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Sanctions, Smuggling, and the Cigarette: The Granting of Iran Office of Foreign Asset Control's Licenses to Big Tobacco

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Review Article

ABSTRACT

Background: Presuming that tobacco taxes, levied both as import duties and ad valorem, would financially benefit the Iranian Government, such the introduction of a highly desired US product to the market would be antithetical to the sanctions regime currently in place.

Methods: This paper as a systematic review and documents through Pubmed and webs seeks to understand the politician economy implications of nicotine addiction in Iran, focusing on the US office of foreign asset control's (OFAC) awarding of Iran operations licenses to American tobacco companies.

Results: By comparing Iran's tobacco industry and the attendant public health crisis that has arisen from high rates of nicotine addiction, to conditions in Turkey, it can be demonstrated that Iran is uniquely unable to extract revenues from the sale of tobacco products. The primary point of comparison between Iran and Turkey is smoking-attributable annual productivity loses of each country as estimated through the use of smoking-attributable mortality, morbidity and economic costs software (SAMMEC) and the available related literature. Based on the calculations derived from the SAMMEC model, Iran is burdened with an incredible cost to the economy borne by a high prevalence of smokers.

Conclusions: It is concluded that an awareness of this condition enables OFAC to award licenses to big tobacco without fear of undermining current foreign policy initiatives.

Keywords: Cigarette, sanctions, smuggling, tobacco

INTRODUCTION

For the past 15 years, US-Iran relations have been strained by the imposition of a trade embargo, which has limited Iran's access to markets for goods, services and capital. Economic sanctions have limited to the growth potential of a country rich in both human capital and natural resources. The industrial inputs and consumer goods Iran needs to thrive, inputs once sourced through healthy trade agreements with the United States and its European allies, are no longer available in the country. Pre-embargo imports from the US to Iran were valued at USD $328 million annually in 1994. Current imports barely reach USD $32 million per annum.[1]

That is not to say that it is impossible for American companies to operate in Iran in the status quo. The office of foreign assets and control (OFAC), a division of the Treasury department and grants licenses to US companies that wish to operate in Iran. OFAC grants an unexpectedly high number of Iran operations licenses to American tobacco companies. Presuming that tax revenues derived from the sale of tobacco products would financially benefit the Iranian Government, the introduction of a highly desired US product to the market would seem antithetical to the sanctions regime currently in place.

This paper explores this inconsistency in five sections. The first section explores a political economy theory of extraction, contextualized to the taxation of tobacco products. The second section analyzes the role OFAC plays in facilitating commercial relationships between American and Iranian entities while sanctions remain in place. The third section explains the recent history of Iran's nicotine addiction crisis and the incredible smuggling program that enables it. In the 4th section, comparisons with Turkey isolate smuggling as a possible explanation for OFAC's concessions to American tobacco companies. Finally, the paper discusses economic and political consequences of this unique confluence of events. By focusing on a single, but significant product – the cigarette – it is possible to elucidate the larger machinations that have bound Iran and the United States in an enigmatic dance of policy and posturing for over 30 years.

THE POLITICAL ECONOMY OF CIGARETTES

Fundamentally, economic sanctions are designed to undermine the sovereignty and stability of the targeted state, by interfering in the extraction of rents. The importance of extraction for the existence of a strong state makes sanctions highly disruptive. According to Charles Tilly, extraction is vital for state building and maintenance of state powers in three ways. Extraction facilitates "war-making," which entails "limiting or neutralizing… rivals outside the territories in which they have clear and continuous priority as wielder of force." Second, the rents derived from extraction fund processes of "state-making," during which a state eliminates or neutralizes rivals within their territory. Finally, extraction enables the state to provide "protection" to its clients by eliminating their (political and commercial) enemies.[2]

Taxation is the most politically salient form of rent extraction and the key mechanism by which a state ensures the maintenance of power. As Herbst notes, "there is no better measure of a state's reach than its ability to collect taxes a widely distributed tax base helps guarantee consolidation of the state by generating a robust revenue stream."[3] By extension, taxation of a wide range of goods and services, both in the form of trade duties and sales taxes, can reduce variability in revenues and provide a stable base for state expenditure.

Iran's state making expenditures are particularly urgent given the geopolitical environment in the Middle East. For a government often portrayed as a survivalist, the combination is understandable: War-making, state-making and protection exist with few distinctions in today's Iran. Insofar as sanctions are meant to inhibit the Iranian Government from engaging in these self-strengthening practices, they must necessarily inhibit extraction.

