

CHAPTER 13

CONTRABAND TOBACCO AND ORGANIZED CRIME: AN INTERNATIONAL PERSPECTIVE

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Underground economic activity plays a significant role in organized crime. This is especially the case with cigarette smuggling, a world-wide phenomenon in the 1990s. First, it provides a low-risk source of income. In Italy, for example, contraband cigarettes are estimated to be a \$1 billion-a-year enterprise for organized crime. Second, it facilitates the establishment of criminal infrastructures that can be used to handle other illegal commodities. Again, to take an example from Italy, there's evidence that, when Sicilian organized crime figures entered heroin trafficking in the 1970s, they used the same smuggling routes and techniques they had pioneered in the 1950s and '60s to handle black market cigarettes. And third, it provides groups of criminals with the capital and opportunities to establish a more extensive and organized criminal infrastructure. An example: Groups of criminals based on some Indian reservations on the Canada-U.S. border have become powerful and well organized as a result of their participation in the bootlegging of cigarettes. They now handle narcotics and illegal firearms. Law enforcement traditionally neglects to examine the role of underground economic activity in combating organized crime. But focusing on this area can generate useful opportunities to attack criminal enterprises in areas where they may be at their most vulnerable.

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1. Introduction

Black markets promote the development of organized crime groups. Once established, these groups are difficult to eliminate. Even if the policies which initially spawned a particular black market are repealed, case studies have shown that criminal groups will simply shift to another illegal sector.

In the United States, for example, a number of organized crime groups came to the fore in the 1920s and early '30s during Prohibition. In circumventing the ban on alcohol, these groups grew wealthy and powerful. When Prohibition was repealed, their criminal infrastructure was so firmly established that they simply moved to profit from other illegal commodities.

Canada suffered a similar fate during its contraband crisis in the 1990s when excessively high taxes spawned a smuggling boom. When taxes were lowered in early 1994, cigarette smuggling slowed to a trickle. But the crimi-

nal groups who had profited from the contraband tobacco trade did not disappear. They simply shifted to other illicit products, including untaxed alcohol, narcotics and banned firearms.

Focusing on the contraband tobacco trade, this report will:

- Draw on international case studies to show how black markets promote the growth and development of organized crime groups;
- Outline the types of policies which facilitate the emergence of underground economic sectors;
- Describe the impact of underground sectors on the legitimate distribution and retail sectors;
- Show how black markets have a corrupting influence on individual citizens and create additional opportunities for public sector corruption; and
- Demonstrate techniques and procedures for taking effective law enforcement action against contraband sectors.

2. Contraband Tobacco: A General Introduction

2.1 The Nature of the Contraband Tobacco Trade

High tobacco taxes create a consumer demand for a cheaper product. Organized criminals take advantage of this situation by establishing networks to smuggle, distribute and retail untaxed cigarettes. Their profit margin is the price difference between taxed and untaxed cigarettes. The higher the taxes, the greater the profit margin to organized crime.

Cigarette smuggling damages society in numerous ways, many of which are unforeseen. Illegal cigarettes allow organized crime to undermine the legal distribution and retailing networks by competing unfairly in the market place. This penalizes honest retailers and wholesalers who dutifully remit taxes. As a result, they can't compete with vendors who sell cheaper, black market cigarettes. Some are driven out of business. Others are forced, out of economic necessity, to participate in an illegal activity.

The evasion of tobacco taxes reduces government revenues, which, in turn, means government programs and services are either cut, reduced or taxes are raised. Moreover, an increase in cigarette taxes can also spur a variety of criminal activities, which put an additional burden on law enforcement and tax compliance resources. Perhaps the most pernicious effect of underground economic activity is that it brings otherwise law-abiding citizens into contact with criminal activity. In our experience, most people who consume contraband tobacco don't think they're doing anything wrong,

even though they're breaking the law. Rather, because they may feel unfairly taxed, they may justify what they're doing as a form of civil disobedience, a popular tax revolt. What they rarely understand is that their actions undermine the moral fiber of their community by promoting law breaking and disrespect for the law. Mr. Peter Spiro, a Canadian expert on underground economic activity stated that any increase in the underground economy represents a decline in respect for legal modes of behavior and a weakening of the social contract.

3. Organized Crime and the Contraband Tobacco Sector

3.1 Overview

Cigarette smuggling is a huge money-maker for organized criminals around the world. Smuggled cigarettes are the perfect product for the criminal underworld for the following reasons:

- They are a relatively low-risk source of cash;
- They provide an entry point for organized crime into legitimate business sectors, at both the retail and wholesale level;
- Like alcohol during Prohibition in the United States, contraband cigarettes permit lower-echelon criminals to establish, finance and consolidate a sophisticated illicit infrastructure; and
- They promote the establishment or enhancement of sophisticated smuggling and distribution systems. These systems are often difficult to detect and can be used to smuggle other illegal goods.

3.2 Types of Organized Criminal Activity

In general, some tobacco smugglers operate in a number of far-flung geographic areas; others stick to local markets. In many cases, they may also handle drugs and alcohol. Cigarettes are sometimes exchanged for other illegal products, including narcotics. Because cigarette smuggling is a major world-wide problem, illicit supplies can be obtained from a wide range of international sources. Popular American brands, for example, are manufactured around the world, from Eastern Europe to Southeast Asia.

