cigarettes. Merchandise that has been certified as originating in one MERCOSUR country and being shipped to another is partially or completely free of import taxes. The Certificate of Origin must specify the products’ point of shipment. Products are considered as being of origin when wholly manufactured in one of the member countries.

Cigarettes have been intercepted coming from outside the region—from China, for instance. But they have been described as having been manufactured in a MERCOSUR country. The purpose is to avoid paying duty on products originating outside the MERCOSUR.

- Entry of merchandise claiming temporary importation

What is referred to in Argentina as “imported merchandise in suspension” (“temporary”, in Paraguay, and “temporary admissions” in Uruguay) is a special “drawback” type of customs regime that allows raw material to enter MERCOSUR countries without payment of custom duties or other taxes on the basis of it being exported later as a part of a processed product.

The smugglers’ strategy here is to declare a fake address for where processing supposedly takes place and so hide the real destination of merchandise entering the internal market, without paying taxes due. It is common for cloth, paper, leather, computer parts and even fuel to enter countries via this means. Little use is made of schemes of this kind for cigarettes, however.

- Entry of merchandise under the “in transit” regime

Merchandise arrives at a MERCOSUR port to be reshipped to its final destination abroad, or through another customs post in the same country. Under present regulations, as a mechanism to aid trade, tax is paid only at the final destination and it is not paid in advance or at the moment merchandise arrives in the country of transit.

At some point along the way, the merchandise is “lost”. This is not difficult to arrange in view of problems inherent to following consignments and ensuring that everything from the point of origin reaches its final destination.

- Under invoicing

A substantial percentage of smuggling in the region is carried out via underinvoicing and by presenting forged invoices.

The reasoning is simple, according to a former employee of the AFIP in Argentina: “Why conceal smuggling when there are no documents if the safest way is to present forged papers?” Invoices are scanned or dispatches are submitted via fax. After a time they become increasingly illegible leaving no basis of proof.

In Brazil, the means by which merchandise enters the country legally through ports and airports but at under-invoiced prices or with forged invoices or irregular

product classification is referred to as “importgling”. According to an authority within the Receita Federal, São Paulo is replacing Paraguay as an important centre for this kind of activity as it is much safer for buyers of products entering the country illegally and those which are forgeries.

- Product substitution

Officially, a low-cost product is declared (for example ground glass) but the container actually contains cigarettes. This is often conducted using containers which are declared as being empty or are filled with stones or sand but which are actually filled with cigarettes or a combination of cigarettes and other illegal merchandise.

2) Undocumented smuggling (associated to retail smuggling)

This is the other main form of cross-border smuggling. It is termed “bootlegging” in most countries but has taken on certain special characteristics in the MERCOSUR region, as outlined below.

a) Characteristics

While smuggling activity tends to be concentrated at certain points and in frontier cities, smugglers take advantage of the enormous length of land-based and river line borders in the region and the inability of security forces to control all points of entry.

A further aspect assisting smuggling is border culture that does not regard smuggling as a crime. This view is shared by large sections of the region’s inhabitants, even those who do not live near the borders.

“In our culture, smuggling is not an offense,” according to Abinzano. “Many people survive by bootlegging and do not recognize or accept it as a crime.” This perception is extensive, particularly in border zones of the four countries.

One of the main smuggling areas is the Triple Frontier region formed chiefly by the cities of Foz de Iguazú (Brazil), Ciudad del Este (Paraguay) and Puerto Iguazú (Argentine); an area of approximately 2,500 square kilometres. Its population has expanded over eleven fold since 1961 and current stands at nearly 700,000 people.

One of the initial impulses to the population increase was construction of the Itaipú dam which provides cheap energy to business in the region, as well as employment that attracted large numbers of workers. It is a region where different cultures merge: Arabs, Argentineans, Brazilians, Chinese, Koreans, Paraguayans and the descendants of Germans and Italians. This intercultural mix adds unique colour to an area undergoing permanent socio-cultural upheaval. “Some 300,000 people who migrated to Brazil when the Itaipú hydroelectric dam was under construction are called ‘Braziguayans’. They have settled on Paraguayan soil, their children were born in Paraguay, grew up and went to school there, but they still maintain their own traditions and believe that at some point they will return to Brazil,” according to academic investigator Roberto C. Abinzano.

The Triple Frontier is renowned for being a region steeped in illicit activities, with Ciudad del Este at its heart. Historical references to this date back as far as colonial times. A parallel can be drawn with the boom of illegal commerce during the Peruvian Viceroyalty in Buenos Aires.

b) Impact of illegal activity in the Triple Frontier region

Criminal activity is mainly based on forgery and smuggling of a variety of products including cigarettes, electronics, drugs and weapons. What is particular to

the region is the extent of trade. Illegal trafficking in goods occurs in a region where it has proved extremely difficult to impose control, especially when people in the Southern Cone have a perception of Ciudad del Este as a region where items such as electronic goods can be obtained cheaper than on the internal market. It is far from being a hidden or exclusive region for the large-scale development of illegal trade. It also serves tourists in search of products. Piracy and marketing of smuggled goods in Ciudad del Este is facilitated by Paraguayan legislation that allows patenting by non-resident companies in the National Registry of International Brands.

(...)

Ciudad del Este is estimated to be one of the most important cities in the Americas in relation to its commercial market. It turns over around USD 10 billion dollars a year via the flow of imports and exports, many of which are illegal.

Evolution of operating bases and destination countries for smuggling originating in Paraguay

Where changes to smuggling routes and operating bases have occurred it has been due to diplomatic offensives and efforts by Argentina and Brazil to combat criminal activity rather than enforcement policies by Paraguay. It is well corroborated that neighbouring countries efforts in deploying security forces and through more aggressive fiscal policies have cause smugglers to change final destinations of products as well as their own procedures and operating bases. The following section highlights the main routes for smuggling that originates in Paraguay and involves cigarettes and a range of other merchandise including marijuana, weapons, clothes, electronics and cosmetics.

First route: High Paraná—frontier with Brazil (main route until 2002, still in use)

It comprises:

- by land: the so-called Friendship Bridge on the Brazilian border.
- by water: Lake Itaipú (250 square kilometres, uncontrolled); the Parana River and illegal posts along the way.
- by air: the first illegal runways for light aircraft were located in this region and in the Chaco zone.¹⁷

This first route is the ‘traditional’ one that survived the dictatorship of General Stroessner and the first years of democracy in Paraguay after 1989. The High Parana became accessible by land, water and air; smuggling was made easier by its proximity to Brazil and Argentina, the Triple Frontier, and the existence of the Friendship Bridge.