How do cigarettes factor in all of this? Sanctions are an inherently exogenous constraint on extraction. The embargo can only limit Iran's commercial interactions with world markets. Therefore, the ability of the Iranian Government to tax goods and services within its own territory is not adversely affected by the sanctions regime. Tobacco taxes generate high revenues because they target a good with large sales volumes, few producers, inelastic demand, easy definability and a lack of close substitutes. Such goods provide for a relatively consistent, stable and profitable revenue stream.[4] In addition, there are low transaction costs associated with the collection of tobacco taxes as they tend to exist in two forms; as an import duty and an *ad valorem* tax, which is an excise based on a percentage of the retail value of tobacco products at the time of sale.

In summary, in the face of reduced extractive capacity through trade, Iran is now more dependent on taxation of consumer goods. Taxation is a powerful source of revenue used in the "consolidation of the state," and tobacco taxes are among the most consistently lucrative.

In this way, OFAC's actions to allow the sale of US cigarettes in Iran would theoretically aid, in the provision of hundreds of millions of dollars in revenue, the consolidation of the Islamic regime. The question then arises; what enables OFAC to award such licenses?

OFAC AND IRANIAN TOBACCO

Major American tobacco companies, such as Phillip Morris and Reynolds American maintain operations in Iran with the permission of OFAC. In addition, a wide range of smaller companies exists to facilitate re-importation of specific American brands into the Iranian market through Iranian import distribution entities. These companies often use the agricultural exemption as the basis for their license applications. Big tobacco makes big profits selling its goods in a market where as much as 24% of the population smokes, meaning that the granting of licenses to tobacco corporations is understandable from the standpoint of American economic interests. But as the above analysis suggests, the sale of an addictive and highly taxable consumer good in Iran should theoretically benefit the Iranian Government. Therefore, there are two competing claims to weigh. The Treasury Department has an obligation to uphold the terms of the embargo and the aim of sanctioning Iran. Big tobacco has an interest to be active in the lucrative Iranian market. OFAC finds itself navigating between these two seemingly incompatible claims. Some lurking aspect of the conditions in Iran must be responsible for bringing the two claims out of competition, facilitating improbable trade.

IRAN'S UNIQUE BATTLE WITH SMUGGLING AND ADDICTION

As a populous country with a young population, little to no government regulation and little domestic competition, American and British tobacco companies have long seen a vital and lucrative market in Iran. As early as the 1980s, major tobacco multinationals were crafting strategies to break into the Iranian market, dominated by a state-owned monopoly. Cigarettes have historically been a cheap commodity in Iran, because of high volumes and low average quality. In order to effectively capitalize on the intrinsic appeal of a foreign brand cigarette, it was necessary that tobacco multinationals deliver their products to the market at a sufficiently low price point.

To keep costs low, American and British tobacco consortiums took to smuggling their own products into Iran, thus avoiding cost additive tariffs levied by a Protectionist Iranian Government.[4] Using various methods of smuggling, RJ Reynolds had captured 50% of the Iranian market by 1994, amounting to 16.4 billion units sold annually.[5] The relatively low-cost access to a foreign brand instantly attracted Iranian smokers. Only recently has the Iranian Government eased importation restrictions in order to stem smuggling and recoup some revenues.[6] But, the effect of the smuggling binge is engrained, especially as borders remain porous.

Driving the expansion of the marketplace, Iranians are also smoking at much higher levels. High sales volumes suggest a massive opportunity for tax revenues, but also represent a public health crisis. The negative health effects of smoking, an increase in the morbidity and mortality of populations, have presented immense challenges for governments around the world. That is to say, the taxation of tobacco products can only be considered successful if the revenues mitigate the costs of addiction. Otherwise, it would be in the social interest to eliminate the sale of tobacco products completely. But for now, in Iran, smuggling is king.

THE SOCIAL COST OF SMUGGLING

In order to elucidate Iran's unique circumstances vis-à-vis the high prevalence of nicotine addiction, Iran is compared with Turkey, a country with which it is highly comparable. The regional neighbors feature broadly similar demographic and socioeconomic conditions. The combination of these factors has led to high rates of smoking prevalence in both countries.

The age standardized prevalence in Iran estimated at 18%.[7] Turkey has a relatively higher age standardized difference of 31%, which is explained by a significantly higher rate of smoking among adult men.[8] Importantly, this is related to relatively similar rates of smoking related mortality between the two countries. Health officials in both Iran and Turkey place the estimate of smoking related deaths per year at roughly 50,000. But, these figures are likely a major underestimation as some have projected smoking related mortality in Iran to reach 200,000 deaths per annum by 2015.[9] Similar increases are projected for Turkey as well. Smoking causes premature death and can reduce life expectancy by as much as 14 years, hugely effecting the productivity of the work force of both countries.[10]

This is where the economic considerations meet the social challenges of nicotine addiction. In order to calculate the economic cost of smoking as a consequence of mortality and morbidity related reductions in the productivity of the labor force; it is possible to use the smoking-attributable mortality, morbidity and economic costs Software (SAMMEC). While SAMMEC is by no means the foolproof method for measuring the economic costs of smoking, it does effectively capture a snapshot of how the smoking habits of a population can translate into significant costs for a national economy.