3.3 Billions of "Missing" Cigarettes

What makes international smuggling possible is a ready supply of "homeless" cigarettes. Every year, tens of billions of cigarettes literally "disappear" off the world's international trade balance sheets. This is an

unusual development for such a high-value commodity that is a key revenue generator for Governments around the globe. In 1985, 17.8 billion packs of cigarettes were exported around the world, according to U.S. Department of Agriculture (“USDA”) figures. But records also show that only 15.7 billion packs were recorded as actually being imported - a difference of 2.1 billion packs. In 1992, USDA preliminary data indicated a gap of 8.5 billion packs. These unaccounted exported cigarettes conceal the billions of cigarettes that fill the international demand for untaxed cigarettes. Gaps between export and import figures can also be an indication of smuggling activity between two countries. Canada, for example, recorded huge levels of exports to the United States in the early 1990s, coinciding with a surge in contraband activity. These cigarettes were primarily Canadian brands for which there is only a small international market. The bulk of these cigarettes ended up in the hands of criminal groups which smuggled them back into Canada.

4. Intrnational Case Studies

4.1 Italy and the Mafia

Contraband cigarettes are believed to generate \$1 billion in profits for organized crime in Italy. It is estimated that the illicit cigarette sector employs nearly 509,000 at the retail level and 25,000 at the smuggling/distribution level. The illegal cigarette trade is especially important in the Italian city of Naples, where according to the Reuters news agency, some 8,000 families live from the annual \$600 million contraband cigarette trade controlled by the Camorra, the local Mafia. Historically, tobacco smuggling gave important elements of the Mafia in Italy the opportunity to establish a sophisticated criminal infrastructure. In particular, there was a symbiosis between the routes/systems used to smuggle cigarettes and those that handle morphine base and heroin, as well as illegal arms.

Contraband tobacco moves through an elaborate network. It begins in Switzerland, Belgium, and Holland, which are manufacturing states. From there, the cigarettes are moved to storage depots in Hungary, Romania, Bulgaria, and Turkey. The former Yugoslavia and Albania are the staging areas for the final run into the Adriatic into Italy. According to author Claire Sterling in *Thieves World*, She stated:

“..... This circuit in reverse constitutes the famous Balkan route. The biggest two-way trade in arms and drugs ever uncovered has depended on it since the 1960s. Three-quarters of the heroin reaching Western Europe and

a substantial portion of America's travels along it ..."

Or consider the case of Tomaso Buscetta, a major Italian Mafia heroin trafficker in the 1970s who became a high-profile, protected government witness a decade later. Buscetta was heavily involved in the contraband tobacco trade, starting in the late 1950s, when Italian authorities caught him red-handed with a shipment of nearly four tons of contraband cigarettes. As investigative reporter Sterling stated in her book *Octopus*:

"The [contraband cigarettes] had come from Tangiers, a conveniently situated free port on the north African coast facing Gibraltar, favored by spies, smugglers, money changers, fugitive crooks, and other assorted villains. This was the seat of a Corsican buccaneer named Paolo Molinelli whose private fleet plied the Mediterranean with contraband tobacco for all of Europe.. his fleet [also] carried morphine base from Lebanon to Marseilles, and refined heroin from Marseilles to Sicily for forwarding to Cosa Nostra in America. This was where the international heroin network got its start, and where master traffickers like Buscetta got theirs."

Added journalist Ralph Blumenthal in *Last Days Of The Sicilians*:

"Initially, loads of five hundred cases of cigarettes were considered substantial; at its height the racket dealt in shiploads of up to forty thousand cases, providing a livelihood for thousands of otherwise unemployable Sicilian poor. Mafiosi and their allies in the Neapolitan Camorra masterminded the traffic."

4.2 The Colombian Cartels

This model also applies to Colombia with respect to the birth of the cocaine industry in the mid-1970s, although cigarettes were just one of the many products being smuggled. Cocaine trafficking became established when experienced groups of smugglers - who had learned their trade by handling cigarettes, among other contraband products - shifted to handling this more lucrative commodity. As Guy Gugliotta and Jeff Leen noted in their book *King of Cocaine*:

"Perfectly respectable men - and some not so respectable - made a living smuggling liquor and cigarettes by ship from the United States. This was where Colombia's cocaine industry took root."

There are indications that some Colombian cocaine barons still handle cigarettes, but for a different purpose. It is believed that, in some cases, they repatriate cocaine profits earned in the United States through cigarette purchases. These cigarettes are imported into Colombia and sold there, provid-

ing cocaine traffickers with a seemingly legal alibi for the source of their wealth.

4.3 Lessons from Italy and Colombia

In both Italy and Colombia, once a smuggling organization was entrenched, it had the organizational and financial resources to participate in a variety of other criminal activities. In the process, it became extremely difficult to destroy. Another example occurred during Prohibition, when the organized criminals who dominated the American underworld into the 1940s, 1950s and 1960s began by running bootleg alcohol. That experience allowed them to gain the expertise, the manpower and sufficient capital to maintain a large-scale criminal infrastructure.

4.4 Hong Kong

Police in Hong Kong report that up to 40 percent of all cigarettes smoked in the British colony are contraband. According to Don Watson, the Commissioner of Customs, the impetus appears to be a 100 percent increase in the tobacco tax in 1991. As he told the *South China Morning Post*: "This inevitably led to a lucrative trade in smuggling [tax free] cigarettes into Hong Kong for sale on the black market."

4.5 Asia

In 1994, China launched "a nation-wide crusade" against the production and marketing of contraband cigarettes. Elsewhere in Asia, media reports indicate that cigarette smuggling is a problem in Indonesia, Taiwan and Vietnam.

4.6 Europe

In Spain, the contraband market has a street value of about \$1 billion, according to a report in the *Financial Times* of London. In 1993, German customs officials seized 624 million cigarettes smuggled from Eastern Europe - more than twice the number in 1992, according to the news agency, *Agence France Presse*. It should be noted that customs officers typically confiscate only a small percentage of illegal shipments. In Eastern Europe, according to media reports, contraband cigarettes are a serious problem in Poland, where 50 to 80 percent of imported cigarettes are smuggled, as well as in the Czech Republic, Bulgaria and Romania.

