



THE TOBACCO PRODUCTS MARKET IN BULGARIA: TRENDS AND RISKS

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The market for legal and illegal tobacco products has been one of the junctures of the transition where the interests of organised crime, secret services and political parties intersect. For this reason, public attention to the issue has always been high, with substantial political overtones. Paradoxically, after Bulgaria's accession to the European Union, in particular between 2009 and 2014, the illegal tobacco market resurfaced as one of the major sources of revenue for organised crime. In this period, illegal cigarette consumption in the country varied between 25 % and 40 %, while sales reached between BGN 300 and 500 million per year, equal to between 0.5 % and 1.0 % of the country's GDP.

The situation changed radically after 2014. The government undertook a series of measures to tighten border control, discourage illegal cigarette producers and tackle the spread of illicit tobacco products, which led to a record decline in illegal cigarette sales leaving the latter at 6-7 % of total sales. Accordingly, excise and VAT revenues rose by 25-30 %. This positive development, however, has turned out to be strongly dependent on the country's political stability. In 2016 and 2017, when presidential and early parliamentary elections were held, it became evident that the process of effectively reducing the illegal tobacco products market is rather unstable and unsustainable.

KEY POINTS

- Bulgaria's commitment to reach the minimum excise levels for tobacco products in the EU has been met through several sharp price hikes, amounting to 60-80 % in some years. This policy has practically boosted illegal tobacco trade.
- The illicit tobacco products market is one of the largest sources of revenue for organised crime in Bulgaria, reaching between 0.5 % and 1 % of the country's GDP.
- The huge revenues of this criminal market generate extremely strong corruption pressure at all levels.
- Revenue from tobacco products (excise and VAT) are of great importance for the state budget. Its share in total tax revenue is 9-10 % per year.
- The government's decision to curb the illegal market for tobacco products led to a sharp drop in the consumption of illegal cigarettes from an average of 20 % in 2016 to 6-7 % in 2017.

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Political and Legal Context

Bulgaria has transposed most of the European legislation in the area and is party to the relevant international treaties, which makes its regulatory regime for tobacco products relatively predictable. The cigarette and tobacco market are shaped by excise taxation, state subsidies and the policy on combatting illicit trade.

Bulgaria has ratified the *Framework Convention on Tobacco Control* (FCTC)¹ adopted under the aegis of the World Health Organisation (WHO) in 2003. The FCTC is the first global public health treaty. The *Protocol on the Elimination of Illicit Trade in Tobacco Products* (EITTP)² developed as a response of the international community against illicit cross-border trade in tobacco products is also part of this framework. At the EU level, the core measures of FCTC and EITTP are incorporated in the *Tobacco Products Directive*³ on the approximation of the laws, regulations and administrative provisions of the Member States concerning the manufacture, presentation and sale of tobacco and related products.

The main legislative act regulating the manufacture, distribution and trade in tobacco and tobacco products in Bulgaria is the *Law on Tobacco, Tobacco Products and Associated Articles*.⁴ The law defines the rules and procedures for trading in raw tobacco, industrial processing of tobacco, including the licensing of tobacco products manufacture, and trading in processed tobacco and associated articles such as electronic cigarettes. It contains both administrative and penal provisions.

The *Law on Tobacco and Tobacco Products* requires manufactures to have registered as commercial entities and buyers of raw tobacco to obtain a valid permit (Article 4) obliging the latter to register the contracts they have concluded. To prevent illicit production of tobacco and tobacco products, Article 24 of the Law allows only licensed entities to participate at the production stage.

Excise Duty Policy

Excise policy and the implementation of the relevant excise and tax legislation are among the main factors influencing the illicit cigarette market in the country. Bulgaria is obliged to reach excise rates equal to the minimum levels in the EU. The much lower local income level and the tight alignment deadline, however, have turned this effort into a challenge.

Bulgaria applies the general provisions on excise duty set out in EU Directive 2008/118/EC.⁵ They refer to the categories of products on which Member States are obliged to levy excise duty, the principles for collecting excise duty and the rules on the production, storage and movement of excise goods. Tax warehouses where excisable products are to be stored under duty suspension arrangements are guided by the principles set out in EC Recommendation 2000/789/EC.⁶ The movement of excise goods within the EU under duty suspension is controlled through the Excise Movement and Control System (EMCS) in accordance with the provisions on computerized procedures for the movement of excise goods under suspension of excise duty contained in Commission Regulation No 684/2009.⁷

¹ Framework Convention on Tobacco Control of the World Health Organisation, SG No. 15 of 18 February 2006.

² Protocol on the Elimination of Illicit Trade in Tobacco Products to the Framework Convention on Tobacco Control of the World Health Organisation, OJ L 268, 1.10.2016.

³ Directive 2014/40/EU of the European Parliament and of the Council of 3 April 2014 on the approximation of the laws, regulations and administrative provisions of the Member States concerning the manufacture, presentation and sale of tobacco and related products and repealing Directive 2001/37/EC Text with EEA relevance, OJ L 127, 29.4.2014.

⁴ Law on Tobacco, Tobacco Products and Associated Articles, promulgated SG No. 101 of 30 November 1993, last amended and supplemented SG No. 103 of 28 December 2017.

⁵ Council Directive 2008/118/EC of 16 December 2008 concerning the general arrangements for excise duty and repealing Directive 92/12/EEC.

⁶ Commission Recommendation of 29 November 2000 setting out guidelines for the authorisation of warehousekeepers under Council Directive 92/12/EEC in relation to products subject to excise duty.

⁷ Commission Regulation (EC) No 684/2009 of 24 July 2009 implementing Council Directive 2008/118/EC.

In Bulgaria, the *Law on Excise Duties and Tax Warehouses*⁸ has been in force since 1 January 2006. The institution that applies the excise legislation is the Customs Agency. Since its establishment, the Customs Agency has engaged in electronic exchange of documents on the movement of excisable goods under duty suspension arrangements. In 2013, it introduced the Bulgarian Excise Centralised Information System (BECIS). The Bulgarian customs have joined the Union Customs Code, an important element of the customs modernisation process serving as an all-EU customs regulatory framework.⁹ Among the objectives set forth in the Code is to ensure an electronic environment that provides for more effective personalised control based on risk analysis, including the risk of cigarette smuggling. Council Regulation 2015/1525 of 9 September 2015¹⁰ aims to improve the EU instruments for investigating and detecting customs and excise goods fraud, allowing investigators, inter alia, to juxtapose data concerning container movements with excise goods import, transit, and export data, including data on cigarettes. The Regulation further facilitates the use of evidence obtained in one EU Member State in proceedings before the administrative and judicial authorities of other Member States.

It should be noted that the *Law on Excise Duties and Tax Warehouses* has been regularly amended in response to changing market risks. In 2010, after a series of steep rises of the excise duty on tobacco products (2008 – 2010) and the expected expansion of the illegal market, penalties against traders in the country were drastically raised (2009 amendment to Art. 108a and Art. 112). Due to such amendments,

distribution of illicit tobacco products through the retail network has been successfully prevented. The Law's enforcement, however, has been more problematic. The courts have refrained from imposing high penalties on retailers selling tobacco products without excise trade license, reasoning that the sanctions are too severe (Article 108a, amended 2009),¹¹ and, in case of minor violations, ruling suspension of the retail business. With a later amendment, the penalty for unlicensed retail sales has been reduced.