Second route: Itapúa—border with Argentina

This was one of the main routes from 2002 until 2004 and is still in use. The appearance of this new route followed a number of successful efforts in 2003 and 2004 aimed at containing smuggling.

Even during this period, however, air, land and river routes across the High Parana continued to be used but were less visible due to smaller quantities of smuggled goods being confiscated by neighbouring countries.

This route comprises:

- by land: a direct line towards the High Parana, entering Brazil.
- by water: illegal ports along the Parana River with a direct line of entry into Argentina.
- by air: significant use of light aircraft specially equipped to deliver large cargoes into Argentina. (Refer to information below concerning provinces and Argentinean landing areas).

A second route which appears to be an alternative to the High Parana shows there has been an evolution not only in the base of operations but also in the classic forms of transportation used for smuggling. Barges and gliders have been used from the illegal ports of the High Parana, although in the region around Itapúa there has been a higher concentration of smuggling efforts.

Third route: Ñeembucu—border with Argentina—connection with High Parana towards Brazil

This is one of the current routes mainly in use since 2001.

- by water: through illegal ports situated near naval bases on the Parana and Paraguay rivers.
- by land: construction of a road to the department's capital permitted relatively unhindered movement through the eastern region of the country where cargo could be stored prior to being moved towards any of the bordering countries.
- by air: this is one of the departments with the highest illegal light aircraft traffic to date.

Ñeembucú is currently one of the favoured locations for trafficking by water, land and air. This is due to access to two rivers, while its irregular geography means illegal runways can be well-hidden by vegetation.

Fourth route: Canindeyu—border with Brazil—also connection with High Parana

Also in use since 2001, it remains one of the main routes up to today.

- by land: cargo is transported along the land border in convoys sometimes consisting of several vehicles.
- by water: the proximity of Lake Itaipú (250 square kilometres) allowed cargoes to be disembarked on the Brazilian side, for example in Guaira.

In 2004, several legal cases ended in the confiscation of smuggled goods destined for Brazil. The existence of several illegal warehouses on both sides of the frontier has been recorded and there were reports of cover-ups and smugglers being protected by local authorities.

Fifth route: Asunción—Transchaco (to date)

- by land and water: several shipments of smuggled goods leave from the capital of Paraguay.

Asunción, Luque and other locations in greater Asunción are bases of operation for cargoes that later go by the Transchaco road having Bolivia, Chile and Peru as their final destinations. Warehouses in the central region are also used to store large consignments that are later dispatched to border countries.

Sixth route: the waterway formed by the Parana River and the Paraguay River towards the River Plate

Nueva Palmira is located 140 km from the ports of Buenos Aires and Montevideo where merchandise goes “in transit” to various Paraguayan regions and is reshipped to ports overseas. Nueva Palmira itself has a special Paraguayan zone to facilitate trade that was granted by Uruguay. The waterway that begins in Puerto Cáceres, Brazil, is a navigable route crossing five countries over a distance of more than 3,000 km.

This route (refer to map) is used for container transport of merchandise, including cigarettes, from Paraguay. Port facilities in neighbouring countries are used to re-export merchandise in transit. Or merchandise is cleverly reclassified and shipped send to countries in Europe, North America, South East Asia, Africa and to China.

Chapter IV presents initial estimates of volumes of illegal trade in the region although it is believed that illegal sales from Paraguay reach various countries around the world.

Perspective on the illegal Paraguayan trade into Argentina

Cigarettes of Paraguayan origin illegally enter the NEA region of Argentina (formed by the provinces of Chaco, Corrientes, Formosa and Misiones) in volumes surpassing those of narcotics or electronics.

Transit zones for smuggled cigarettes

The map below indicates the main river line border crossings with Paraguay. Lines show the main land-based smuggling routes, particularly routes 11 and 12 running to the west and east, respectively, of the river Paraguay/Parana as well as route 14 west of the river Uruguay.

According to sources in tobacco factories, the illegal market formerly involved high-priced and internationally-known brands or Argentinean brands of exported cigarettes which were re-imported into the country tax-free. In 2003, it consisted mainly of low-priced Paraguayan brands destined for low-income sections of the public. Sources indicate that products of this kind account for 90% of smuggled goods in the country and are marketed chiefly in the interior of the country, throughout the entire northeast, along the rivers Parana and Paraguay and in a number of the second belt regions around greater Buenos Aires.

It is common for only one kind of product, in this case cigarettes, to be shipped from one country to another, especially when smuggling crosses a river. However, combined shipments by air of cigarettes, drugs (mainly marijuana) and weapons have been identified.

Their destinations are primarily the peripheral neighbourhoods of large cities. Products are aimed mainly at low-income sections of the population, as well as young people and teenagers who are new to tobacco.

Most informants agree that the transfer and sale of these cigarettes is conducted by small groups of not more than six or seven persons who do not normally handle volumes exceeding \$30,000 in value (equivalent to around USD 10,000) in order to avoid legal penalties. Those involved in transporting the merchandise are often young people for whom this provides a means of economic survival in towns where there are no other sources of work. Merchandise, kept in bags, is transported in canoes, high-speed launches, modern vans, fast cars and small planes.

Those involved in transporting the product often handle distribution. Alternatively, it can be stored in warehouses, which are generally improvised, and then rapidly divided and offered to consumers.

Brands of confiscated cigarettes most frequently mentioned in newspapers were: Rodeo, Eight and 51, of Paraguayan origin, and, less frequently, brands from transnational companies located in Argentina, such as Philip Morris, Viceroy and Derby. The latter are usually counterfeit, although the means of verification is not specified. (The only mention concerns comparison of fiscal stamps on confiscated cigarette packs, which were undoubtedly genuine). Reports by the Naval Prefecture between 2004 and 2008 showed that 62.5% of confiscations involved the brand Rodeo, followed by Eight (10%), Mil (8%) and 51 (6%).

(...)

Air traffic

Use of light aircraft is another means by which criminal organizations illegally import merchandise into Argentina. Reliance on aircraft appears to increase where access by land or river becomes more difficult, although the use and type of aircraft, and the route involved, are directly related to the weight and value of the cargo.

Light aircraft in use by smugglers cross the vast northeastern border on a daily basis, transporting goods including cigarettes, clothes, drugs and weapons. It is estimated that there are in excess of 1,000 flights per year along a length of border exceeding 2,200 kilometres and that in northeastern forest regions there are 895 clandestine landing strips, according to official reports released to the press by senior sources in the security division.