5. Canada: A Case Study

5.1 Introduction

High tobacco taxes in Canada fueled the explosive growth of an organized crim-dominated black market in the early 1990s. At its height in 1993, it was estimated that nearly one in three cigarettes consumed in Canada was contraband.

5.2 Size of the Contraband Market

In 1985, there was virtually no contraband tobacco for sale in Canada. By 1993 - as the result of continuous tax increases that shot up the price of a package to more than US\$4.25 in many parts of the country - Lindquist Avey estimated the tobacco black market at more than 770 million packages of cigarettes (20 to a pack). That was approximately 30% of the total number of packages purchased in Canada. Tobacco smuggling was particularly out of control in the province of Quebec. Law enforcement officials estimated in 1993 that up to two-thirds of the cigarettes smoked in the province were purchased illegally.

5.3 Lost Tax Revenue

The cost to the federal and provincial governments (especially Ontario and Quebec) was staggering. In 1993, the tax revenue lost to the federal government was approximately US\$1 billion.

5.4 Massive Tax Cuts

Faced with an unofficial tax revolt and a growing lawlessness, the federal government made massive tax cuts on cigarettes in February 1994. "Smuggling is threatening the safety of our communities and the livelihood of law-abiding merchants," said the Canadian Prime Minister, Jean Chretien, as he announced the reductions. "It is a threat to the very fabric of Canadian society." His words were echoed by the Solicitor General of Canada, Herb Gray. "Organized crime has become a major player in the contraband market," he said. "What we are facing is a frightening growth in criminal activity. We are seeing a breakdown in respect for Canadian law. Canadian society is the victim."

5.5 High Taxes in Canada Created a Gangster Economy

"There are strong parallels between the cigarette smuggling trade and

the days of Prohibition,” a Canadian newspaper concluded. “[You might as well] put a fedora on the head of today’s cigarette smuggler and give him a nickname like Machine-gun Kelly.” The Prohibition analogy was cited frequently in Canada during the past few years to describe the popular revolt against high taxes on cigarettes - and the extensive criminal underworld that exploited the eagerness of many smokers to flout the law. In an ironic twist, instead of alcohol being smuggled into the United States from Canada, as happened during Prohibition, cigarettes were smuggled into Canada from south of the border. Just as many U.S. citizens in the 1920s and early 1930s rebelled against the 18th Amendment - which banned alcohol - many Canadian smokers considered the high cigarette prices unjust and unfair. And just as Prohibition gave birth to organized criminal gangs that continued to flourish long after temperance was repealed, so too has tobacco smuggling in Canada introduced new criminal players into Canadian society.

5.6 Organized Crime in Canada

Organized crime’s involvement in the contraband tobacco trade in Canada took two forms:

- traditional crime groups saw it as another profitable illicit enterprise; and
- non-traditional groups, including some based on native Indian reserves, built up expertise and a criminal infrastructure as a result of their experience in the cigarette business.

As Prime Minister Chretien warned Canadians in February 1994: “When you are buying contraband cartons of cigarettes, you aren’t just saving a few dollars for yourself, you are directly supporting organized crime.”

5.7 A Money-Maker for Organized Crime Groups

Contraband cigarettes became a valuable commodity to organized crime groups. In some cases criminals exchanged them instead of money for illegal drugs. According to a report by the Royal Canadian Mounted Police (“the RCMP”), Canada’s national police force:

“RCMP in Edmonton concluded a major investigation in June 1991 involving cocaine trafficking by criminal elements within the Edmonton Vietnamese community. The medium of exchange, however, was cigarettes rather than money - a ‘flashroll’ consisting of [CDN] \$200,000 worth of cigarettes was exchanged for 1.1 kilograms of cocaine.

In some cases, traditional organized crime groups purchased duty-free cigarettes from American wholesalers and looked after the smuggling op-

eration themselves. A popular method involved hiding contraband products in shipments of legitimate products such as fruits and vegetables. In other cases, traditional organized criminal groups took delivery from non-traditional groups that specialized in smuggling tobacco into Canada. The traditional groups then transported and distributed the contraband tobacco to their communities. As a result of their experience in other criminal enterprises, including the drug trade, traditional organized crime groups knew the techniques and strategies required to maintain the clandestine nature of their networks. They instructed delivery drivers, for example, to pick up a vehicle at Location A and leave it at Location B. The drivers didn't know how the vehicle got to Location A or what happened to it after they drove their designated route and dropped it off.

5.8 Key Smuggling Route

Groups based on native Indian reserves conducted much of the cigarette smuggling across the border. This was especially true of those in the Akwesasne-St. Regis Reserve, which straddles the Canadian-American border between Cornwall, Ontario, and Massena, New York. This region became the number one conduit for smuggling cigarettes into Canada. Police estimate as many as seven of every 10 contraband cigarettes consumed in Canada entered through the Cornwall-Massena area. Geography made it a smuggler's paradise. Not only is the St. Lawrence especially narrow there but its channel is also sprinkled with myriad islands and channels. Passage across the river is relatively easy in winter and summer. The risk of detection is quite low.

First Nations people can purchase for personal use unlimited amounts of tax-free tobacco in the United States. But this tobacco is required to remain on the reserve. Bona fide American wholesalers legally imported huge quantities of tobacco from Canada and sold it to vendors on Akwesasne-St. Regis. They, in turn, either smuggled the products into Canada themselves or sold them to other smugglers. They used planes, boats, snowmobiles and tractor trailers to do so. Smuggling groups based at Akwesasne-St. Regis began to take advantage of other profitable opportunities and smuggled other goods into Canada including illegal drugs and arms.