In February 2017, the Ministry of Finance issued a revised version of the *Regulation on the Implementation of the Law on Excise Duties and Tax Warehouses*.¹² The Law itself was last amended in December 2017 in an attempt to curb the advertising of illegal tobacco products online, which is a new channel replacing the public markets and bazaars in cities as the place to sell illegal cigarettes and hand rolling tobacco. The amendments also aim to regulate the rapidly expanding hookah market.¹³

Excise legislation, though, like other legislation is not corruption-proof. At various times, particular components of the government's excise policy are influenced by the lobbies of different companies from the cigarette industry. The changes made to the so-called excise calendar in 2015 and 2016 are a glaring example. At the start of its term in office (2014), the then government, after consultations with the industry, had planned to raise excise duty and the ratio between its specific and ad valorem components. However, this arrangement was broken to the benefit of a couple of cigarette companies.

⁸ Law on Excise Duties and Tax Warehouses, promulgated SG No. 91 of 15 November 2005, last amended and supplemented SG No. 103 of 28 December 2017.

⁹ Regulation (EU) No 952/2013 of the European Parliament and of the Council of 9 October 2013 laying down the Union Customs Code.

¹⁰ Regulation (EU) 2015/1525 of the European Parliament and of the Council of 9 September 2015 amending Council Regulation (EC) No 515/97.

¹¹ First time violations are penalised by a fine of BGN 50,000, whereas repeated violations result in a temporary closing of the retail outlet for 6 months.

¹² Regulation on the Implementation of Law on Excise Duties and Tax Warehouses, promulgated SG No. 42 of 23 May 2006, last amended and supplemented SG No. 80 of 6 October 2017.

¹³ Regulation Amending and Supplementing the Regulation on the Implementation of Law on Excise Duties and Tax Warehouses, promulgated SG No. 42 of 23 May 2006.

Policies and Measures to Curb Illicit Trade

The *Criminal Code* contains a number of provisions on illegal activities related to tobacco and tobacco products. Art. 234 regulates the prosecution of offenses with excise goods, Art. 242 refers to smuggling, while Art. 321 governs the establishment, leadership and participation in an organised criminal group. Smuggling is also defined as a customs violation under Art. 233 of the *Law on Customs*.

The Ministry of Interior (Mol) is the main authority investigating crimes related to the illicit manufacture, distribution and transportation of tobacco and tobacco products. Within the Mol responsibilities are divided as follows: the General Directorate for Combating Organised Crime (GDCOC) focuses its efforts on countering organised crime groups, the National Police General Directorate (NPGD) counteracts the spread of illicit tobacco products at the regional level, while the Border Police General Directorate (BPGD) tackles the smuggling of tobacco products. Since 2010, fighting illicit trade in tobacco products has become a priority for GDCOC and NPGD, leading to the transfer of resources from other key areas such as drug trafficking, car theft, etc.¹⁴

Although Mol agencies have stepped up efforts to tackle tobacco related crimes, they are challenged by the rapid adaptation of the criminal networks operating on the illegal tobacco products market. To circumvent prosecution illegal retailers and distributors would hold and transfer small amounts of tobacco products. After being incriminated several times, however, they would be forced to leave the market. This positive trend was reinforced by extending the Customs Agency's powers to investigate crimes under the Criminal Code. Thus, when a person is caught at customs transporting or selling illegal tobacco products, the customs are no longer obliged¹⁵ to transfer the case to an Mol agency.¹⁶

¹⁴ Interviews with Mol and Customs Agency officials.

¹⁵ Interviews with Customs Agency officials.

¹⁶ Amendment to the Criminal Procedure Code from 2011.

Overcoming Institutional Deficiencies

Over the last decade, the peaks in illicit tobacco products trade have frequently shaken state revenue levels. Institutional response, however, has ranged from blocking measures aimed at curbing the illicit market for years to hasty efforts that miss the target. Legal and regulatory amendments and the lack thereof have depended on the political party balance in parliament and, often, on lobbying activities. The *Law on Duty-Free Shops* was perhaps the most flagrant example of blocking – it took 8 years and 3 parliaments to close down the high-risk duty-free commercial outlets on Bulgarian land borders. In other cases, anticipating the boost of illicit trade, hasty legislation has been adopted containing such severe sanctions against commercial outlets that a large number of them have had their operations suspended, and some have gone bankrupt.

These often contradictory legal grounds leave it at the discretion of judicial bodies to interpret violations in relation to various political, economic, and sometimes local factors. The prosecution thus raises charges against vendors of illicit tobacco products or refrains from doing so on the grounds of insignificance in completely identical cases. Similar offenses related to the illegal tobacco market are penalised with confiscation of the vehicles transporting illegal tobacco products in some regional and district courts, whereas in others confiscations are reversed even if whole containers of cigarettes have been transported in these vehicle.

In addition, in times of steep illegal market growth the law enforcement and revenue administrations' response tends to be slow due to the time needed to catch up on human resources and funding.

The Legal Tobacco Products Market

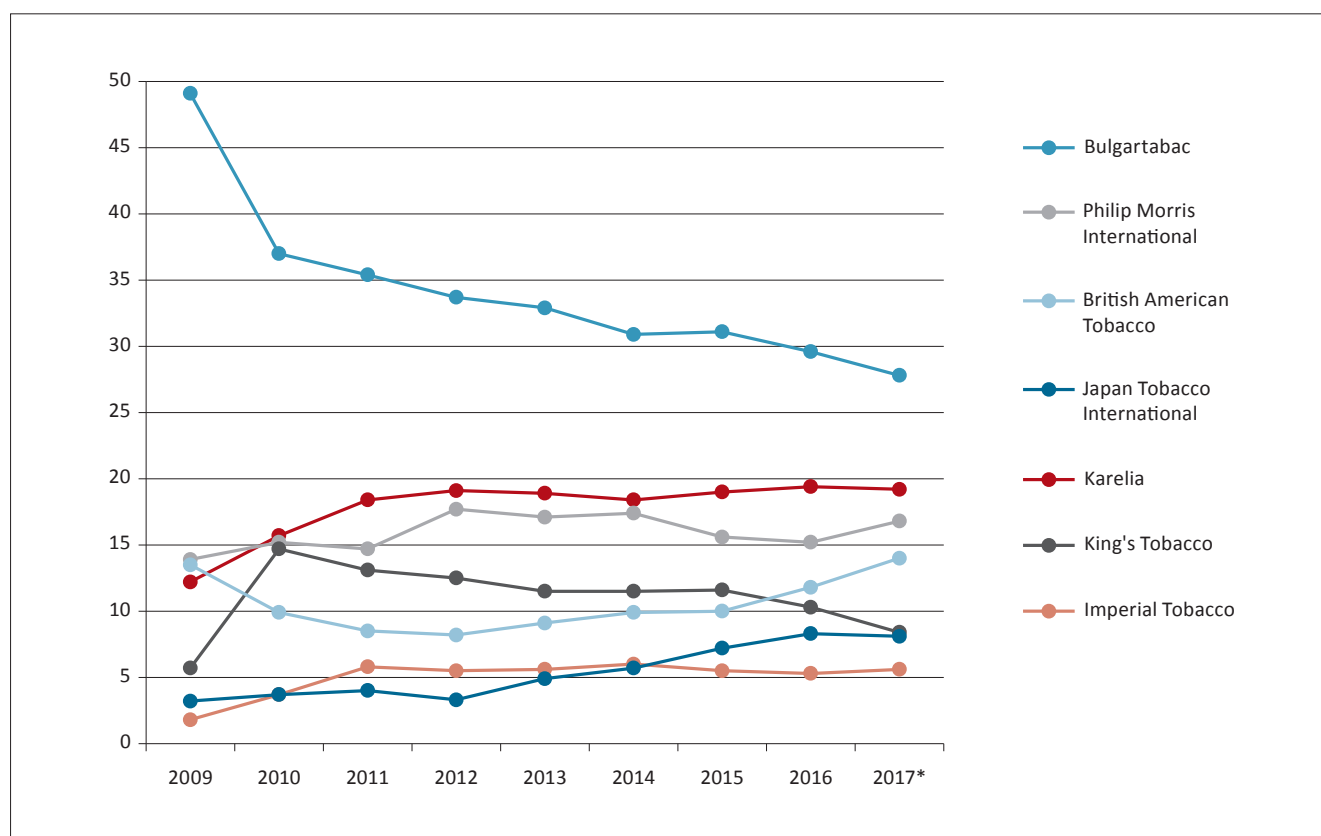
Tobacco products consumption in Bulgaria is hugely popular and usage is heavy. The country ranks second in the EU according to several national representative surveys, the average percentage of smokers in