Iran is not particularly data rich in the specific areas that SAMMEC requires; subsequently some extrapolation from trends seen in US data was necessary. The lack of hard data does introduce some error into the findings, but the goal of employing SAMMEC is not necessarily about complete accuracy, but the illustration of comparative trends between Iran and Turkey.

The results show that smoking attributable economic costs in Iran as measured by annual productivity losses alone, amount to a staggering USD $3.7 billion. Looking to productivity as the sole point of comparison, the findings suggest Iran is losing the equivalent of 1.1% of its gross domestic product (GDP) each year to largely preventable causes. The corresponding figures in Turkey are a substantial USD $12.1 billion amounting to 1.1% of GDP lost each year. Once again, the similarities between Iran and Turkey are striking as each country forgoes roughly 1% of GDP worth of productivity due to lowered levels of public health. There is one-way by which states are able to mitigate such economic costs. Recalling the political economy of cigarettes, the state has the opportunity to extract tax revenues from the sale of tobacco products in order to reduce the effect of smoking attributable on economic performance.

The Turkish Government has been very effective at levying taxes on the distribution and sale of cigarettes, both in order to combat addiction and bolster state coffers. The *ad valorem* tax rate is currently set at 63.4%. When value added tax (VAT) is included, the total tax rate reaches 78.7% of the retail price. Estimates place the tax revenue derived from cigarette sales at USD $12.7 billion, a figure slightly greater than the cost associated with smoking attributable productivity losses.[11] With only 7% of the cigarettes available in the Turkish market believed to be illicit, the Turkish Government generates healthy revenues from the taxation of tobacco products.[8]

In Iran, the circumstances are very different. Estimates place the proportion of illicit cigarettes in the Iranian market at between 14% and 22.5%, 2-3 times the proportion in Turkey. A well-designed 2009 study by researchers at Iran's tobacco control and Prevention Research center found that 20.9% of all cigarettes on the market were illicit. In years where domestic supply has faltered, that figure has risen as high as 74%.[12] On whatever cigarettes do go to sale legally, the Iranian Government levies a 7% import duty and a 5.13% *ad valorem* tax on cigarettes. When VAT is included, the total tax share as a percentage of the retail price is 19.16%.[13] This equates to roughly one-fourth of the tax rate in Turkey. It would be reasonable to question the necessity of smuggling by American tobacco companies in light of this low tax rate, but it is important to consider that the baseline price of cigarettes in Iran is incredibly low. The daily cost of smoking is estimated at a minimum daily expenditure of 100 Islamic republic rial (IRR), a maximum of 63,000 IRR and an average daily expenditure of 4,680 IRR or USD $0.48 by the concurrent exchange rate.[14] Although the average seems like a low figure, it costs a mere USD $0.46 to buy a pack of the local brand and USD $0.96 to buy a pack of Marlboros or the equivalent international brand. Trends indicate that cigarettes are getting substantially cheaper; over the past decade the local and international brands have seen price reductions of 9.00% and 9.06% respectively.[15]

The low-price brands in Turkey sell for USD $2.24 per pack on average and the premium brands for USD $3.67 on average.[11] Thus, cigarettes are roughly 4 times as expensive in Turkey as they are in Iran, which corresponds directly for the four-fold difference is the total tax rate. Therefore, an increase in the total tax rate in Iran to global median levels would be an incredible distortion to current prices. By the same token, the pressure for American tobacco companies to suppress the price of their goods relative to domestic product is acute. Mere cents can equate to whole percentage points of the retail price in Iran. While the market has liberalized in recent years, reducing the pressure on foreign brands, deliberate smuggling persists as a means of maximizing profits and market share.

The market value of cigarettes by annual sales can be estimated using the annual sales volume of 50 billion sticks.[5] With 20 sticks in each pack there are 2.5 billion packs sold annually. Given an average price of USD $1.32 cents per pack, the total market valuation of by annual sales is roughly $3.8 billion. Therefore, based on the tax rate of 19.6% of retail value, Iran's Government collects a paltry USD $600 million each year in revenues from the sale of cigarettes. This figure pales in comparison to the USD $3.7 billion in annual productivity losses from smoking. Whereas Turkey recoups, 105% of the cost attributed to smoking-attributable productivity losses, Iran by comparison recoups a mere 16%. It is in this instance that Iran and Turkey, though broadly comparable, diverge. Turkey is simply better positioned to mitigate at least some of the costs of addiction (recall that other costs such as costs to the health-care system are not considered here). Turkey's robust tax policy earns it significant revenues. If Iran's tax rate were equivalent to Turkey's event at current prices per pack of cigarette, the percentage of costs recouped would jump to 80% of smoking-attributable productivity loss.