Alcohol was also a popular commodity for smugglers. In the latter part of 1993, for example, Canadian police found that about 25 percent of shipments of contraband tobacco also contained illegal alcohol. Since the sharp cut in tobacco taxes in February 1994, indications suggest many smuggling

groups now focus heavily on bootleg alcohol. By the end of 1994, seven native liquor distributors on the Akwesasne-St. Regis reserve were taking delivery of five to seven truck loads a day. Distributors said there was no U.S. tax paid on the shipments because the liquor was for export. New York State tax investigators said that 97 percent of the alcohol shipped to the reserve was smuggled into Canada.

The morality of tobacco smuggling is hotly debated among native groups in Canada. Many native Canadians believe they have a legal and constitutional right to travel freely across the U.S.-Canada border and to transport "their own proper goods and effects" (according to rights granted under the 1794 Jay Treaty) without paying or having to collect tax or duty. They also feel a spiritual ownership of tobacco, which native Canadians and Americans introduced to the European settlers. Some oppose the contraband trade. They claim smuggling has corrupted natives into abandoning their traditions and brought weapons, increased crime and violence into their communities. Others, though, passionately assert they have an historic right to trade in cigarettes - a legal product. "It puts food on my table," a Mohawk living on the New York side of the Akwesasne Reserve told a reporter. "Our grandchildren have to have a way to take care of themselves. Why is it that any time an Indian stands up to help himself he's an outlaw?" Only a minority of residents of Akwesasne-St. Regis participated in smuggling.

5.9 Individual Citizens Corrupted

Canadians tend to be law abiding. They're appalled by dealers selling illicit drugs or stolen property. Yet when it came to contraband tobacco, many showed a far different attitude, turning a blind eye to this illegal product much in the way many people saw nothing wrong with bootleg liquor during Prohibition. Perhaps the most worrisome effect of the Canadian government's high-tax policy was its widespread corruptive influence.

All kinds of individual entrepreneurs got into the business: husbands and wives, illegal immigrants, pensioners, the unemployed, college and even high school students. With limited finances, cost to young people is particularly important. Consequently, the black market, which offered cigarettes, on average, 20-50 percent cheaper than retail prices, was most attractive. "Just as every school has a drug dealer," one high school student said in 1993, "now every school has a cigarette dealer." Buying from that dealer or others became a "cool thing" for students to do. Breaking the law

was perceived as a positive act, a way of sending a protest message to the government. Without really knowing it, they learned tax evasion and how to deal in an illicit product.

There was no stigma to participating in the contraband market. Many smokers saw it as a victimless crime, and did not seem to care that it enriched the criminal element. Nor were they mindful that they evaded significant taxes. Government officials also noticed the growth of a “me-too” attitude, a type of behavior identified in a number of social studies. According to these studies, people are more inclined to cheat the tax system if they believe their neighbors are doing so.

5.10 Store Owners and Employees

Owners and employees of corner stores, donut shops, restaurants and other places that sold cigarettes were likewise drawn into the contraband network. Although some did not sell contraband cigarettes under the counter, others did. Faced with the prospect of customers shopping at competitors who stocked dual inventory, many store keepers - often reluctantly, as they reported to us - followed suit. As a result they didn't collect taxes and didn't report some revenue on their income tax. In other words, they broke the law when they didn't really want to. Their survival in a struggling economy was threatened. They not only lost cigarette sales if they didn't sell contraband but other purchases, such as milk and bread. They felt they had no choice.

5.11 Low Risk of Getting Caught

What also drove individuals and organized groups into the contraband trade was the low risk of getting caught. Although penalties for smuggling increased significantly, only a trickle of contraband tobacco was ever seized. One enforcement officer for the Ontario Provincial Police (“the OPP”) said that in one month in 1993 it seized only 30,000 cartons along a busy smuggling route near Cornwall, Ontario. That monthly total was less than the 50,000 cartons that law enforcement estimated went through undetected each day.

5.12 The Challenge for Law Enforcement

Tackling the contraband tobacco trade, said one Canadian police officer, was akin to “a mouse trying to manage an elephant.” Enforcement alone cannot control a major consensual crime, as shown by the huge resources expended against the illegal drug trade. Although federal and pro-

vincial governments tried desperately to increase the resources devoted to combating the tobacco trade, the size, sophistication and pervasiveness of the trade simply overwhelmed law enforcement agencies. The tide began to turn against the smugglers only when governments drastically reduced taxes.

6. Cigarette Smuggling in the United States

6.1 Introduction

Cigarette smuggling and tax evasion first became a serious problem in the United States in the 1960s due to state tax differentials and peaked in the mid-1970s before declining a decade later. At its height in the mid-1970s, this illicit trade sparked growing concern among law enforcement. "Cigarette smuggling is probably the most lucrative crime in America today," said Herman Lisnow, Deputy Controller of Texas, in the December 15, 1977 issue of *Forbes* magazine. This criminal sector grossed as much as \$1.5 billion in 1976 alone, according to *Forbes*.

What primarily sparked the growth of cigarette smuggling in the United States in the 1960s was the emergence - and subsequent widening - of the differential between state tobacco taxes. In 1960, this differential was quite narrow, ranging from a low of zero tax in Virginia, North Carolina, Colorado and Oregon to a high of eight cents in Texas. A decade later, the picture had changed dramatically as states raised tobacco taxes. At the high end was Pennsylvania with an 18-cent-a-pack rate; at the low, North Carolina with a two-cent-a-pack levy. Twenty-eight states levied taxes of 10 cents or more a pack. By 1975, North Carolina remained the lowest tax state with a two-cent-a-pack levy. At the other extreme was Connecticut with a 21-cent-a-pack tax. Fourteen states levied taxes of 15 cents or more; 39 states levied taxed of 10 cents or more. The federal tobacco tax stood at eight cents a pack from 1951 to 1982 until it doubled to 16 cents on January 1, 1983. As a 1985 report issued by the Washington-based Advisory Commission on Intergovernmental Relations ("the ACIR") stated:

"The large state tax differentials created inviting opportunities for independent 'entrepreneurs' and organized crime groups. The large profit potential combined with the ease of handling cigarettes, the limited resources allocated by the states to law enforcement, the light penalties imposed by the courts and the lack of federal laws against cigarette smuggling, resulted in an epidemic of organized cigarette smuggling and illegal diversion of cigarettes from the legal distribution system by the 1970s."