the period 2006 – 2017 varying from 35 to 39 %.¹⁷ Eurobarometer data from 2017 show that active smokers in Bulgaria are 36 % of the population,¹⁸ which ranks the country second in the EU, preceded only by Greece (37 %). Moreover, the average daily consumption is 15.9 cigarettes, again – above the EU average of 14.1 cigarettes, and the level of consumption has slightly increased compared to 2014, returning to the 2006 level.

The main players in the legal tobacco market emerged in 2007 – 2008. Bulgaria’s entry into the EU in 2007 involved dropping the state monopoly on tobacco products that had been maintained through customs duty collection. In the first months of 2007, five multinational corporations entered the local

market: *Philip Morris International, British American Tobacco, Japan Tobacco International, Imperial Tobacco* and the Greek *Karelia*. Within a year their market share reached 23 %. In 2008, two of the factories of the former state monopolist *Bulgartabac* were sold at the stock exchange to two Bulgarian companies that entered the tobacco products market with the brands *Kings Tobacco International* and *Sluntse Stara Zagora – Tabac*. In 2009, there were already 7 major players on the Bulgarian tobacco market: *Bulgartabac* with a market share of 49.1 %, *Philip Morris International* with 13.9 %, *British American Tobacco* with 13.5 %, *Kings Tobacco* with 5.7 %, *Karelia* with 12.2 %, *Japan Tobacco International* with 3.2 %, and *Imperial Tobacco* with 1.8 % (see Figure 1).

Figure 1. Market Share of the Seven Largest Companies on the Bulgarian Tobacco Market (2009 – 2017)



* December 2017 is not covered.

Source: Retail Data.

¹⁷ Flash Eurobarometer – Survey on Tobacco, 2009; Special Eurobarometer 429 – Attitudes of Europeans towards tobacco and electronic cigarettes, 2014.

¹⁸ Special Eurobarometer 458 – Attitudes of Europeans towards tobacco and electronic cigarettes, 2017.

In the autumn of 2011, after 13 years of unsuccessful privatisation attempts, *Bulgartabac* was sold to the Russian *VTB Capital* owned by *Vneshtorgbank* (VTB). In 2014, the company was resold to the Liechtenstein based offshore *Levero Estates*. The deal kindled numerous journalistic investigations and critical comments of political corruption involving Bulgarian oligarchs.¹⁹ Afterwards, *Bulgartabac's* market share consistently dwindled from 34.6 % in 2011 to 29.6 % in 2016. Despite the company's opaque ownership, no data on its involvement in the illegal tobacco products market appeared throughout this period.²⁰

In April 2017, a major shift in the legal tobacco market occurred. Following its 100-million EUR purchase²¹ of all Bulgarian brands of *Bulgartabac* and its distributor *Express Logistics and Distribution*, *British American Tobacco* became the market leader with a share of 40-42 % and the main Bulgarian tobacco market players – already one less.

Along with the large tobacco products manufacturers, distributors are another key factor on the market. In the 1990s, a significant portion of the illicit tobacco products circulated through the legal distribution networks. During the 2009 – 2014 criminal market upsurge there were reasonable grounds to suspect²² that a Greek and a Bulgarian manufacturer used their distribution networks to sell some of their legitimate products without Bulgarian excise bands. Overall, however, after the market liberalisation in 2007, licensed distributors managed to steer clear of illegal products distribution. The ground had been prepared by the state-owned monopolist *Bulgartabac* before Bulgaria's EU entry, when the number of distribution companies had been significantly re-

duced to streamline distribution management. After 2007, some of *Bulgartabac's* distributors were made redundant, while others tried to shift to selling products of the multinational cigarette manufacturers. *British American Tobacco* made an attempt to establish its own distributor, whereas *Kings Tobacco International* tried to use its alcohol distributor. Such efforts failed for a number of reasons, leaving as a result only three distribution companies after 2009: *Tabac Logistics Group*, *Tobacco Trade* and *Orbico*. In 2014, the new, unidentified owners of *Bulgartabac* replaced *Tabac Logistics Group* with *Express Logistics and Distribution*. Despite the assumption that this might result in the formation of a shadow network of former and current distributors as it did in the 1990s, this did not happen.

The Illegal Tobacco Products Market

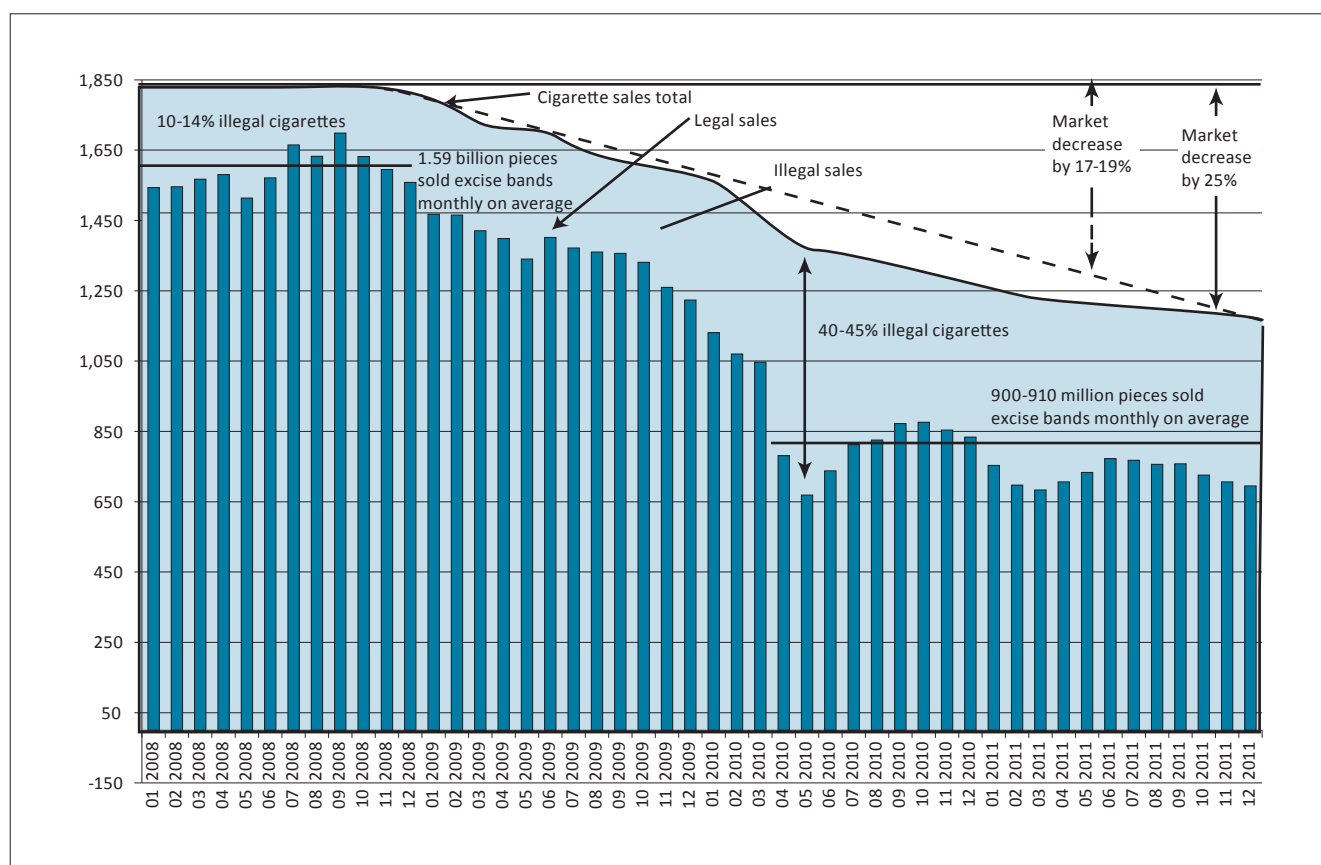
As the policy decision to steeply raise excise duties on tobacco products came at the economic crisis' peak in 2009, Bulgaria seemed to revert to the smuggling golden age of the mid-1990s. Within two years, legal tobacco product sales dropped by an incredible 45 % or from 19 billion cigarettes in 2008 to 10.6 billion pieces in 2010. Measurements using the 'empty pack' method have revealed that the use of cigarettes without excise labels increased from 14 % in the autumn of 2008 to 34-43 % in the spring of 2010. Comparison of data on the drop in tobacco consumption, retail market data and the *Empty Pack Survey* data for 2008 – 2011 shows that during its peak in 2010 the illegal market reached 40-45 % (Figure 2).