In summary, the sale of cigarettes in no way benefits the Iranian economy or helps to bolster the Iranian state and in fact seems to do a great deal to harm Iran's economic interests. This is the political cover that renders the granting of OFAC licenses to Big Tobacco as consistent with the aims of the current embargo, thereby enabling OFAC to award licenses it know will be abused, if only because the consequences are essentially identical to the aims of the current foreign policy actions targeting Iran.

THE POLITICAL ECONOMY IMPLICATIONS OF SMUGGLING

From the perspective of the Iranian Government, there are a few advisable actions. It would behoove the Iranian Government to assert greater authority over its boundaries and stem the tide of illicit cigarettes. Herbst notes the importance of boundaries when he writes, "Boundary politics (is) defined as attempts by states to mediate pressures from the international system through the use of buffer mechanisms to maximize their authority over territory." In this case, the buffer mechanism would entail stricter guidelines for tobacco products passing through customs and greater pursuit of smugglers. Herbst continues by noting the advantages of such actions, "States can and do lower the costs of controlling a territory by developing a set of boundary institutions that insulate them form possible economic political threats while enhancing capabilities at the center."[3] The threat posed to Iran by big tobacco is two-fold. First, the threat manifests as the negative externality of smoking related productivity losses at the magnitude of 1% of GDP each year. Second, the rampant smuggling of American tobacco into Iran exposes the weakness of Iran's Central Government.

A concerted effort on the part of the Iranian Government to tackle smuggling would considerably improve "capabilities at the center." It has been estimated that "if the global illicit trade were eliminated, governments would gain at least $31 billion and from 2030 onward would save over 160,000 lives a year".[5]

Tax revenues have a two-fold significance in the battle against nicotine addiction. First, in the near term, revenues from cigarette sales can offset the detrimental effects of increased morbidity and mortality among the population associated with the tobacco related illnesses. A large body of evidence suggests that "high tobacco taxes increase revenues" despite lower overall consumption. The relative success of Turkey in offsetting the high costs of addiction testifies to the importance of strong taxes and effective regulation. In fact, many in Turkey advocate raising the taxes. Research commissioned by the Turkish Ministry of Health has concluded that "raising the specific tax to 3.10 TL per pack and the *ad valorem* tax to 65% will lead 0.9 million current smokers to quit and prevent 0.7 million young people from initiating smoking, preventing 0.5 million premature deaths among Turkey's population. Further, it would generate an additional 4.1 billion TL in tax revenues."[11] Should Iran adopt similar measures, it could considerably reduce the negative economic impact of smoking related mortality and morbidity. Second, as the above findings suggest, higher taxes increase barriers to consumption by raising the cost of maintaining a smoking habit. Although proportions vary by country; on average, a 10% increase in price is likely to reduce consumption by 8% for middle-income and by 4% for high-income countries.[16] In Iran, an 8% reduction in the number of cigarettes consumed each year would be an incredible reversal, especially considering that consumption is growing by a mere 1% per year. Finally, tax levies provide governments leverage over the industry, enabling regulation. If Iran can develop a track record where it has successfully passed regulations to increase the total tax rate on tobacco products and has also enforced those regulations through the proper channels, the government will develop credibility as a regulator of tobacco products, perhaps signaling to would be abusers – multinationals looking to smuggle and officials looking to enable – that the weight of the law finally applies to the realm of tobacco.

Importantly, these actions should be considered from a political economy perspective. In pursuing the control of boundaries and the extraction of tax revenues, Iran would be engaging in processes of state consolidation. Iran cannot prosper until it is allowed, to generate institutional knowledge and solidify sovereignty by processes of basic state building. A crippled Iran, one in which the whims American Tobacco Companies are able to paralyze a government into inaction, is not the Iran that will give rise to positive regional leadership. If Iranians were to live longer, healthier and more economically productive lives, an amelioration of the larger political and economic conditions would become more tenable.

CONCLUSIONS

This paper provides a snapshot into Iran's struggles with nicotine addiction from a rather unique angle, focusing on implications of political economy. Further research is required to understand tobacco use in both Iran and Turkey, specifically in the application of statistically robust methods to probe the true economic and social costs of addiction in each country. Ascertaining such costs is a vital step in building the case for higher taxes and stricter regulation. Ultimately, progress in the fight against tobacco will require clarity on how the state can maximize its outcomes as the prevalence of smoking is actively reduced. In Iran, such action would enable greater territorial authority and better economic outcomes, perhaps liberating the state from the burden of its own passivity.

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