6.2 Smuggling and the Mexican Border

Organized crime also took advantage of cross-border opportunities involving ostensibly duty-free exports of cigarettes - via bonded warehouses - to Mexico.

According to a 1977 article in the New York Times:

“The warehouses sell cigarettes tax-free for importation into Mexico. But Rex Davis [the then director of the Bureau of Alcohol, Tobacco and Firearms] said most of the tax-free cigarettes never made it to Mexico. They are sold in the United States through a black market that thrives in border cities.”

Added the 1985 report on cigarette tax evasion by the ACIR:

“In some Mexican border communities, the smuggling of cigarettes, (alcohol) and luxury items purchased from duty-free stores and smuggled back into the United States is a constant source of friction between customs and retail merchants.”

In Texas, indicated Mr. Lisnow, cigarettes supposedly exported to Mexico were, in fact, diverted to the black market. As he told the Houston Post in 1976:

“We have an export-import problem. You don’t pay state or federal taxes on cigarettes shipped into Mexico. So people buy legally in the United States, ship them over the border where they turn around mid-river and come back into the country.”

To address this situation, regulations governing duty-free export warehouses on the Mexican border were tightened in 1977.

6.3 Why Smuggling Declined in the Early 1980s

The decline of smuggling in the early 1980s was due to several factors. The passing of the Federal Cigarette Contraband Act of 1978 enabled the Bureau of Alcohol, Tobacco and Firearms to have a considerable success in stopping over the road smuggling and reducing the illegal diversion of cigarettes. Increased law enforcement played a major part in reducing smuggling to such an extent that, in 1984, Robert J. Kleine, a Senior Analyst with the ACIR, concluded: “Cigarette smuggling is under control.”

But a much stronger factor may have been a reduction in the profit incentive for cigarette smugglers. This was the conclusion of a 1982 study entitled “Cigarette Tax Evasion and Interstate Smuggling: An Assessment of Recent Activity” by Kenneth E. Warner. It noted that a number of states sharply raised tobacco taxes in the 1960s and early 1970s. But there was a

marked absence of such hikes between 1973 and 1981, a period of high inflation and rapidly escalating energy costs. Increases in the cost of living trimmed the real value of the smugglers' profit margin - i.e. the amount of tax paid by the consumer. Moreover, the oil price shocks boosted the cost of transporting contraband cigarettes. These two developments had the effect of substantially eroding the profit margins of cigarette smuggling.

6.4 Extent of the Problem Today in the United States

The duty-free outlet on the West Coast of the U.S. did a booming business selling tax-not-paid cigarettes to either outbound freighters docked at local ports or ship chandlers. But it was also engaged in an equally lucrative sideline in which it knowingly evaded both federal and state tobacco taxes.

According to law enforcement, although shipments of U.S.-brand cigarettes were, in some cases, actually loaded on freighters in port, they were subsequently unloaded and sold untaxed at huge profits. Similarly, crooked chandlers funneled their untaxed cigarette purchases, intended for outbound ships; to the domestic black market. Over the past two years, it's estimated that this scam resulted in thousands of cases of cigarettes leaking into the hands of smugglers. These kinds of schemes are difficult to detect because the paperwork associated with them appears genuine, making it seem as if the cigarettes were actually exported. Detection is further complicated because the illicit cigarettes often change hands five or six times before reaching their final destination.

Sophisticated schemes like this one, which evade both federal and state taxes, are a growing feature of cigarette smuggling in the 1990s. There appears to be a criminal effort to supply smugglers with cigarettes diverted from duty-free operators on both the Canadian and Mexican borders. In some port cities, ship chandlers supply untaxed cigarettes to smugglers. There have been convictions of ship chandlers in Texas and Washington State and investigations are under way in the New York-New Jersey area.

6.5 Organized Crime

When New York City investigators raided a significant distributor of illegal cigarettes in the city's Brooklyn area in 1994, they heard an unusual justification. The distributor claimed to have an arrangement to supply a local company with cigarettes in return for the perpetual care of some grave sites in Russia. The arrangement proved as fictitious as the company that was supposed to get the cigarettes. What was especially noteworthy about

this black market operation was the apparent involvement of a new key player in organized crime - the Russian mob. This is not an isolated incident linking Russian organized crime - already an influential player in the illicit gasoline trade - to the black market in cigarettes on both the east and west coasts. Stated a well-placed federal law enforcement official: "They've come on the scene fairly strongly recently." The Russians are not alone. The federal official added: "We've found almost the entire scope of organized crime involved."

In many cases, criminal groups that are in the illegal cigarette business also handle other illegal commodities, including drugs and alcohol. One group on the East Coast, for example, is believed to traffic in both heroin and cigarettes. Casual alliances are also made between criminal groups to facilitate the distribution of illicit cigarettes. The federal expert compared it to the kind of arrangement that might be struck between two legitimate companies, one of which has excess inventory of a product needed by the other. He stated: "They can cut an appropriate deal even with a competitor if it's mutually beneficial."

There are organized schemes in some states to avoid the payment of both federal and state taxes through phony export schemes, according to law enforcement sources. In such schemes, individuals and companies buy cigarettes for shipment abroad and - while the paperwork shows the cigarettes leaving the U.S - they never do. Rather, the cigarettes are diverted into the contraband market. Investigators interviewed in the states of New York, Washington, Texas, New Jersey as well as federal agents say this type of scheme is difficult to detect. They believe it will flourish if the federal cigarette excise tax is raised significantly.