¹⁹ BIT TV, „Мафиотски уроци – Цветан Василев в специално интервю за Сашо Диков“ [Mafia Lessons – Tsvetan Vassilev in a Special Interview with Sasho Dickov], 20 November 2016, <https://www.bitelevision.com/mafiofski-urotsi-tsvetan-vasilev-v-spetsialno-intervyu-za-sasho-dikov/>

²⁰ Both *Empty Pack Surveys* and police and customs illegal tobacco products seizures confirm this.

²¹ Капитал. Пеевски продава цигарения си бизнес на британско-американската БАТ (допълнена) [*Capital weekly*, Pееvski Sells His Cigarette Business to British American Tobacco], 12 April 2017.

²² Interviews with customs and law-enforcement officials.

Figure 2. Illegal Tobacco Products Market Assessment (2008 – 2011)

Source: Monthly Retail Surveys; Vitoshka Research, National Representative Surveys.

Structure of the Illegal Tobacco Products Market

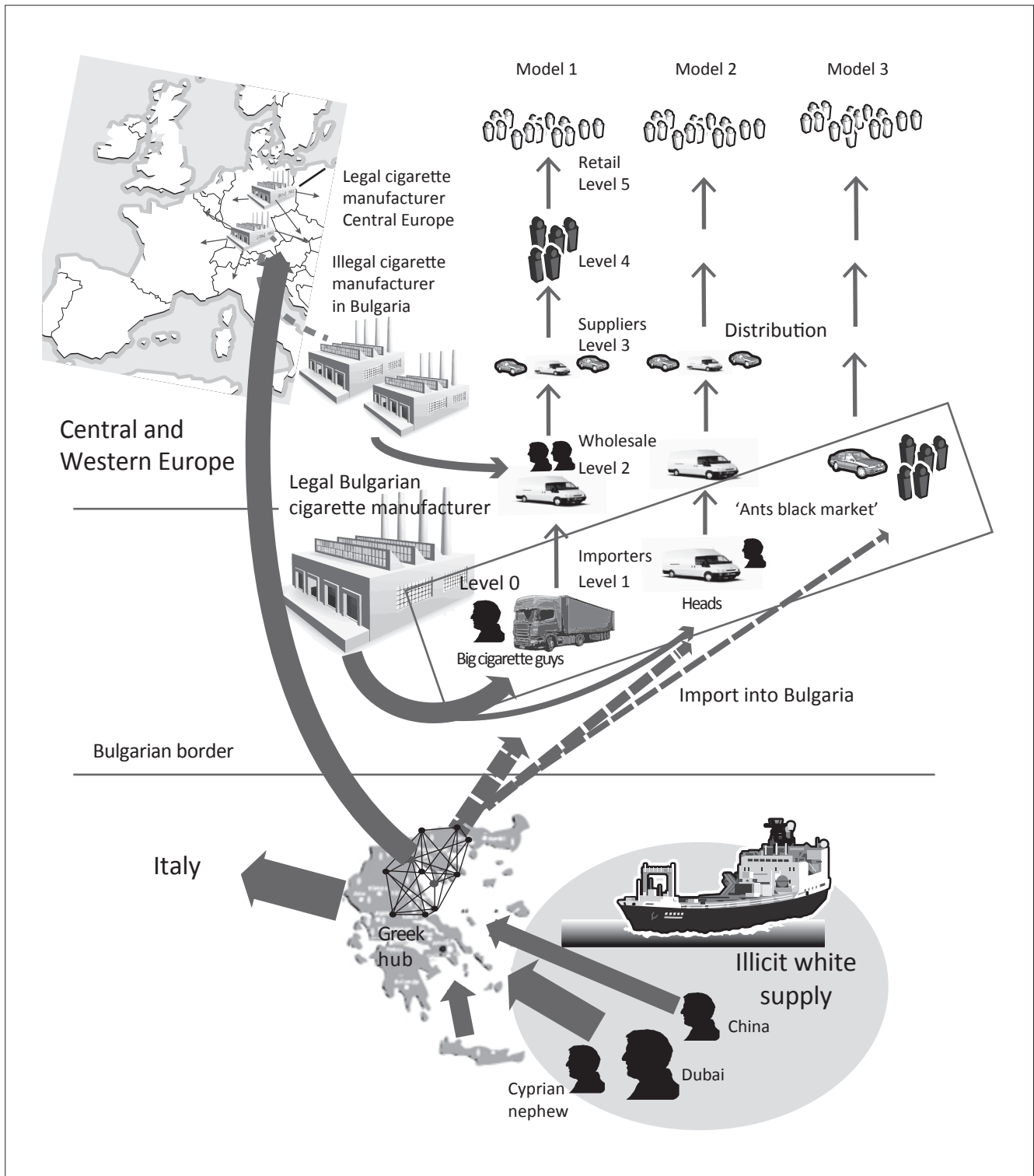
The features of criminal organisations active at home and internationally can be identified on the basis of various Bulgarian and European police investigations. The illegal market's structure and types of actors have remained relatively stable throughout the period under analysis (Figure 3). A suitable representation of the way this market functions in Bulgaria would be a system of cascading reservoirs. The imported or manufactured cigarettes from the top reservoir overflow into tanks at the lower levels, which in their turn supply the ones below them. This system is not a formal hierarchy, as criminal entrepreneurs at the highest level work within the top reservoir, importing or manufacturing cigarettes and selling hundreds of containers annually to the lower levels, but not interfering in any way with the organi-

sation and the interaction of the criminal structures below them.