A modified Cessna aircraft can carry up to 500 kilos of any type of cargo. Depending on its size, an aircraft can transport between 20 and 80 boxes of cigarettes. Boxes hold 50 cartons each of which contain 10 packs of cigarettes.

A security and defence expert attached to the Casa Rosada (the Presidential house of government in Argentina) confided, “Transporting cigarettes or marijuana from Paraguay is not the same as transporting heroin or cocaine. The value of cigarettes and marijuana only justifies the use of piston engined aircraft, or transport by foot, extending possibly as far as to the north of Entre Ríos or the

centre of Santa Fe. Otherwise the market price would increase.” This source disclosed that dozens of flights violate the country’s air space, defence of which rests with the Air Force.

The country has roughly 4,000 official runways for medium-sized transport aircraft, 150 of which are in Santa Fe.

Main Argentinean provinces receiving smuggled goods Corrientes

According to a report by the 48th Squadron of Corrientes, “The region extending from Itatí to Paso de la Patria, including the jurisdictions of San Cosme, Ramada Paso and Puerto González, is an entry point that smugglers frequently use in spite of strict controls by the National Police and other forces.”

Secondary roads between the sites of Paso de la Patria, San Cosme, Ramada Paso, Itatí, Paraje Ensenada Grande, National Route 12, are also “hot zones”, including even roads and/or alternative paths leading to the banks of the Parana River.

Smugglers arrive by the Parana River and head along the Prayuí tributary. Consignments of cigarettes or marijuana are left at the shore. Minor roads are used to avoid controls. South of the city of Corrientes is a very dangerous “red zone”. Neighbours told *La República* of having seen movements of various types of vehicles around where the Pirauí flows into the Parana River.

Misiones

In the province of Misiones, most operations are conducted on the banks of the Parana River near Santa Ana (22%), Oasis (12%), Puerto Rico (8%), Posadas (6%), Aristóbulo Del Valle (5%), Jardín América, Eldorado and Iguazú (4%) . Cigarette shipments entered from Paraguay at three points: Paraje Nemesio Parma, south of Posadas, and via Ituzaingó and Itatí, in Corrientes. In the case of Parma, shipments were taken to a warehouse in Posadas. Trucks took shipments from locations in Corrientes directly to distribution centres in Venado Tuerto, Santa Fe and Claypole, Villa Madero and Gregorio Laferrere, in Buenos Aires. Cigarettes were then distributed to retailers.

In most cases, cigarettes were hidden under beer crates. But empty containers going to the Port of Buenos Aires were also used. (<http://misionesonline.net/paginas/detalle.php?db=noticias2002&id=47820> 12-07-2002).

Formosa

Clorinda, Prané and Tatané are the main locations in Formosa where successful smuggling operations have been carried out. Clorinda is the Formosan city on the northern border, neighbouring Asunción.

News reports mention intensive non-authorized air traffic coming from the south of Paraguay and a substantial number of illegal runways in the Argentinean provinces of Santiago del Estero, Corrientes, Misiones, Chaco, Northern Santa Fe, Entre Ríos and Córdoba.

The most sought-after destinations are rural areas in Misiones, Corrientes and Chaco.

Territorial characteristics of the northeast offer generous opportunities for landing light aircraft. In Chaco alone, landowners, aviation enthusiasts and fumigators report more than 100 such sites. The number of similar, nonregistered, sites is unknown.

Santa Fe

Flights to this province start from Pilar, in Paraguay, and other nearby locations, all south of Asunción. Use of chartered aircraft is common, with unarmed hired pilots to avoid major criminal charges should they be arrested and appear before the courts.

Dedicated cigarette smuggling organizations in Argentina, having their bases on Paraguayan soil, have for at least the last five years been operating in the north of Santa Fe using illegally-built runways in fields, combined with little-used routes. Lack of radar installations means the government is unable to track aircraft movements in the departments of San Cristóbal, 9 de Julio and Vera and General Obligado “From Santa Fe capital and Paraná, cigarettes are distributed up to Mendoza and Buenos Aires, as well as to other places in Argentina. It is a weekly business amounting to two million pesos (USD 2 million, at that time). In order for it to function the illegal money circuit depends on the involvement of officials from various jurisdictions and members of the security forces. There are no major controls on airspace or in the interior of the large provinces.”

Perspective on smuggling by land, river and the Itaipu Lake into Brazil

Routes leading from the Triple Frontier and to the south and north, from Paraguay to São Paulo, are probably those with the highest incidence of cigarette smuggling in the world.

An investigation of news reports, conducted by ACT Brazil, (see map) has identified some of the cigarette smuggling routes from Paraguay. — The first route leads directly from Foz do Iguazú to São Paulo. There are numerous ways of reaching São Paulo that avoid highways and major roads, such as BR 277 and BR 369, relying on state roads in Paraná and São Paulo.

It is significant that smuggling operations cover large distances within Brazil without being intercepted. In January 2008, the newspaper *Estado de São Paulo* reported a confiscation operation concerning 750,000 packs of cigarettes being transported in two fully-loaded trucks which were escorted by a car. After crossing the Paraguayan border the vehicles had covered over 900 km before Federal Police intercepted them near São Paulo. For a cargo of this kind to be able to cover such a distance suggests complicity by several Federal and State Police control posts.

Based on retail prices the value of the confiscated cigarettes was around USD 500,000. This implies a significant gang operation having financiers, intermediaries, transporters, bribed officials, substantial warehousing mainly in and around São Paulo and a variety of distributors.

- The second route is from Foz towards Curitiba, the State capital of Paraná, where according to newspaper reports three out of every four confiscations were made. The route continues to São Paulo and can be considered as a variation on the first route.

