



Palestine Economic Policy Research Institute (MAS)

Background Paper

Roundtable (6)

Smuggling and Evasion of Custom Duties and Taxes: The Cost to the Palestinian Treasury and Market

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¹ This paper was prepared in cooperation with the Custom Police Agency (CP), in particular Mr. Lotfi Nasser, Director of Control and Inspection Unit and Mr. Amjad Barahma, Director of Petroleum Unit (Customs Department).

Background and rationale

What renders the topic of this paper highly sensitive and important is two-fold: first, it attempts to examine ways of minimizing the Palestinian Treasury's financial leakages. Second, it examines methods of reducing the adverse effects of smuggling on the Palestinian market.² Reducing smuggling helps in cutting the Treasury's deficit, protecting law-abiding taxpayers and establishing fair business competition. There are many sources for trade-related leakages, such as: indirect imports, smuggling of goods from the Israeli market, smuggling of goods (especially cigarettes and tobacco) from the Jordanian market (i.e. shuttle trading), as well as tax evasion through misdeclaration or under-invoicing of goods imported from the Israeli market or from third countries.

Different studies, reports and statements by officials of the Palestinian Ministry of Finance (MoF) and the Customs Police (CP) demonstrate that smuggling is on the rise in various geographical regions of Palestine. CP raids are frequently reported on the news showing seized smuggled fuel and foodstuffs, whether expired or edible, from Israel and its settlements. However, in recent years fuel smuggling has become an issue due its significant spread. Evidently, smuggling cases reported by CP reached 5,672 in 2017, while the number reached 5,348 in the first eight months of 2018. Moreover, these figures do not include the many cases that were already resolved before filing them, along with their judicial proceedings. These figures include different types of custom duties and tax evasion cases, whether of goods that enter without import documentation or whose declared values are manipulated, or those that concern tradesmen who evaded taxes or did not register officially. According to CP, smuggling covers a wide range of goods, such as: fuel, tobacco, poultry, dates, agricultural goods and building materials.

Mostly, smuggled goods are either sensitive goods (revenue-generating goods, such as fuels and cigarettes), or essential goods (basic commodities essential for every-day life). Generally speaking, smuggling of goods causes harmful economic and social consequences, including Treasury losses, negative effects on law-abiding taxpayers, and distorting prices in the market, in addition to other ramifications caused by expired goods that reach the market or goods which do not comply with Palestinian standards and specifications.

This part of the paper sheds light on the impact of financial leakages resulting from smuggling and customs duties and tax evasion. Many studies³ associate these types of leakages with the Paris Protocol on Economic Relations and partial application of its provisions by Israel, especially those pertinent to Palestinian presence at the borders and crossings, the clearing system mechanism, and withholding of Palestinian financial revenues. All these factors have added to the deficit of Palestinian Treasury. The latest MoF report estimated Palestinian trade-related leakages and withheld revenues in 2018 at around USD711 million, some USD120 million of which resulted from the clearing system enforced by the Paris Protocol and falsely declared clearance invoices.⁴ These estimates do not include the value of leakages resulting from smuggling unregistered goods from the Israeli or Jordanian markets. An UNCTAD study issued in 2014 estimated the annual value of goods smuggled from the Israeli market at more than USD725 million, translating into more than USD190 million losses for the Palestinian Treasury, in addition to other losses resulting from indirect imports.

Through this Roundtable session, Palestine Economic Policy Research Institute (MAS) aims to focus on the aforementioned two important sources of financial leakages, namely smuggling and customs duties and tax evasion of imported goods especially from the Israeli market. In addition, the paper looks into the reasons behind the spread of this phenomenon, and the associated economic and social risks. The paper also touches upon the noticeable rise in fuel smuggling and the potential reasons for

²² smuggling or custom duties evasion is the illegal transportation of goods that have no official papers, while in the case of tax evasion, goods have fake tax invoices or falsely declared value, or when goods are entered by an unregistered trader. Although different, the drivers of smuggling and evasion are still the same.

³ STOPPING FISCAL LEAKAGES. The Government of Palestine's report to the Ad Hoc Liaison Committee (AHLIC) meeting. September 2018.

⁴ UNCTAD studies and reports, multiple years, World Bank, IMF, and MAS reports.

its spread lately. Hopefully, the discussion between the specialists and experts will generate recommendations and policies for curbing this phenomenon.