The top level of criminal entrepreneurs, most commonly called "cigarette guys", provides the bulk of illicit tobacco products through three different sources: a) import of illicit whites from non-EU countries to Bulgaria and other Member States;²³ b) local production through legal cigarette manufacturers with significant market share in the legal cigarette markets of Bulgaria and Greece. In this case, the manufacturer declares the cigarettes are intended for export in non-EU countries and part of the production may actually be exported only to be returned to the country through organised criminal networks; c) manufacture in small illegal production facilities in Bulgaria or another neighboring country organised by experienced players in the tobacco industry. The production lines and the output of such factories that have been un-

²³ CSD (2015) *Financing of Organised Crime*. Sofia: Center for the Study of Democracy.

Figure 3. Illegal Tobacco Products Import and Distribution Models (2009 – 2014 r.)



covered by law enforcement bodies are of varying quality, with the manufactured cigarettes either imitations of well-known brands or illicit whites.²⁴ The top

level supplied to the Bulgarian illegal market between 400 and 500 containers in 2010 and between 230 and 250 containers per year in the period 2011 – 2014.²⁵

²⁴ CSD (2015) *Financing of Organised Crime*. Sofia: Center for the Study of Democracy.

²⁵ The period when, according to *Empty Pack Surveys*, the share of the illegal cigarettes market amounted to 20%.

The second or middle level comprises regional criminal entrepreneurs who buy wholesale from the big cigarette guys. These players, often referred to as “heads”, provide the link between the top level and the distribution networks. They operate in a market-driven mode, buying from the supplier that offers the lowest price and selling in a targeted area in competition with fellow local criminal entrepreneurs.

These criminal enterprises are responsible for the supply of tobacco products throughout the country and bear most of the risks in the process. Criminal entrepreneurs from the top level supply cigarettes by containers,²⁶ the usual quantity for the Bulgarian market being 4-5 containers per week on average (2011 – 2014). The middle level’s capacity is measured by vans, i.e. they handle about 100 – 250 master cases, or 1/4 – 1/10 of a container (TIR truck). Depending on the size of the local market they cover, deliveries are made from once a week to once a month. Corruption transactions with local authorities are made to secure protection and early warning. Bribes are means to escape pressing charges or getting an effective sentence, if a member of the distribution network is arrested. To maximise their profits some middle level players try to import directly from Greece or elsewhere, but lacking established contacts with international cigarette suppliers and corruption relations with high-level central government officials, they are rarely successful. As a rule, the top level criminal entrepreneurs have managed to hinder such direct supply by cautioning police and customs bodies.

The third or low illegal tobacco market **level** deals with logistics and supply to retailers and, in some cases, its actors operate as retailers as well. Their purchases from distributors (second level) are market driven. This level is further stratified as per the regional market size and custom into 3 to 5 levels, such as warehousekeepers, merchandisers, couriers, etc.

To escape involvement with higher level player’s small-scale importers in some border regions in South and

West Bulgaria form ant smuggling partnerships made up of socially disadvantaged locals and foreigners. Criminal subordination in this system is much more clear-cut than with regional dealers (Figure 3). Ant smugglers cross the border several times a day transferring small amounts of cigarettes at each crossing, which are stored in designated depots and distributed wholesale on the domestic market. They can count on getting away with administrative penalties such as confiscation and fine if caught with small amounts of illegal cigarettes.

A fairly marginal level of the distribution networks within the country is the production and merchandise of hand rolling tobacco. The consumers of the fine-cut tobacco are people with the lowest income or around 20-25 % of smokers in Bulgaria. Tobacco is illegally bought from Bulgarian producers and cigarettes are hand-rolled by the lowest level retailers or the end buyers. Distribution is run at the middle or low level in close relation to organised crime networks.

Development of the Illegal Tobacco Products Market after Bulgaria’s Accession to the EU

The post-EU accession period was the time when the major organised crime schemes at the illegal tobacco products markets were shaped, remaining relatively unchanged until the present. A number of studies have concluded that Bulgarian organised crime has adapted promptly to the changes²⁷ that followed the unexpected closure of duty-free shops on the borders with Turkey, Serbia and Macedonia. There are three roughly distinct stages of this adaptation: 2009 – 2010, 2010 – 2015 and 2015 until the present.

The second stage (2010 – 2015) was dominated by illicit white cigarettes for two key reasons. Following Bulgaria’s accession, customs control at those borders that became internal for the EU was removed. At that time Greece was the major hub for illegal

²⁶ A ship container holds 1,000 master cases on average, which is 500,000 boxes of 10 million cigarettes.

²⁷ See CSD (2012) *Serious and Organised Crime Threat Assessment 2010 – 2011*. Sofia: Center for the Study of Democracy. CSD (2015) *Financing of Organised Crime*. Sofia: Center for the Study of Democracy.

cigarettes in the EU and the Bulgarian route to Central and Western Europe was put in nearly immediate use after accession in 2007. Meanwhile, no illicit white sales were recorded in Bulgaria until 2010 – a sign that the country served as a transit route. The second reason was the sharp rise of excise duty on tobacco products introduced in 2009 and peaking in 2010. Until 2009, illicit whites were not found on the Bulgarian market due to the availability of cheap legal cigarettes produced by *Bulgartabac* which were both of better quality and more affordable. When their prices surged due to excise duty, illicit whites turned into a pillar of the local illegal tobacco market. In addition, Bulgarian organised crime has always been strongly tied to the Greek hub.²⁸ There is ample evidence from the period until 2010 that Bulgarian criminal networks smuggled cigarettes from Greece to EU countries. As demand for illicit whites rose in early 2010, new sustainable smuggling channels for supply from Greece emerged within a few weeks.

The next step was to establish a large retail network, a process of downward “contamination” facilitated by the economic crisis underway and the large number socially disadvantaged people. Some of them, such as Roma and peddlers at open-air bazaars, had previous illegal cigarette dealing history. Others, such as marginalised urban and low-income rural dwellers, had no criminal past and relevant experience, but got involved in retail at industrial sites, public buildings, small village shops, etc. upon huge pressure from criminal networks. At the time of the cigarette smuggling peak (2009 – 2010) there was a massive influx of criminal population into the middle-level, regional distribution networks.²⁹

Law enforcement bodies and the revenue administration were unprepared for the illegal market boom that followed the 2010 dramatic increase of excise duty. It took two years to the Customs Agency to purchase and put in place the equipment necessary to trace the main cigarette import routes. The police, border guards and the General Directorate for Combating Or-