- The third route leaves Guaira, on the frontier with Paraguay, and heads towards São Paulo via BR 272, passing through Umuarama, Cianorte and Maringá. It overlaps with the first route and continues to São Paulo via Londrina. However, there is a route that avoids roads with heavy traffic, bypassing Londrina, that is a fairly direct and safer route for smuggling which finally reaches São Paulo via Sorocoba.
- The fourth route leaves Ponta Porá, on the border with Paraguay near Pedro Juan Caballero, via the BR 463 towards Dourados and then by BR 376 through Maringá and Londrina — where many confiscations have been made — before joining other roads leading to São Paulo. However, a route that does not use national roads goes via Campo Grande to the north and then towards Presidente Prudente, Assis and Ourinhos where it merges with the route to Londrina and São Paulo, as mentioned above.
- The fifth route leads south from Foz de Iguazú to Porte Alegre, passing through Passo Fundo. The distance to Porto Alegre is over 800 km.
- Finally, the sixth route is one which, after reaching Passo Fundo, heads southwards towards the border with Uruguay, feeding Santa María, Rosario do Sul and Santana do Livramento (the sister city to Rivera, on the Uruguayan side), leading on to Artigas and possibly Uruguayana, and by a southeastern route from Passo Fundo to Cacapava do Sul and Bage, before going on to Yaguarao on the border with Uruguay. It is possible there is also an alternative route to Pelotas, Rio Grande and Santa Victoria leading to Chuy in Uruguay, which is a shopping and free port centre.

Routes heading from São Paulo to the north of Brazil are not included here as there are a wide range of possibilities and actual routes are extremely difficult to determine.

Borderregion smuggling into Uruguay

As has been described, smuggled goods arrive in Uruguay through the country's ports and free zones, by crossing land borders with Brazil and via the Uruguay River with Argentina. The land border not a significant source of smuggling, which tends to make use of other avenues.

Firstly, we consider bootlegging across frontiers and smuggling in containers through ports.

The main access routes for cigarette bootlegging are on the land border with Brazil (the departments of Cerro Largo, city of Aceguá, Rivera, Artigas, city of Bella Unión) or on the western sides via the three international bridges on the Uruguay River that separate Uruguay and Argentina (the cities of Salto, Paysandú, Fray Bentos in Uruguay) and the river port of Colonia further to the South, although the main smuggled item there is clothing.³⁸ The main routes for transporting smuggled goods to Montevideo and its metropolitan area are highways 5 (Montevideo-Rivera), 8 (Montevideo-Melo), 9 (Montevideo- Rocha) and 18 (Treinta y Tres-Río Branco).
(...)

Coastline cities in Uruguay having bridges that cross the Uruguay River (Salto, Fray Bentos and Paysandú) are the destination for Argentinean merchandise and cigarettes originating in Paraguay.

Secondly, smuggling networks use the port of Montevideo and free zones in Uruguay as entry points and rely on merchandise in transit in the port of Montevideo.

None of the news reports surveyed contained information on the use of illegal airfields in smuggling of any particular tobacco product. However, there are cases of such runways being used for drug trafficking by criminal organizations that specialize in narcotics.

Nonetheless, an expert source acknowledged that tobacco smuggling is conducted by air. This source considered it as unacceptable that Uruguay lacks a radar system covering its entire country: “They still come in by air. There are 200 illegal runways in the country.”

Chapter IV

Quantification of the legal and illegal market for cigarettes and tobacco

- 1) In general the legal trade in cigarettes between countries in the MERCOSUR region is extremely small. Trade between Uruguay and Paraguay stands out, however, and lower levels of trade occur between Argentina and Uruguay. With respect to trade in raw materials, Argentina is the main supplier of tobacco for cigarette manufacturing in the region although Brazil is much more important as an international exporter.
- 2) Exports of cut tobacco and cigarettes from Uruguay to Paraguay in 2006 were valued at around USD 20 million and had a gross weight of 6 million kg. This tended to involve blond cigarettes valued at around USD 16 million and weighing 3 million kg; which implies around 2.5 billion sticks. Except for very small differences, Uruguay’s export statistics match those for Paraguay’s imports. As already outlined, the majority of cigarettes are not sold on the Paraguayan market but are sold to operators who smuggle them into Brazil.
- 3) Argentina’s tobacco raw material exports to Paraguay were around 21.7 million kg half of which was tobacco leaf, the other half being tobacco wastes of lower value. Cigarette exports from Argentina to Paraguay are negligible. Official Argentinean exports trade statistics also basically match those for imports into Paraguay. Cigarette exports from Argentina to Uruguay are explained by BAT not having a cigarette factory in Uruguay. BAT competes in the Uruguayan market by importing cigarettes from Argentina.
- 4) Brazil is the world’s largest exporter of tobacco leaf with exports amounting to around 600,000 tons. A very small proportion of this ends up in the MERCOSUR region. Tobacco exports to Paraguay were around 7,000 tons in 2006; the quantity was considerably lower in previous years. To a great extent this is due to fiscal policies that Brazil introduced in 1998 in order to restrain contraband from bordering countries. Refer to Chapter III above.
- 5) In 2006, Paraguay’s potential supply of cigarettes for the illegal market was around 66 billion sticks. This figure is arrived by calculations based on imports of tobacco raw materials (leaf and waste, other) of 39.2 million kg in 2006, equivalent to a manufacturing potential of around 60.4 billion cigarette sticks,

plus domestic Paraguayan tobacco leaf production of 15,000 tons which would allow for additional production of around 14.6 billion sticks.

(...)

- 6) The estimate of 66 billion cigarette sticks being available to the illegal trade in 2006 is arrived at in the following way. Supply was around 75 billion locally manufactured cigarettes, to which should be added net imports of 700 million sticks (the balance of imports minus exports). From this should be subtracted: tobacco raw material exports, equivalent to around 6.6 billion cigarettes, and annual domestic consumption of 3 billion sticks. In summary, the calculation is: $60.4 + 14.6 + 0.7 - 6.6 - 3$. Legal cigarette exports, however, amounted to only 2.5 billion sticks in 2006. Destinations were mainly the rest of the world rather than MERCOSUR countries. This is shown by comparing trade statistics from the four countries. (Only exports of tobacco leaf, waste, cut tobacco and cylinders for cigarette filters were of relevance in trade with MERCOSUR countries). In other words, it is estimated that, in 2006, Paraguayan operators participated in “illegally exporting” a quantity of cigarettes that was 26 times greater than the country’s legal exports.
- 7) Tobacco industry capacity in Paraguay may have permitted a larger volume of production. During 2004, Paraguay’s imports of tobacco raw materials were almost 22% higher than in 2006. Consequently, and applying this new figure to the previous calculation, Paraguay’s potential for illegal cigarette sales in 2004 can be estimated at approximately 72 billion units. This is equivalent to almost twice the annual cigarette consumption of Argentina, and half that of Brazil.
- 8) At this stage of intelligence gathering in the region it is extremely difficult to determine the destination of Paraguay’s illegal tobacco production. Nevertheless, it is possible to make an approximation. Experts consider that contraband cigarettes arriving in Argentina make up between 7% and 12% of total consumption. Assuming this to be 10% implies around 4.5 billion cigarettes per year. Contraband cigarettes circulating in Uruguay account for 12% of consumption, equivalent to around 0.4 billion sticks per year. If we further assume that all illegal imports to Argentina and Uruguay came from Paraguay, this would account for only 6% of the volume that Paraguayan dealers are selling illegally outside the country’s borders. This therefore places Brazil at the centre of attention.
- 9) A survey by VIGITEL assessed Brazil’s annual domestic consumption at 145–150 billion units, with illegal supplies from domestic factories of 9–10 billion cigarettes. If the figure for the legal market is 111 billion the difference is due to contraband, with around 2.5 billion sticks arriving through Paraguay from Uruguay, and 28 billion being illegally produced and imported from Paraguay. (Refer to the Table below). This means that more than 30 billion sticks coming from Paraguay are contraband cigarettes destined for other Latin American countries and the rest of the world.
- 10) In conclusion, a preliminary estimate is that the illegal cigarette market within the four MERCOSUR countries amounts to around 45 billion sticks, and that Brazil is the destination for over 90% of this trade. The remainder of the estimated 30 billion illegal cigarettes coming from Paraguay appear to be distributed in Aruba, Bolivia, Peru, Chile, Colombia, Ecuador and Panama,

