



REINSTATING THE DUTY-FREE TRADE AT BULGARIAN LAND BORDERS: POTENTIAL SETBACK IN THE FIGHT AGAINST ORGANIZED CRIME AND CORRUPTION

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An old ghost revived

Since the early 1990s the duty-free shops along Bulgaria's land-border crossings were used as a channel for illegal import of excise goods (cigarettes, alcohol and petrol). With the increase of excise and VAT taxes in the second-half of the 1990s, the risk of alcohol and cigarettes smuggling increased rapidly. The duty-free shops gradually evolved into **one of the main channels for the smuggling of cigarettes, alcohol, and fuel**. At that period, duty free operators existed without a legal regulation but only with a licensing permit from the Minister of Finance. The smuggling was tacitly tolerated from the highest political level.

As a result, until 2008 the markets for excisable goods in Bulgaria were flooded with illegal cigarettes and alcohol and millions of liters of excise-free fuel. In border areas **thousands of local people were engaged in smuggling** of small quantities of excise goods and petrol. Over the years, this created a specific environment, corrupting the social fabric of the local community, nurturing local oligarchs and aiding organized crime networks penetration. At the national level illegal proceeds from duty-free trade have been deployed to **capture the state**, using

KEY POINTS

- In January 2012, a proposal to amend the *Duty Free Trade Act* was submitted to the Parliament by an independent MP (Emil Vasilev, formerly of the marginal opposition party Order, Law and Justice). The sole purpose of the proposed amendment is to allow for the reopening of the duty-free trade outlets at Bulgaria's land borders with non-EU countries in the exact same format with the exact same operators as at the time of their closure three years ago;
- The proposal is a major threat to border security, tax revenues and might undermine the stability of the state budget;
- The reopening of the duty-free shops would reverse the progress made in the fight against corruption, organized crime and excise goods smuggling and threatens to re-ignite political corruption and clientelism.

political corruption to secure perpetual monopoly business positions to a selected well-connected few. Legal regulation of duty free trade was first

introduced by Parliament on the very eve of EU accession (the last days of December 2006) only to cement existing operators, providing them with licenses and monopoly for life.

During the years of accession negotiations with the EU, various governments' attempted to close the duty-free outlets, but their efforts were sabotaged by strong lobbying by several individuals /economic groups¹ who control the duty-free trade. Duty-free stores on the borders with Romania and Greece were finally shut only when Bulgaria joined the EU in 2007. Under further international, EU and US pressure, and due to the growing evidence of contraband activity, in 2008 the government closed the remaining duty-free shops and petrol stations selling tax-free fuel along Bulgaria's (which also became EU's) land borders with Macedonia, Serbia and Turkey.

A threat to the budget stability

CSD analyses showed a significant gap between the declared turnover of duty free outlets (until their closure) and the passenger flow through the country's land borders.²

In 2006 the Bulgarian government began to raise excise taxes steeply to reach minimal EU levels, which made smuggling even more lucrative. Duty-free sales of cigarettes in Bulgaria, at that time, increased from 2 billion in 2005 to 6 billion pieces in 2006. Without any underlying rise in the flow of passengers or the demand for cigarettes in neighboring countries, the only plausible explanation was that duty-free outlets

¹ The non-transparent ownership of duty-free trade operators in Bulgaria has been rarely investigated. Behind the numerous offshore vehicles stand about 10 highly controversial businessmen and 4-5 companies

² Policy Brief No 13: *Effective Policies Targeting the Corruption – Organized Crime Nexus in Bulgaria: Closing Down Duty-Free Outlets*, Center for the Study of Democracy, December, 2007; *Organized Crime in Bulgaria - Markets and Trends*, Center for the Study of Democracy, 2007; *Transportation, Contraband and Organized Crime*, Center for the Study of Democracy, 2004; *Corruption, Contraband and Institutional Reform*, Center for the Study of Democracy, 2002.

were involved in the smuggling of cigarettes. **Duty-free sales of cigarettes amounted to 38% of the Bulgarian domestic market in 2006.** Although shuttle trade flourished along Bulgarian land borders, such sales would still be impossible to realize without large smuggling operations inside the country. Data also showed that a substantial part of the **fuel sold at the duty-free petrol stations** was smuggled and sold in border regions: as a result it made no financial sense for any of the major legitimate fuel distributors to maintain a distribution network in the border regions, especially with Turkey.³

Data provided by the Customs Agency confirms that after the closure of duty-free outlets at Bulgarian land borders in 2008, **there was a significant rise in legal sales of excisable goods inside the country.** Although duty-free outlets at the Turkish side of the border remained active and continue to facilitate some smuggling of cigarettes and other goods into Bulgaria, the damages are barely comparable to the volumes of illegal sales before 2008.