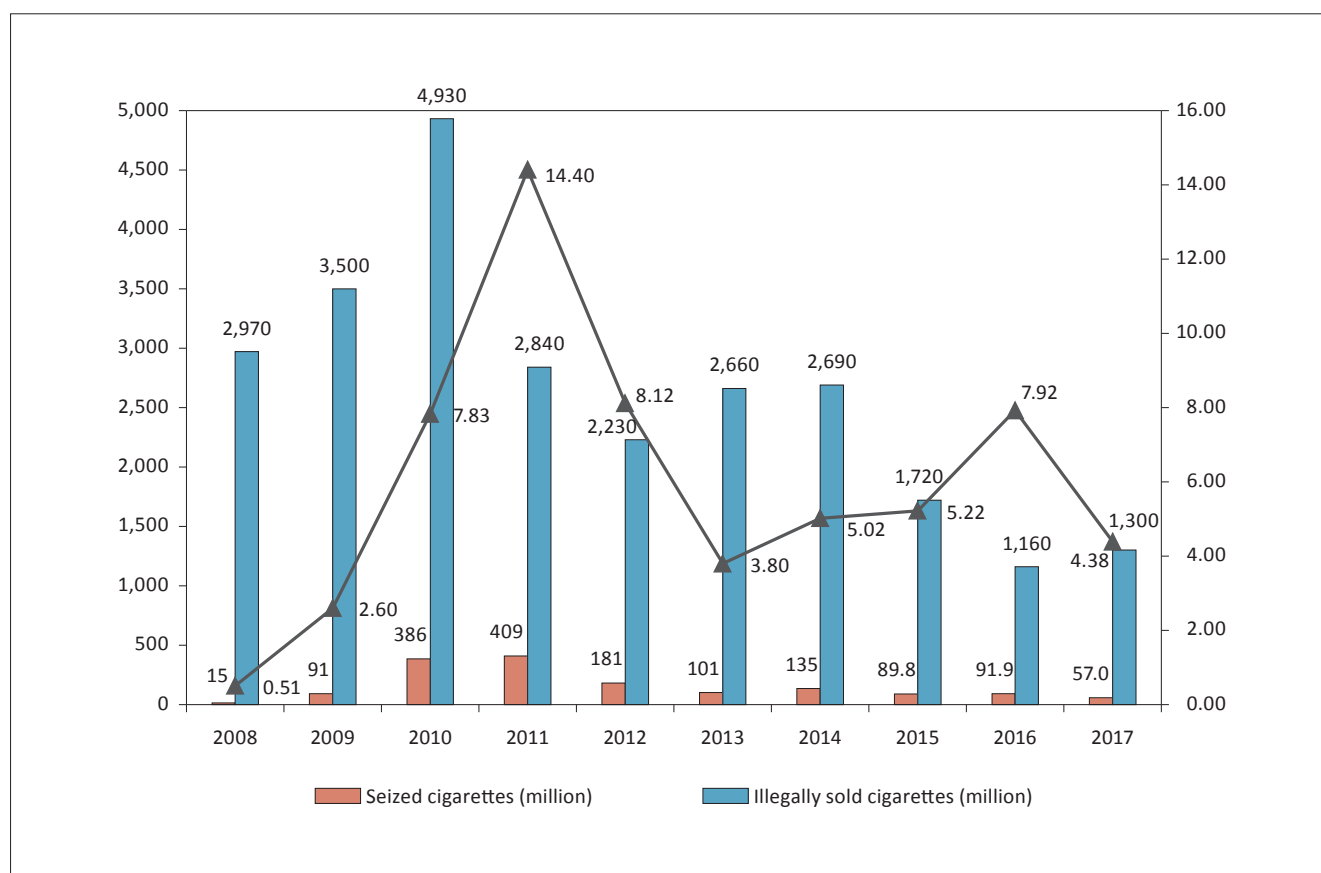
ganised Crime were equally off-guard. Despite their solid experience in tackling the import and distribution of illicit tobacco products, they did not work effectively enough until 2011. Thus, the ratio between illegal tobacco products seized by law enforcement agencies and those sold in the country rose slowly from 0.5 % in 2008 to 14.4 % in 2011, three years after the tobacco market crisis began (see Figure 4).

Sales peaked in 2010 and gradually shrank in the next 3-4 years to become stable afterwards. The numerous odd dealers were driven out of the market. Studies show that the supply of illegal cigarettes has become much less regular, suppliers are constantly changing, and contract quantities and prices are not fulfilled. Consumers have become familiar with illicit whites, with the poorest among them and the country dwellers switching to the cheaper hand rolling tobacco, others – to buying only certain illicit white brands, and still another sizeable group – to legal cigarettes. The number of open-air bazaar peddlers has shrunk due to the riskiness of the business, and the ones who are still active take special precautions and supply only a closed circle of clients even at the largest public bazaars.

In the first half of 2010, most illicit cigarettes were sold at retail outlets, but due to peaking confiscations and imposed fines distributors were forced to look for alternative ways of merchandising, such as mobile sales or sales at private homes and the like. This was a method to escape checks by customs officers, as they are not empowered to enter private houses, garages and other premises where illegal tobacco products can be safely concealed. Some distribution schemes even resemble drug dealing in their conspirative approach, e.g. ordering cigarettes over the phone, home and office deliveries, or using as selling points taxies or shops in Roma neighbourhoods harder to access by the police. A caste of in-house vendors also emerged – people working as cleaners, drivers or guards at public buildings, offices, and enterprises, who are in everyday contact with the employees. A staple technique to be em-

²⁸ Ibid.

²⁹ Ibid.

Figure 4. Seizures vs. Sales of Illegal Tobacco Products (2008 – 2016)

ployed in all these cases is to hold as few cigarettes as possible in one's home or car and to get frequent supplies from the depot (a garage, basement or derelict building which is someone else's property). This allows vendors to employ the drug dealing cliché of possession for personal use and, when caught holding small amounts of tobacco products, to get away with a fine for petty violation.

The success of illicit whites and the revival of smuggling routes going through the Greek hub are the first signs of an emerging new model, the so-called "domestic illicit white" or "Greek model" in the terms of Bulgarian tobacco experts (see the box). *Empty Pack Surveys* for the first half of 2011 have revealed that a small portion of illegal cigarettes are related to Bulgarian and Greek legitimate cigarette manufacturers.

The "Greek model"³⁰ has various aspects, but its main feature is the tacit agreement between government (irrespective to the ruling party or coalition) and certain tobacco industry players.³¹ This model guarantees a small-scale market of illegal cigarettes and is profitable for both the state, which can easily collect the planned excise duty, VAT and other taxes, and the private Greek companies, which can sell the planned volumes of legitimate tobacco products and incur profits from the illegal market as well. Much like interconnected vessels, when the sales of smuggled illicit whites grow, Greek cigarette companies increase their

³⁰ Interviews with representatives of cigarette multinationals, and a former director and deputy director of the General Directorate for Combating Organised Crime. See also CSD (2015) *Financing of Organised Crime*. Sofia: Center for the Study of Democracy.

³¹ These should be necessarily cigarette companies owned by Greeks; it is considered that large corporations owning production facilities in Greece are not allowed to take part in this process.

sales on the black market with the government's tacit approval. The cigarettes of better quality force smuggled illicit whites out of the market and their importers and sellers incur losses as their sales slow down. Illicit white smugglers stop importing for the Greek market until the available cigarettes are sold out. At this point legitimate Greek producers restrict illegal sales, which are in decline as illicit cigarette prices are up. With the next rise in the demand for illegal cigarettes, smuggling has to be resumed and the sales of legitimate Greek producers on the illegal market peak anew. The big criminal networks refrain from entering the Greek market, and, after importing illicit whites in Greece, tend to export them right away to the EU. This is what makes Greece the primary gateway of illicit whites to the EU, while keeping domestic illegal cigarettes level below the EU average.