reaching Africa, Europe, the Far East and the United States. Based on a recent estimation that the worldwide illegal cigarette market amounts to 600 billion sticks, Paraguay would therefore account for 11% of this total. Taken together, the MERCOSUR region would account for 12.5%.

(...)

Although sizeable, this is lower than estimates made by tobacco multinationals in the region and by experts such Cabral that have put the industrial capacity for illegal cigarette production in Paraguay and Brazil (from the 10 illegal factories identified in Brazil in 2000) at about 100 billion. Cabral estimates Paraguay's annual cigarette production capacity as being around 87 billion units.

Quantification of fiscal losses in MERCOSUR countries from illegal cigarette trade

The following estimate is based on data from the previous section of this report regarding the extent of legal and illegal markets for tobacco in MERCOSUR countries as well as information on countries' levels of tobacco taxation. The following Table is based on numbers of packs containing 20 cigarettes. The information relies on the most recent estimations and hypotheses by experts in each country.

In 2006, a survey carried out in Uruguay by ITC found that 12% of cigarettes had been smuggled. This figure is for Montevideo and it may be somewhat higher for the rest of the country. Prices are those for average retail domestic sales.

(...)

Fiscal losses to MERCOSUR countries resulting from contraband and the entire illegal market for cigarettes are calculated to be around USD 900 million dollars per year. Some 71% of these losses occur in Brazil.

This suggests that fiscal losses in MERCOSUR countries constitute between 2% and 5% of the estimated worldwide loss due to the illegal tobacco trade.

Chapter V

Relevant legislation in the four MERCOSUR countries

Refer also to jurisprudence in Annex A.

Analysis of regulations in MERCOSUR countries that relate to illegal commerce in general, and tobacco products in particular, is a complex issue. It requires specialist knowledge of how different jurisdictions apply civil, administrative, customs, fiscal and criminal provisions. Also, because provisions have arisen from laws aimed at specific areas of concern, in this case regarding contraband and tobacco.

A preliminary analysis reveals that legislation in Argentina, Brazil and Uruguay is chiefly related to fiscal aspects and seeks to protect countries' economic and taxation interests. Little attention is devoted to health-related concerns or the implications of illegal trade as the majority of cases are considered to be customs infringements. In cases which may be regarded as criminal offenses, society and administrative and judicial authorities do not view them as being serious.

Argentina's Customs Code regards dealing in contraband as an offense punishable by imprisonment: as a common offense, a special offense or a minor offense. The

Customs Code stipulates the same punishment for attempted offenses as for offenses which have been committed. Concealment of contraband activities results in legal penalties which are heavier in the event of the involvement of public employees, customs officials or members of the security forces. Brazil's Criminal Code defines illegal trafficking in illegal substances, such as drugs etc., as a deliberate offense. In Paraguay, contraband is considered to be a customs infringement and a criminal offense to be handled by the public prosecutor. It carries a maximum sentence of five years imprisonment. The quantities or the form of merchandise involved are not considered to be aggravating circumstances. In Uruguay, contraband is viewed as a customs infringement that leads to civil and criminal law procedures. In Argentina, Paraguay and Uruguay, the competent authorities are customs, security forces and various judicial bodies. In Brazil, prosecutions are conducted by police authorities and a variety of judicial authorities.

Legal proceedings are conducted via administrative investigations performed *ex-officio* by respective authorities or may be based on complaints from third parties or those negatively affected by customs infringements. These may or may not lead to judicial proceedings. In cases concerning contraband and counterfeiting, the courts are obliged to intervene but this results in few judgments either because those who are ultimately responsible are not detained or because matters are not handled according to correct procedures. In general, administrative and tax authorities are the competent bodies regarding customs infringements. Contraband and counterfeit are regarded as being criminal offenses.

In cases involving contraband and customs infringements, a variety of bodies are involved including customs and security forces, (Port Police, Naval Police, Aeronautical Police, and Federal Police in Argentina or State Police in Brazil, Transport Police, specialised units, and judicial authorities). Legal procedures are not always conducted in a coordinated way and sometimes result in offenses being committed.

Customs regulations are focused on protecting the state against tax offenses and only to a lesser degree deal with security or health risks.

Products which are addictive or dangerous to health are dealt with more severely by Argentina and Uruguay.

Specific legislation concerning illegal trade has been set out in a variety of legal fields via, for instance, the Customs Code, the Criminal Code, tax legislation, legislation covering tax evasion, trademark law or intellectual property laws, money laundering, falsification of public documents and those concerning illegal associations. Provisions are generally not enforced in an integrated manner that increases penalties and this is even less so in the case of tobacco.

Legislation is also partially obsolete and incomplete in some MERCOSUR countries. This works to the benefit of transgressors and is further aggravated by public employees failing to discharge their duties, which encourages noncompliance. At the same time, defence lawyers tend to have a higher level of expertise compared to prosecutors and the judiciary.

Each country differs in respect to how its legal procedures handle cases involving contraband tobacco. Considerably less consideration is paid to regulations covering health-related aspects. Addressing these deficiencies would require changes to national legislation in some MERCOSUR countries. In Uruguay, it could be achieved by means of an administrative resolution or by Presidential decree. Brazil

has adopted specific administrative legislation covering tobacco but this does not extend to criminal law.