New threats and vulnerabilities

The continuous hikes of excise taxes in 2010, mandated by EU harmonization legislation, in combination with the effects of the economic crisis on domestic consumption, have led to a new rise of illegal sales and smuggling of cigarettes and fuel. Furthermore, the volumes of smuggled cigarettes from Greece have been increasing in the past three years. CSD studies show that in 2009-2011 the illegal cigarettes market is among the three major sources of revenues for organized crime in Bulgaria, accounting for 30-40% of the domestic

³ According to the Ministry of Finance data (presented at a May 2006 hearing of the Parliamentary Anti-Corruption Committee) only in 2005 the budget lost as much as BGN 95 million in revenues from the operation of the duty-free petrol stations.

consumption. **Duty-free trade is much riskier in the current economic conditions than 4-5 ago, because the excise duties are a major source of revenue to the state budget.** The budget revenues from excises at the moment amount to BGN 3.75 billion (1.87 billion from excises on oil products and 1.7 billion from cigarettes).

When added another BGN 2.1 billion from VAT on cigarettes (size of the market: BGN 2.5 billion) and fuel (BGN 8-9 billion), the share of revenues from excisable goods exceeds 30% from all state revenues for 2011. As such, Bulgaria and Romania are the most vulnerable countries in the EU, as budget revenues depend mainly on VAT and excise duties (in 2011 excise duties in Bulgaria accounted to 23% of the total budget revenues and 26% from the overall tax revenues). The excise revenues in Western countries form a much smaller portion of the overall revenues (France 1.1%, Austria and Belgium 1.2%, Germany 1.3%, England 1.4%, Spain 2.0%).

Moreover, law enforcement institutions already in 2009 have implemented successful measures to curb the illegal alcohol trade. The new measures to reduce the illegal fuel trade are expected to give results in 2012. In the context of the great importance of excise revenues for the state budget and the progress made in curbing illegal sales of excisable goods, the following conclusions can be drawn:

- The re-opening of the duty-free outlets **would reverse recent success of law-enforcement in curbing trade in smuggled excisable goods.** Providing legal cover for avoiding excise and VAT payments through the reopening of duty free outlets along the EU external borders would further stimulate smuggling and complicate investigations.
- The reopening of duty-free shops might result in cigarettes sales returning to the level of around 2 billion pieces of cigarettes

(the level registered 2005, when the excise levies were still relatively low). Given the low price elasticity of cigarette consumption, even in this favorable scenario, and even without smuggling, **the state will suffer actual fiscal losses**, as the 20 + percent of revenues from VAT and excise duty would not be compensated by increased revenues from corporate income tax.

- If the cigarettes sales through duty free shops return to their 2006 levels, which is a more likely scenario due to the higher excise levels compared with neighboring countries, **the stability of the state finances will be seriously jeopardized.** A similar development can be expected in the illegal fuel trade, which would reverse all effective measures to tackle the grey economy in this sector over the past two years.
- The reopening of duty-free shops along Bulgaria's land-borders will also have **adverse effect on neighboring countries**, in particular FYR Macedonia and Serbia, who closed down their duty free shops, as well as on Romania and Greece. The smuggling of duty free goods, therefore, is likely to take place on both sides of the border. In border crossings near the Greek and Romanian border, smuggling is also likely to have a spill-over effect to these countries, and to the EU, as well.

A good example of the risks associated with the re-opening of duty-free shops is Romania, where the delayed closing of duty free trade resulted in 2009-2010 in sales of cigarettes from duty-free shops reaching 30% of the illegal cigarettes market. This forced the Romanian Government to render significant efforts in 2010 to stop sales of excisable

goods in duty free shops at its borders with countries outside the EU.

Policy action

Ever since the closure, the Bulgarian Duty Free and Travel Retail Association has made repeated attempts to amend the duty-free trade act. Still, if reopened the duty-free trade may become again a **major smuggling channel**. The duty free shops are particularly challenging for law-enforcement agencies to control. Ministry of Finance inspections revealed that it is practically impossible to monitor the real number of customers that daily use the shops. CSD analyses, as well as unofficial information from border guard / customs officials from other countries and OLAF investigators have indicated that until their closure, duty-free outlets at the land borders of other East European countries (EU external borders) were also **exploited by organized criminal groups** for smuggling of excise-free goods.

Reinstating the duty-free trade would be a major setback in the fight against corruption and organized crime and would destroy any progress made in the effort to curb smuggling and contraband at the country's land borders.