A. California

The smuggling, distribution and sale of untaxed cigarettes has become a significant crime problem for California law enforcement agencies and all citizens of California. In parts of Los Angeles, untaxed cigarettes are available from a variety of outlets, including mom-and-pop corner stores, bars, donut shops, canteen trucks, out of the back of cars and street vendors. As Monte Williams, Administrator of the Excise Taxes Division of the California Board of Equalization, stated in April 1994:

"We believe California is suffering a significant revenue loss due to the purposeful evasion of the cigarette tax. We believe the largest issue facing California is cross-border evasion of the "Export Only" ciga-

rettes. This problem opens up markets for illegal cigarettes to all persons that smoke.”

Law enforcement authorities say that profits from cigarette smuggling have attracted armed and dangerous Russian/Armenian and Hispanic criminal groups. They quickly established sophisticated smuggling and distribution systems in the state, largely in the greater Los Angeles area. There were two homicides in the last five months of 1994 involving contraband cigarettes. In both cases Russians are suspects. “One street vendor who had ripped off his supplier was found with a slug in his head,” says one investigator. “It was an execution.”

These criminal gangs supply street vendors or runners (who are the lowest level of the distribution chain) using many of the same methods found in the narcotics business. The street vendors also sell to a variety of outlets including small mom-and-pop stores, liquor stores, catering trucks, bars, and independent grocery stores. In 1994, the Ventura, California Sheriffs Department discovered that a gang of young Russian criminals committed a rash of cigarette thefts from liquor stores. They broke in through roofs of liquor stores and took nothing but cartons of cigarettes - as many as 500 cartons at a time. Later, cigarettes similar to those stolen in the liquor store robberies turned up in the possession of Los Angeles street vendors. Many of the vendors also sold cigarettes labeled for export that were illegally obtained from the same criminal gang. Criminal groups which supply California smuggle untaxed cigarettes from Mexico and Indian reserves in neighboring states.

B. Michigan

Michigan levies the second highest state tobacco tax in the country at 75 cents a pack. Importantly for smugglers, it does not require cigarettes sold in the state to carry a tax-paid stamp - only an inked stamp on each one-half case of cigarettes. The consumption of smuggled cigarettes has grown dramatically in Michigan, in direct response to the 200-percent rise in the state tobacco tax in May 1994.

Smuggling networks supply the burgeoning underground markets of Michigan. Through them, organized smuggling groups, dual-inventory distributors, dual-inventory suppliers and others connect to distribute their illegal products. They face a low risk of detection and far more lenient penalties than for other illegal activities. Organized smuggling groups dominate the transportation of untaxed cigarettes into Michigan, as well as their distribution to dual-inventory distributors. Between six and 10 organized smug-

gling groups supply the illicit cigarette market in Metropolitan Detroit alone. Organized smuggling groups are both illegally importing cigarettes from low-tax states and tapping into the pool of suppliers on Indian reservations in upper New York state, many of which supplied the Canadian contraband market in the late 1980s and early 1990s.

A major out-of-state tobacco supplier that illegally distributed cigarettes to criminal groups during Canada's recent smuggling crisis now supplies illicit cigarettes in Michigan. It is closely linked to a transport company whose principals are connected to a major traditional organized crime group in Buffalo. In a highly organized operation, armed robbers in 1995 hijacked a large shipment of cigarettes in the southern United States. A significant portion of the shipment later appeared in an illicit cigarette warehouse in Michigan.

C. Texas

Texas investigators are aware of a large organized scheme to divert for-export-only cigarettes to the contraband market. The cigarettes are believed to be either sold in Texas or transported to other western states through New Mexico. In one major case involving a sophisticated ring, authorities seized 75,000 cartons of untaxed cigarettes when they raided the group's warehouse in 1993. Smuggling in Texas is committed by either individuals or small, close-knit, family-based groups. Typically in such cases, they obtain 'cigarettes legally from a duty-free shop and transport them into Mexico. The purchaser then either sells the cigarettes to a smuggling organization or smuggles them himself. The large volume of traffic at ports of entry makes it difficult to detect such shipments. Only a small percentage of vehicles are inspected and the emphasis is on detecting narcotics, not illicit tobacco.

7. Understanding the Dynamics of the Illicit Cigarette Trade: An Investigative Framework

7.1 A Consensual Crime

It is difficult for law enforcement to investigate consensual crimes, such as drug offenses, prostitution and illegal gambling. Goods and services are exchanged between willing buyers and vendors. Although some participants may, in fact, be victims, they are unlikely to file a complaint with the police. That may be the last thing on their minds. Of the many consensual crimes, contraband tobacco presents a unique challenge. The

product is legal. Possession of a package of cigarettes is not illegal - as possession of cocaine or heroin would be.

7.2 Why Do Consumers Buy Illegal Cigarettes?

Our research has found a correlation between a contraband problem and a general feeling among local residents that their taxes are too high - and that the tax burden, in general, is not fairly shared. This feeling tends to translate itself into a greater willingness to participate in underground economic activity, including purchasing illegal cigarettes. Moreover, whenever money is tight, otherwise honest people are under greater temptation to make ends meet by purchasing untaxed goods and services. Social studies indicate that people are more prone to cheat if they believe their neighbors are cheating too. Once individuals cheat on one type of activity, they may find it easier to cheat on other things as well. They get into the habit of cheating leading to a general corrupting of the social fabric. Many people who participate in the underground economy don't believe they're doing anything wrong. With respect to illegal cigarettes, they either fail to comprehend that they're putting money into the pockets of organized criminals, or don't care.