In some cases contraband is treated as a criminal offense, for instance in respect of large-scale contraband in Argentina. Situations involving small-scale contraband are customs infringements. Brazilian legislation also takes into account the type of product, distinguishing “contraband” (the illegal trafficking of illegal substances) from “re-routing” (illegal commerce in legal merchandise). In contrast, Argentina and Uruguay take into account the monetary value of the infringing products. In addition, there are aggravating situations such as illegal association, falsification, and participation by public officials.

Repeat offenses are not penalized, except in Argentina, although there is no list of offenders to ensure compliance.

The distinction between large-scale and small-scale contraband (except in the case of Brazil) results in differences in legal sanctions:

In Argentina, the Customs Code (Law 25.8986 of 29/12/2004) states that in the case of tobacco or its by-products an act is considered to be a customs infringement involving lesser contraband when the market value of the merchandise being smuggled or attempting to be smuggled is under 30,000 Argentinean pesos (approximately USD 10,000). The penalty in such cases is a fine and confiscation of the merchandise. Above this figure an act constitutes an offense subject to a penalty of up to eight years imprisonment.

In Paraguay, smuggling is regarded as a customs infringement and a criminal offense to be prosecuted by the public prosecutor. It carries a penalty of up to five years imprisonment. Paraguayan legislation does not consider either the amount or type of merchandise as aggravating circumstances. Confiscated merchandise, and the means of transport used in its conveyance, can be handed over by customs authorities and courts and tribunals, based on the earlier conclusion of the administrative investigation and payment of fiscal taxes and fines. Paraguay has a regulation concerning low-value contraband of an FOB value not exceeding USD 500 by which the merchandise is confiscated and there is no criminal penalty.

If goods confiscated in Uruguay exceed a value of USD 20,000 there is a presumption of money laundering. Penalties for imprisonment increase and a prison sentence follows automatically.

In Brazil, the legal principle of insignificance is applicable to contraband or rerouting of merchandise, including cigarettes. Application of this principle means it is possible that illicit conduct can be considered as being irrelevant under criminal law, including cancellation of any tax due and costs of filing of proceedings. Law 9.099/95 allows for conditional suspension of proceedings under certain circumstances, for instance where no other crimes have been committed or there is no evidence of re-offending in cases involving intentional offenses, a criminal record, or the conduct and personality of the individual.

Final destination of confiscated merchandise

In Argentina, the Customs Service confiscates and destroys merchandise. In Uruguay, while the general principle is to auction confiscated merchandise, cigarettes and tobacco pose a more complex problem. If counterfeit, they will be destroyed. In Paraguay, goods can in principle be returned to the owner subject to prior payment of

taxes due but can be destroyed in the case of counterfeit products or brands associated with large-scale offenses. This has rarely been exercised, however. In Brazil, on the other hand, merchandise can be returned in the event of prejudiced parties being third parties acting in good faith. Should the product be a fake cigarette, however, it can be destroyed on the basis of it not being fit for consumption.

Among MERCOSUR countries, Brazil is quickest to pass cases involving contraband to criminal authorities whether infringements involve a trademark or tax evasion. This applies to issues of falsified products, falsification of public papers, illegal association or falsification, corruption, adulteration or alteration of substances for human consumption. According to the Federal Court, falsification of tobacco — which is considered as a substance for human consumption — means that the offense can fall under the terms of the criminal code and under legislation for protecting consumer rights, the latter being considered as a special regulation under the former?

Asset laundering

Paraguay is a multimillion-dollar center for money laundering derived from drugs and other commodities such tobacco and weapons. Operations involve the financial sector and other sectors of the country's economy. Weak financial sector controls, open borders and lack of enforcement mean that Paraguay is one of the key centers of asset laundering in the region.

In December 2007, parliament approved a new Criminal Code that includes money laundering as a specific form of criminal activity punishable by up to five years imprisonment. The law allowed for a one-year introductory period to allow judges and prosecutors to prepare for the new regulations. Laws covering bank secrecy laws hamper application of the new standards, however.

Uruguay penalises asset laundering via Law No. 17.343, of 2001, and Law No. 17.835, of 2004. Law 17.343 defines offenses such as drug trafficking, corruption, terrorism, contraband exceeding USD 20,000, illegal trafficking of weapons, explosives, human organs, tissues or medicines, the illegal trafficking of men, women or children, extortion, kidnapping, bribery, illegal trafficking in nuclear substances, and the illegal trafficking of animals or antiques. Asset laundering is considered as an autonomous offense to that of the other underlying offenses. The courts have the power to impound and confiscate properties, products or financial instruments relating to the activities of asset laundering.

Law 17.835 significantly strengthens the regime against asset laundering in Uruguay by including terms specifically related to the financing of terrorism and to freezing of assets related to terrorist organizations. It also contains terms regarding covert operations and monitored transactions.

The first arrest and trial for asset laundering following passage of Law 17.835 took place in October 2005.

Summary of similarities and differences

In the following chart we outline the principal similarities and differences concerning the legal treatment of contraband of cigarettes and contraband in general within MERCOSUR countries.

(...)

Drug trafficking has links to the illegal cigarette trade as it involves people who deal or have dealt in contraband cigarettes or other illegal goods. This calls for a new approach, increased specialization and greater assistance for the court system.

A spokesman for Uruguay's Supreme Court recently argued there should be specialized courts and prosecutors for drug trafficking, money laundering and new offenses emerging from these areas. Operation "Cancerbero", which exposed a large drug trafficking network operating out of Uruguay, showed that current policing methods and judicial resources need to be strengthened. The operation raised the question as to whether the country has the necessary resources to tackle organized crime. According to the Supreme Court spokesman, "Drug trafficking is taking place in Uruguay on a large scale and the State and society as a whole have to be aware of this and have the resources to be able to combat this reality."

Regional and international agreements, mechanisms for coordination via agreements between Customs agencies and police forces in the MERCOSUR region

MERCOSUR countries are Parties to a number of regional and international legal instruments relating to contraband, drugs, money laundering and corruption.

Among these are the United Nations Convention against the Illicit Narcotic Traffic and Psychotropic Substances (1988), the International Convention for the Suppression of the Financing of Terrorism (1999), the Inter-American Convention Against Terrorism (2002), the United Nations Convention against Corruption and the United Nations Convention against Transnational Organized Crime.