Following the sale of two out of four cigarette factories by the state-owned *Bulgartabac* in 2008 it was surmised that Bulgaria would follow the Greek model.³² The presumption was based on the tobacco market's highly competitive nature, Bulgaria's recent EU membership, the presence of the world's major cigarette producers on the legal market and the fact that former monopolist *Bulgartabac* had kept two of its newer production facilities. The steep excise duty rise was already planned and a sharp decline in legal consumption was expected. Although nothing of this happened at first, *Empty Pack Surveys* in 2010 found out the first packs of illicit cigarettes manufactured by a privatised *Bulgartabac* facility purchased by one of Bulgaria's major alcohol producers.³³

A second, post-EU accession, stage of the evolution of Bulgaria's illegal tobacco products market was the emulation of the Greek model at home as a result of two main precursors. First, the installation of scanners at seaport and land border crossing points and the assignment of mobile customs and police teams to control risky highway segments made anti-smuggling efforts more effective. Second, as in Greece, tacit governmental protection of the illegal supply of popular legally manufactured brands was available.

Political bargaining can be surmised both from *Empty Pack Survey* data (Figure 5) and data about the brands available on the legal and illegal market alike (Table 1). After mid-2011, the illegal cigarette market level remained poised between 18 and 20 % (Fig-

ure 5). At the same time, since 2012 a fast growth of domestic illicit whites has been observed by looking at 'empty pack' brands. In the autumn of 2014, when political instability had nearly subsided, their share was about 77 %, two thirds of which were provided by Bulgarian manufacturers (Table 1). Notably, the rise of Bulgarian illicit whites was not prevented, but rather facilitated when a new government assumed power in 2013.

The third illegal tobacco market evolution stage commenced with the next government change in 2014 and continues to date. A month into its office, the government took an unprecedented step, placing all Bulgarian tobacco products manufacturing facilities under on-site physical control. Over the next six months, there were customs and Mol officers at and around their premises, with illegal distribution of tobacco products plummeting and tax revenues rising ostensibly (Figure 5 and Table 2).

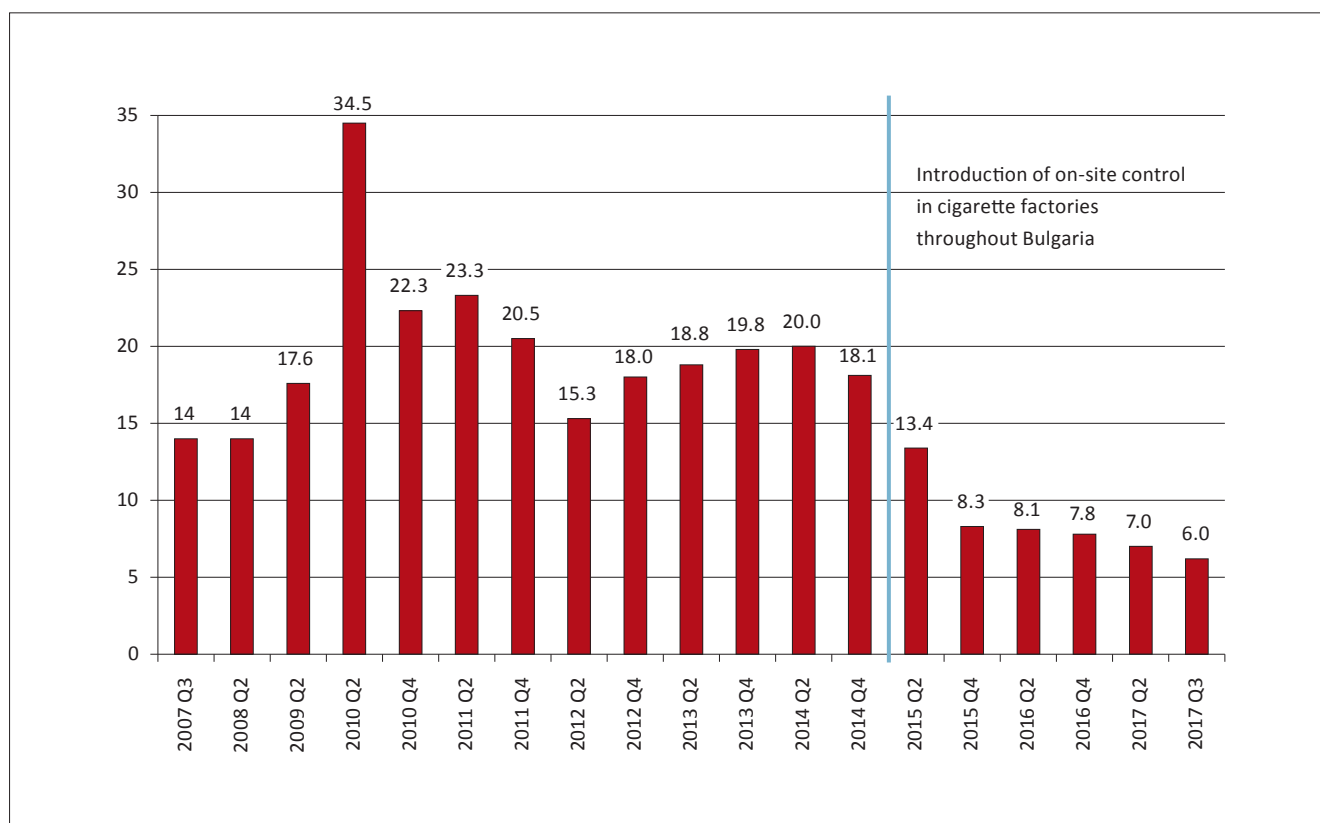
These measures brought about changes in the relative presence of illicit tobacco products from the three main sources: domestic illicit whites from legitimate factories, illicit whites from Greece/Turkey and from illegal manufacturing facilities, whereas supplies from all three declined.

Domestic illicit whites' supplies that dominated the market until 2015 greatly decreased due to the described on-site control. In mid-2015 customs and police officers were withdrawn from production facilities

³² Interviews with tobacco industry representatives and senior officials at the Customs Agency and the General Directorate for Combating Organised Crime.

³³ See CSD (2015) *Financing of Organised Crime*. Sofia: Center for the Study of Democracy.

Figure 5. Share of Brands Not Produced for the Local Market (2007 – 2017)



Source: Empty Pack Survey.

Table 1. Share of Some Illegally Distributed Cigarette Brands (2011 – 2016)

	2011 Q4	2012 Q2	2012 Q4	2013 Q2	2013 Q4	2014 Q2	2014 Q4	2015 Q2	2015 Q4	2016 Q2	2016 Q4
Greek brands	12.8%	6.7%	10.1%	18.2%	6.5%	15.5%	11.3%	11.6%	21.4%	18.0%	7.3%
Bulgarian brands	8.8%	2.6%	38.0%	47.7%	52.7%	54.1%	65.9%	28.7%	4.7%	12.5%	8.6%

Source: Empty Pack Surveys.

but, according to available data, supplies to criminal distribution networks remained low since suppliers recoiled at the threat of renewal of law enforcement’s rigorous presence. Studies reveal that in late 2016 domestic illicit whites accounted for 15-16 % of illegal sales in the country, a drastic shrink from the 2-2.2 billion cigarettes sold in 2014 to the 180-190 million two years later.

Smuggled illicit whites, on the other hand, re-emerged as the dominant source. Expectations that their imports from Greece, Turkey and other neighboring countries will grow further as a result of another excise

duty increase to fill the newly formed niche, however, were not fulfilled. Annual sales reached 500 – 600 million pieces, which was one third of their 2011 – 2012 level. The uneven distribution of illicit whites in various parts of the country and the multitude of brands and packs were a sign that supply was problematic, which was corroborated by MoI and customs data on illegal cigarette seizures and *Empty Pack Surveys* in 2017. Clearly, it was not possible to establish big and stable smuggling channels.

Since the start of the period in 2015 small illegal factories (the third source) have practically been missing.