7.3 Why Do Vendors Sell Illegal Cigarettes?

Evading tobacco taxes increases the profit-making opportunities of retailers and wholesalers. Using the United States as an example, say a carton of cigarettes legally retails for \$20, including \$7.50 in federal, state and local tobacco taxes. And let's say the retailer evades the \$7.50 in taxes and sells the untaxed cigarettes for \$15 a carton. He will therefore increase his profit margin by \$2.50 a carton. Moreover, he may also decide not to declare the \$2.50 a carton he's earning from illegal cigarettes on his income tax.

In Canada, which experienced an alarming contraband tobacco crisis in the early 1990s, some vendors were extorted to participate in this illegal sector. Criminal gangs operating in certain ethnic communities forced retailers to either:

- Begin selling contraband cigarettes that the gang provided; or
- If they were already selling such goods, to switch suppliers and buy their stock from the gang.

Then there is the factor of economic necessity. When Lindquist Avey began its cigarette smuggling investigations in Canada in the early 1990's,

a number of owners of mom-and-pop corner stores were interviewed who vowed never to sell contraband tobacco products. By late 1993 and early 1994, so many corner stores in parts of the City of Toronto were selling illicit cigarettes that other retailers either had to join in or face bankruptcy. This was a particularly difficult decision for retailers who prided themselves on their personal honesty.

Once underground economic activity takes root, it can drive otherwise legitimate wholesalers or retailers either out of business - or (unwillingly) into the underground sector. As happened with individuals, breaking the law becomes "habit forming". A corner store owner who evades federal and state tobacco taxes may go further and also evade the income tax on those sales. He may also decide to evade taxes on other products. In addition, a vendor who sells one type of illegal product may begin to sell others. We have found that some purveyors of smuggled cigarettes, for example, also began to sell bootleg liquor.

8. Case Initiation

8.1 Initial Awareness

The first hint of cigarette smuggling may come from police officers, state or federal tax authorities or an organized crime intelligence unit. It is equally likely to come from an informant, legitimate cigarette wholesaler or from store owners who notice a sudden shift in the cigarette buying patterns of regular customers. An investigator with responsibility for cigarette smuggling should immediately verify the information and, if possible, find another source to confirm it.

8.2 Case Planning

The penetration of the cigarette market by sophisticated smugglers has caught some investigative agencies off guard. The sudden loss of millions in tax revenue has put pressure on investigators to respond quickly. That response should be determined by the nature of the target and the type of offense being committed. The response will clearly differ if the suspect is just a small neighborhood distributor or a large cross-border, or inter-state, smuggling ring.

In case planning, it is worth noting that in many jurisdictions narcotics, alcohol bootlegging and illegal gun trafficking offenders, and cigarette smugglers often use similar methods. Indeed, the same organization may - depending on the circumstances and profit potential - handle a number of

illicit products. Not surprisingly, their organizational structures are also frequently quite similar. In many instances, they exhibit the characteristics of what has been called “the informal organization.” This is defined by the Police Executive Research Forum as “a structure that naturally arises among people carrying on a continuous activity that requires numerous participants. This structure serves the participants well, eliminating the need for a more formal organization.”

8.3 Asset Forfeiture

A contraband cigarette investigation may also provide attractive asset forfeiture opportunities for law enforcement. Criminal organizations involved in the illicit cigarette trade face many of the same problems as narcotics traffickers. That is, they typically have to disguise the origins of their ill-gotten gains so they can be used without raising the suspicion of law enforcement and/or tax authorities.

At the street level, for example, cigarette sales generate a large amount of cash, which needs to be laundered. This may necessitate the use of smurfs – who inject dirty cash into the banking system through a series of innocuous-seeking small transactions – and other techniques intended to avoid money laundering statutes. Thus, many of the same approaches that have been successfully employed in drug money laundering investigations and prosecutions can also be used in cigarette smuggling cases.

8.4 Information Sources

If cigarette smuggling is a new offense in a particular jurisdiction, it does not necessarily mean a shortage of potential leads and background documentation from existing files. Experienced investigators suggest looking at:

- prior case reports on cigarette smuggling which may suggest patterns or possible suspects;
- reports filed by officers on the scene of a reported offense;
- arrest records that contain details of previous offenses, home addresses of alleged perpetrators and former employers;
- fingerprint files for an identification check;
- firearms registration records containing the owner’s name, address and type of gun;
- traffic violation records which contain the names of individuals and most importantly the type of vehicle used by the possible suspect;

- traffic accident reports which may contain names of witnesses which could be friends or acquaintances of the suspect;
- motor vehicle records which can give address, license plate and car make and model information;
- personal property records containing information on loans for cars, boats or airplanes;
- probation and parole records which can give current and former employment history, residence and comments of parole staff; and
- marriage records for current and former spouses.

8.5 Private Information Resources

Holders of private records may be persuaded to volunteer background information to help investigators. The most likely are companies doing credit checks, telephone companies, insurance firms or banks.

8.6 Using Conspiracy Law

Deciding how best to use the law in a specific case is an important part of case initiation. Traditionally, investigations into illegal cigarette activities have made little use of criminal conspiracy statutes, which have been effective against narcotics traffickers. A criminal conspiracy is a group of people coming together for illegal purposes. An agreement to commit criminal acts establishes the crime of conspiracy. No crime has to be enacted for a conspiracy to exist. Usually the initial criminal venture begins with two or three people and as others are brought into it, they too become members of the conspiracy. As in drug trafficking, the brains and money behind cigarette smuggling usually are well insulated from those driving contraband across borders or from street runners who distribute to party stores or restaurants. Conspiracy investigations can help to penetrate the top echelons of contraband networks.