All four countries participate in the Inter-American Drug Abuse Control Commission's anti-money laundering expert group. Argentina, Brazil and Paraguay, together with the United States, are members of the "Three Plus One" mechanism that focuses on the security of the tri-border region.

They are also members of the Financial Action Task Force on Money Laundering in South America (GAFISUD).

While analysis of the participation of MERCOSUR countries in these agreements is not the subject of this report, the various mechanisms are explicitly intended to promote approaches and cooperation for combating problems such as transnational crime and money laundering.

Experts believe that coordinated efforts by MERCOSUR countries are essential. Nevertheless, issues of sovereignty and tradition tend to hamper such coordination.

Irrespective of treaties and diplomatic initiatives, the day-to-day reality of border operations to combat smuggling involves mistrust and unfortunate incidents that have their roots in inadequate cross-border collaboration.

For example, uniformed Argentinean police officers have been detained at the Paraguayan border for illegally entering the country. An agreement between Brazilian and Paraguayan customs officers to allow law enforcement officers from Brazil to enter Ciudad del Este also fell through because of sovereignty questions raised by Paraguay, even though this would have meant additional resources for combating illegal operations.

Border cooperation is also problematical when it is not backed by more general agreements based on the participation of national authorities.

Agreements to combat tobacco crime and contraband in the MERCOSUR

Representatives of Interior Departments from MERCOSUR countries, along with Bolivia, Chile and Peru, signed an agreement in December 2004 to combat counterfeiting and contraband cigarettes and agreed to introduce measures such as labels, seals and sealing waxes. The agreement was adopted as a MERCOSUR decision.

The Parties agreed to exchange customs information on cigarette trade in the MERCOSUR, as well as information on the quantities of cigarettes manufactured and data on domestic consumption.

The agreement also called for Interior Ministers to analyze the main problems of piracy and illicit trade of regional significance, detailing geographic areas, forms of criminality, the number of administrative cases and judicial sentences, as well as details of merchandise and the values of seizures in operations to combat smuggling concerned with factories and premises for illicit cigarette distribution.

The Parties also reported on legal cases involving individuals involved in illicit trade and arrests and sentences for smuggling cigarettes and other products. In 2006, the agreement was replaced by a MERCOSUR decision that led to a new agreement between MERCOSUR and associated countries. Specific regulations covering the illegal tobacco trade were absent from this new agreement, however.

The objective of the new agreement, which is yet to be ratified by most countries concerned, is to safeguard security in the region by promoting wideranging cooperation between the Parties as well as reciprocal assistance in preventing and combating illegal operations, particularly those of transnational origin including illicit drugs, terrorism, money laundering, the illicit trade in firearms, ammunition and explosives, illegal trafficking in human beings, the smuggling of vehicles and environmental damage. Smuggling of cigarettes and tobacco is not mentioned specifically.

The agreement included a new information system (“SISME”) which is intended to ensure the effective exchange of information between Parties.

One of the key provisions is that border police forces may enter the territory of another Party without prior permission when engaged in the pursuit of criminals. However, they have no legal jurisdiction and are required to request assistance from their domestic counterparts.

The agreement is mainly an instrument for police forces and does not apply to Customs agencies. This is because Interior Ministries were the original signatories to the agreement, whereas Customs comes under the ambit of Finance Ministries. This adds to coordination problems among enforcement agencies in the region. Without adequate coordination on the national level the treaty will have little effect.

The feeling that diplomatic efforts move faster than political will within MERCOSUR countries is indicated by the agreement not having been ratified, as of August 2008, by any of the Parties that signed it two years previously.

Regional Customs agencies meet on an occasional basis but their meetings have never focused on cigarette smuggling.

Nonetheless, after having conducted several interviews in the course of this report, there does appear to be a certain “esprit de corps”, whereby Customs agencies in the region work in a coordinated fashion, although some are more willing to cooperate and exchange information than others.

Standard working procedures are based on informal agreements and customary practice. The Customs agency of country A alerts its counterparts in country B, and possibly C, to evidence of a consignment of illegal merchandise leaving its jurisdiction. This commonly results in Customs in country B opening a container to verify its contents since forewarned Customs officials generally act on reliable data. In the majority of cases this results in the seizure of illegal merchandise, which frequently involves cigarettes.

Regional Customs bureaus face budget restrictions that prevent them from meeting more frequently. The information network, although well established and functioning, remains highly dependent on the will of highly placed figures in Customs authorities. It is unhelpful that there is high degree of rotation due to political decisions.

Chapter VI—recommendations

Optimize legislation and implementation

- Incorporate in legislation rules classifying the contents of cigarettes, such as nicotine, as addictive substances. And, consequently, revise the Criminal Code to increase sentences for trafficking in addictive substances.
- Impose stiffer penalties for the repetition of smuggling offenses by individuals or companies and ensure cases are submitted to criminal courts.
- Increase sentences for government and public officials involved in criminal activities related to illicit trade.
- Introduce rules for the immediate destruction of illegally imported cigarettes.
- Create new specialized means for public prosecutors and judicial courts to deal with organized crime and wholesale smuggling, devoting to the illicit cigarette trade the same highly qualified and well-trained officers who track down and deal with drug trafficking and money laundering.
- Revise regulations regarding merchandise passing through free trade, transit and free ports in order to reduce under-declaration and false declarations. Penalties should be increased significantly to discourage the smuggling of products, such as cigarettes, which are injurious to health.
- Increase economic penalties for those caught dealing in cigarettes distributors, including retailers.
- Prepare and instigate public relations campaigns to promote law abiding behaviour and disseminate information on the penalties for smuggling so that citizens increasingly regard contraband as a crime and understand that smuggling cigarettes is a public health issue.

Fight corruption in Customs agencies and other law enforcement bodies

- Establish more stringent mechanisms for supervising and evaluating the activities of civil servants in Customs and law enforcement who are engaged in controlling smuggling.
- Explore an incentive scheme for agencies which rewards significant seizures of smuggled cigarettes. Use Brazil's "Fundo Nacional Antidrogas" as an

example and earmark a small percentage of fiscal returns from tobacco taxation.

Improve the qualifications and training of Customs agents and personnel

High priority should be given to improving the qualifications of Customs personnel in MERCOSUR countries. This will help fill the current vacuum that is being exploited by multinational tobacco companies which conclude agreements with Customs authorities and supply training and equipment to Customs agencies.