According to the interviews,³⁴ the old criminal entrepreneurs from the cigarette business have exported their assets to Western and Central Europe to capitalise on profits 2-3 times as high as those on the domestic market. In addition, Bulgarian law enforcement agencies, have started actively cooperating with their European counterparts despite their limited resources, as they have become aware that a criminal entrepreneur, albeit operating abroad, would continue to pose a risk on the internal market. As a result, several illegal factories have been uncovered in Spain, Greece and Central Europe.

Structure-wise, the illicit market for tobacco products has remained unchanged. The only deviation has been the dwindling of groups and individuals participating in criminal networks. The top level that comprised 5-8 groups in the period 2011 – 2015 has allegedly shrunk to 1-2 networks since 2016. Criminal distribution networks (the middle level) have also diminished to two thirds of their size in the preceding period.

Open-air bazaars/markets in larger cities are indicative of what has happened to the bottom distribution level. Of the near 40 markets under monitoring where illicit tobacco products were actively peddled, a mere 8–10 continue to host cigarette dealers. The latter have massively left the sites under pressure from patrolling police officers. Thus, the average Bulgarian smoker opting for cheaper products at the next price

rise or income drop has no easy access to illicit cigarettes.

The rapid expansion of migrant and refugee smuggling since 2014, has had a significant impact on the criminal landscape as well. Since one of the important smuggling route for migrants from Turkey to Western Europe is the one through Bulgaria, a sizeable portion of criminal entrepreneurs have switched from illegal cigarette trade to people smuggling, considering the latter more profitable and less risky.

Factors for Curbing the Illicit Tobacco Products Market in the Period 2015 – 2017

2015 was a year of transformation driven by the political will to strictly curb the criminal market of tobacco products. The measures against domestic illicit whites are targeting influential economic actors in Bulgaria. There is every reason to believe that the Greek model sustained by political corruption has been discarded. This change may well be rooted in awareness of the two major risks stemming from the illegal tobacco market expansion. The first one is economic, ensuing from the fact that in Bulgaria excise and VAT on tobacco products account for a significant share of the state budget, providing between 9 % and 11 % of all tax revenues (see Table 2). By comparison, in Western Europe, this

Table 2. Fiscal Revenues by VAT and Excise Duty on Tobacco Products and Total Budget Revenues in Bulgaria (2009 – 2016)

	2009	2010	2011	2012	2013	2014	2015	2016
Cigarettes (billion)	16,395.8	10,360.5	10,875.8	11,582.8	11,511.3	11,343.3	13,160.9	13,832.1
Excise duty total (BGN billion)	1,787.7	1,520.5	1,694.6	1,803.1	1,804.0	1,787.0	2,008.2	2,304.0
VAT total (BGN billion)	459.0	343.5	431.9	458.9	465.0	456.9	532.1	567.4
Total (VAT + excise duty)	2,246.7	1,864.0	2,126.6	2,262.0	2,269.0	2,243.9	2,540.3	2,871.4
% Total Revenues	15.4%	9.6%	10.1%	10.3%	9.9%	9.6%	10.3%	10.5%

Source: Ministry of Finance.

³⁴ Interviews with a former chief secretary of the Mol and officials from the police and the General Directorate for Combating Organised Crime.

Table 3. Monthly Sales of Tobacco Products (2016 – 2017)

	Aug-16	Sep-16	Oct-16	Nov-16	Dec-16	Jan-17	Feb-17	Mar-17	Apr-17	May-17	Jun-17	Jul-17	Aug-17	Sep-17	Oct-17	Nov-17
Million cigarettes	1012,0	1000,5	934,2	914,8	891,4	865,6	859,6	896,9	912,8	948,1	975,4	1005,0	1025,3	1015,9	976,9	948,1
Change from same month of previous year	-3.4	-20.6	-47.4	-46.4	-61.0	-35.4	-22.6	11.4	-10.8	2.1	-0.54	-0.59	13.3	15.4	42.7	33.3

Source: Retail Surveys of the Bulgarian Tobacco Products Market.

figure is about 1-2 % (France – 1.1 %, Austria and Belgium – 1.2 %, Germany – 1.3 %, England – 1.4 %, Spain – 2 %). During the economic crisis, the collapse of revenues from tobacco products in 2010 was one of the major factors that led to drastic budget cuts, further aggravating social tensions. The planned excise duty revenues from tobacco products were BGN 2.4 billion, whereas those collected were BGN 1.520 million.

The policy change of 2015 demonstrated that curtailing the illegal tobacco market has become a most effective government instrument for increasing revenues. In 2015 and 2016 alike, scaling this market down led to a rise in legal sales and revenues by an average of BGN 300 million compared to each of the previous years (see Table 2).

Assessing the policy change would be incomplete without considering the impact of the *Empty Pack Survey*³⁵ – a strong driver of crushing the illegal tobacco market in Bulgaria. This entirely research tool was recognized by the government as an opportunity for a recurring PR campaign on the one hand, and as a method of assessing the senior, national and local, Mol and customs management on the other hand. When survey data reveal a high level of illicit tobacco products in a given region, senior officials at all levels start taking measures. Experts on excise goods have explained this unprecedented phenomenon with the simplicity and clarity of the data and their widely recognised objectivity.

The Bulgarian tobacco market is extremely responsive to the political situation, as can be observed in Table 3, which covers a year when presidential elections (late 2016) and preliminary parliamentary elections (early 2017) were conducted – the decline in sales continued until the “political scene” had stabilised.

Besides policy, there were two economic factors that facilitated the curtailment of the criminal market for tobacco products after 2014. First, Bulgaria no longer needed to step up its minimum excise duty rates in leaps (70-80 %) and since 2015 excise taxes have been rising by a mere 2-5 %. The next planned increase is in 2018 to be followed by another increase no earlier than 2021. Second, for the first time since 2001 the population’s incomes have been growing faster than excise duties, the average wage rising by about 10 % per year between 2015 and 2017.

Risks

The government’s decision to block the Greek model whereby legally produced cigarettes are sold on the illegal market has had a boosting effect on the revenues from tobacco products. For a sustainable impact, however, the government and all relevant agencies need to take into account several key risk factors in their strategic analysis and policy planning as regards curbing the illicit trade. **The main risk** would be to ease political pressure on institutions responsible for tackling smuggling channels and local black

³⁵ The *Empty Pack Survey* was funded by 5 tobacco products manufacturers operating in Bulgaria – PMI, BAT, JTI, Imperial Tobacco and Bulgartabac.

cigarette production. This would seriously endanger the collection of revenues, as evidenced recently by the shrinking of legal tobacco sales in late 2016 and early 2017 when Bulgaria was politically unstable. **Another risk** is posed by the local criminal markets themselves. With the relative standstill since 2016 of the refugee and migrant flows through the country, it might be expected that some criminal entrepreneurs would switch back to the illegal tobacco market. Opaque political coalition arrangements are a **third risk** as they might conceal political meddling into the work of agencies vested with curbing illegal trade in excise goods. Administrative capacity and vulner-

ability to corruption are a **fourth risk**, most apparent at some local administrations whose corruption vulnerability is above the country average. Last but not least, there are **external risks** related to neighbouring countries' domestic policies, which have the potential to create new sources of illegal tobacco products. Apart from taking these risks into account, and given the positive impact of the *Empty Pack Surveys* as an objective measurement tool of the illegal market, the government might also benefit from expanding its geographical scope and complementing the Empty Pack Surveys method with related instruments gauging the consumption of illicit tobacco products.