9. Intelligence Operations

9.1 Outline

Collecting precise knowledge of illegal cigarette operations is crucial for any law enforcement or tax administrative agency intent on developing a successful long term investigative strategy. Intelligence can give agencies a dear understanding of specific criminal activities. It can provide:

- the source of contraband supplies;
- the quantity, price and storage location of illicit tobacco products;

- the identity of people heading and financing the criminal enterprise;
- the transportation routes used in the various stages of distribution; and
- the identity of street distributors.

9.2 Tactical Intelligence

Tactical intelligence involves information whose aim is to assist a specific ongoing investigation. It can rapidly result in arrests.

9.3 Operational Intelligence

Operational intelligence involves information which can be gathered to support an investigation into a continuing criminal enterprise.

9.4 Strategic Intelligence

Strategic intelligence involves developing an overview of specific activity or trends in tobacco smuggling in one jurisdiction or region. It is usually the fruit of long term intelligence gathering and the pooling of intelligence gathered by a number of agencies. It is used to shape future intelligence efforts and to determine the focus of future investigations.

9.5 Building an Intelligence Unit

Experienced cigarette smuggling investigators emphasize the importance of having an intelligence unit. Existing organized crime and drug intelligence units can be utilized for this purpose, especially given the increasing overlap between the trafficking of drugs, alcohol, guns, stolen cars and contraband tobacco products.

9.6 Collecting Intelligence

The gathering of tips, complaints and reports from excise tax officials and street patrol officers forms what is known as overt information. It yields data on the activities of known smugglers, the identities of those with whom they associate, cars or vans they drive and indications of the locations where they operate. Covert methods can be used to gather detailed information on specific targets. This can include physical and electronic surveillance, as well as the use of informants and undercover agents.

9.7 Processing Intelligence Data

Raw intelligence data should be collated so that it can be analysed and accessed whenever necessary. New information should be immediately cata-

logged and quickly made available to other intelligence officers and those in command of ongoing investigations.

9.8 Analysing Intelligence

In analysing intelligence data, valuable information should be separated from irrelevant or inaccurate raw data and converted to useful intelligence. It can help agents determine what information they are lacking and shape future covert intelligence gathering.

9.9 Distributing Intelligence

Formal written intelligence reports should be prepared for regular distribution to task force commanders and field investigators containing known factual information and analysis by intelligence specialists. The reports are sensitive and distribution should be limited to those involved in the investigation.

10. Controlled Delivery

A controlled delivery is a widely used drug enforcement technique. It permits investigators to monitor the nature and extent of activities of a drug trafficking group by tracking a cargo of narcotics as it moves through a transportation network. If drugs are discovered in a truck carrying fruit, for example, rather than seizing the drugs, investigators will allow it to continue to its destination. The cargo will be kept under surveillance so investigators can see who picks it up and where the drugs are delivered for distribution. A controlled delivery of illegal cigarettes can yield similar benefits to a tobacco investigator. Cigarettes are a bulkier commodity than cocaine or heroin. Thus, it is more difficult to conceal large quantities of illegal cigarettes for shipment, especially across international borders. In the United States, for example, transport trucks are frequently used to bring loads of smuggled cigarettes across both the Mexican and Canadian borders. Often up to a dozen cases of cigarettes (50 cartons to a case) can be hidden behind loads of produce or behind other bulk goods shipped by truck. With automatic pre-clearance of transport trucks at customs becoming more common at both borders, there is less and less physical inspection of trucks and more opportunity for cigarette smuggling.

11. Undercover Operations

11.1 Outline

This chapter seeks to provide some context for conducting such operations in respect to an illegal cigarette investigation.

11.2 A Consensual Crime

Because of the consensual nature of the illicit cigarette trade, ordinary police methods will, in many instances, have limited results. Buyers and sellers of illegal cigarettes are unlikely to complain with law enforcement. In fact, their main intention will be to avoid any contact with law enforcement. In some cases, therefore, undercover operations may be the most appropriate strategy in investigating an illegal cigarette operation.

11.3 An Undercover Response

In an undercover operation, evidence is gathered by gaining the confidence of a suspected violator through the use of disguises and pretexts. That can lead to the identification of co-conspirators, other criminal or civil violations, and help determine future investigative goals and activities.

11.4 Purpose of the Operation

In general, an undercover operation seeks to establish whether a Undercover crime is being planned or committed, identify co-conspirators, obtain evidence, and collect intelligence.

11.5 Follow Appropriate Guidelines

As in any undercover operation, it is critical that undercover cigarette smuggling investigations follow the undercover operational guidelines and practices of the agency(ies)/police department(s) that support it. Such guidelines and practices should cover a number of topics, including, but not limited to, the following:

- Safety factors and requirements;
- Legal considerations and requirements;
- Possible pitfalls and precautions;
- The selection and training of the undercover agent and/or operative;
- The selection and training of the cover team;
- Surveillance techniques and protocols; and

- Pre-activity preparations, including developing a cover story and an undercover identity, obtaining an appropriate location for the undercover agent/operative.

12. Conclusion

Empirical evidence from around the world shows that high tobacco taxes create a consumer demand for a cheaper product. Where this occurs, organized criminals invariably establish networks to smuggle, distribute and retail untaxed cigarettes.

Cigarette smuggling damages society in numerous ways:

- Illegal cigarettes allow organized crime to undermine the legal distribution and retailing networks by competing unfairly in the market place. This penalizes honest retailers and wholesalers who dutifully remit taxes.
- Government revenues are reduced. This means government programs and services are either cut, reduced or taxes are raised.
- Underground economic activity is that it brings otherwise law-abiding citizens into contact with criminal activity.

It is crucial for Governments to avoid instituting policies which create a black market in any product - for black markets inevitably promote the development of organized crime groups. Once established, they are difficult to eliminate. Even if the policies which initially spawned a particular black market are repealed, criminal groups will simply shift to another illicit sector.