- Strengthen the internal organization of Customs bureaus in the region to provide improved career opportunities for personnel and ensure that personnel identify more closely with the goals and objectives of a law enforcement agency that is battling powerful economic interests.
- Make greater use of options such as scholarships and internships to send selected personnel to regional and international training centres and educational institutes, including the WCO.

Improve intelligence and coordination among Customs bureaus and other law enforcement agencies in the four countries

The estimated annual fiscal loss of USD 900 million to governments in the MERCOSUR region due to the illegal cigarette trade is a reason for them to instigate immediate action.

Concrete measures are needed, in addition to international and regional treaties:

- Introduce specific practical mechanisms for coordination, for example via periodic regional meetings that focus on cigarette contraband.
- Promote inter-agency exchanges of qualified personnel for short periods to enhance interaction and build up mutual acquaintances.
- Increase the interlinkage of Customs information systems in the region.
- Capacity building for Customs and enforcement agents in the use of technology (radar, scanners, etc.), modern computerized systems and security equipment for personnel.
- Conclude legal agreements for patrolling the borders of the four countries so that law enforcement officers receive rapid response assistance from their counterparts without sensitive issues of sovereignty arising. It is smugglers who profit from rigid “nationalistic” thinking by governments.
- Establish strategies for controlling contraband cigarettes and include these is a wider effort to curtail illicit trade, for instance in narcotics, pharmaceutical drugs etc., and asset laundering.

Governments should take a more direct approach to crossborder smuggling

Combating contraband tobacco and similar forms of illegal activities calls for extra resources and commitment to range of strategies for promoting more rapid

development in border communities by providing alternatives for local economic progress and cultural change.

The fight against criminal smuggling organizations will be more successful when supported by a structure of sound intelligence

Linking of intelligence work should be a core strategy for leading agencies in all four countries, allowing faster data collection and more efficient responses in field work.

Recommendations by country and for MERCOSUR

1) Argentina

- Promote an institutional approach and a framework for greater collaboration among law enforcement agencies including AFIP/Customs and Internal Revenue (DGI), Naval Prefecture, National Gendarmerie, police, prosecutors and judges.
- Strengthen regulations and develop improved systems for the control of national airspace control, in view of the significance of aircraft in transporting contraband tobacco and drugs.
- Impose heavier penalties on landowners and tenants in regions where there is widespread use of clandestine landing strips for illicit activities.
- Improve coordination and efforts to increase controls on the movement of containers of illegal cigarettes using the port of Buenos Aires and its facilities, as well as free zones in La Plata and elsewhere, plus other feeder ports serving B.A.

2) Brazil

- Fight corruption by imposing stiffer penalties and via other measures. It is unacceptable that huge quantities of smuggled cigarettes and other illicit goods are allowed to travel unhindered on a daily basis over long stretches of Brazilian territory.
- Improve inter-agency coordination and collaboration to ensure illicit trade is combated effectively. Brazilian agencies tend to believe they are self-sufficient in terms of data and resources. But there is much to be gained from enhanced intelligence cooperation and the sharing of resources.
- Overcome the inward-looking approach to controlling tobacco smuggling, ensure the problem is accorded greater prominence and additional capacity to establish solid mechanisms for cooperation and coordination with governments and law enforcement agencies in the region, including improved intelligence and border controls.
- Analyze an alternative approach involving amending regulations to permit courts to include cigarette smuggling under laws against counterfeit, resulting in longer prison sentences with no eligibility for early parole.
- Establish standards to simplify the sale of seized vehicles, ensuring the proceeds go to providing incentives to combat criminal activities.

3) Paraguay

- A necessary precondition is a change in the political attitude and response to organized criminal activities. This applies to illegal operations across the board, and not only to the cigarette trade.

In addition:

- Increase levels of tobacco taxation and ensure that manufacturers pay taxes on cigarettes destined for the domestic market. The government of Paraguay is presently missing out on a significant fiscal windfall estimated at USD 130 million. Confronting this problem would deliver a bonus of reducing tobacco consumption and the prevalence of smoking in Paraguay and other countries in the region.
- Implement measures such as a system of “tracking and tracing” to ensure all cigarette manufacturers in the country provide information about their operations and products. This is in line with recommendations of the CMCT, a treaty that Paraguay has already ratified.
- Improve levels of qualifications within key law enforcement agencies, such as Customs, and continue to improve the identification of personnel with the values and goals of these agencies in order to strengthen resistance to corruption.

4) Uruguay

- Promote the strengthening of the Customs bureau and raise the level of qualifications of personnel in fighting corruption.
- Pass a new Government Decree in line with legal regulations derived from the Anti Drug Act to include nicotine as an addictive substance, by means of which sterner criminal sentences for smuggling of cigarettes can be applied.
- Ensure an increasing number of smuggling cases reach the criminal courts by relying on existing regulations concerning third party accusation or judicial intervention; money laundering laws, when smuggled goods valued at more than USD 20,000 are confiscated; and association to commit a crime, where more than one person is involved. Combined offenses carry higher penalties. This demands close coordination between agencies and the court system.

5) MERCOSUR

- Promote adoption of a new chapter in the Customs Code relating to violations. Or, if the Code is adopted as it currently stands, open negotiations on a protocol including regulations on illicit trade.
- All four countries should address domestic legislation that currently allows for reduced or non-custodial sentences and the restitution of merchandise or seized vehicles. They should also legislate to penalise repeat offenses involving smuggling or other forms of illicit trade, for instance by means of publicly available registries of criminals.

- Continue to develop improved intelligence by Customs and law enforcement agencies in MERCOSUR countries, based on acknowledgment of this being an effective way of continuing to exert pressure on criminal organizations. Step up efforts to improve the quality of information networks of law enforcers in the four countries; place greater emphasis on the efficiency of controls; and establish a target for the numbers of seizures in a given year.
- Authorities should impose stricter controls and stiffer penalties on smugglers who extensively exploit common instruments for trade promotion and development (such as free trade zones, ports and merchandise transit rules, etc.) in the region.
- Evaluate the feasibility of a MERCOSUR satellite monitoring system for tracking containers as a way of preventing merchandise from being diverted.
- Promote the creation within MERCOSUR of an organisation along the lines of OLAF, the European Union's body for fighting fraud, corruption and irregular activity. This would deliver benefits extending far beyond control of the illicit tobacco trade. Were governments in the region to decide in favour of creating such an agency it would send clear signals to the international community, and to smugglers, about the priority assigned to combating illicit trade of all kinds.

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