Reasons behind expansion of smuggling

The absence of Palestinian oversight and control mechanisms over internal crossings and external borders is at the heart of the growing prevalence of customs duties and tax evasion. In addition, Israel's complex security measures cause delays and have led a large portion of Palestinian businesses to favor importing from the Israeli market rather than from other destinations, which has in turn maintained the volume of trade imports from Israel to 75% of foreign trade. This also means that the share of the Israeli market as a source for smuggling has increased. In examining studies addressing this topic, there are several reasons that have exacerbated this phenomenon in Palestine over the years (Alawneh 2002; Sabri 2004; Mousa 2005; Abu Salah 2013; UNCTAD, 2014; 2013; 2012), mainly:

- 1- The weak role of the PNA in the economy coupled with weak oversight mechanisms due to Israel's control over crossing points, stipulated by the Paris Protocol, have negatively affected the implementation of trade and tax policies.
- 2- Poor human and technical capacities of CP in addition to Israel's full control of borders and crossings in Area C, constituting more than 60% of the West Bank's lands, have exacerbated customs evasion and undermined efforts to curb this phenomenon. Taking into account Area B, which is under partial Palestinian control, raises the total area under Israel's control to 82%, i.e. CP has full control over a mere 18% of the West Bank's lands.
- 3- Because of different geographical factors, the West Bank is an attractive environment for smuggling. The West Bank's open borders and settlement infrastructure have created alternative routes through which goods can be transported without passing through the four main crossing points (constructed by Israel and considered illegal by the PNA since they are not within the 1967 borders) on their way into areas under PNA control. According to the IMF report issued in 2012, only 34% of Palestinian goods pass through these four crossings.
- 4- Expansion of settlements: According to CP, 80% of smuggled fuels and poultry come from Israeli settlements.
- 5- The big price difference of cigarettes between Palestine and Jordan has contributed to shuttle smuggling at al-Karameh (King Hussein) bridge crossing especially due to the absence of Palestinian customs controls.
- 6- Old-dated laws which are not enough of a deterrent to combat this crime.
- 7- Other drivers of customs evasion include: illegal profit⁵, disregard of national interest, and the high tax burden of the private sector, especially indirect duties levied on some commodities such as tobacco, cigarettes and diesel. Notwithstanding that custom evasion leads to income tax evasion as well.

In conclusion, many factors contribute to smuggling and tax evasion worldwide, however in the Palestinian case there are two distinct underlying factors: first, the nature of Palestinian-Israeli economic and trade relations, which is a unilateral customs union and open borders from one-side, and the expansion of settlements disconnecting the geographic areas of the West Bank on the other. Second, the lack of Palestinian control over external borders and internal crossings and the lack of Palestinian customs control in Areas C and B.

The Paris Protocol also enforces customs tariffs and indirect taxes that are disproportionate with the size of the Palestinian economy and per capita income. To escape the heavy tax burden, a large portion of private sector institutions resort to smuggling and customs and tax evasion, which help in reducing production costs, increasing profit margins, and eventually helping their products compete with imported products. A World Bank report issued in 2016, estimates that value declarations by importers are 32% lower for imports from a third country, and 23% lower for imports from the Israeli market.

⁵ Profit on goods that entered the market illegally, i.e. which evaded customs duties and taxes.

Fuels Smuggling- the case of diesel

Smuggling of diesel from Israel to West Bank's Area C has increased significantly during the last four years. This is ascribed to the price difference between smuggled and legal diesel, the constant rise in fuel prices, complicit smugglers in origin country (Israel), in addition to the previously mentioned causes and factors. Unlicensed fuel stations that sell adulterated diesel are estimated at more than 90, mostly concentrated in the central and southern regions. According to CP, smuggled diesel ranges between 17% and 25% of total consumed fuel in the Palestinian territory (i.e. smuggled diesel accounted for USD120 million per year at minimum in lost revenues). Approximately 60 million liters of diesel are consumed per month. This high rate is alarming, owing to its adverse implications on the Palestinian economy, as it drains Treasury revenues, distorts the market, and creates environmental and health risks, in addition to the losses to the automotive sector due to usage of adulterated diesel that does not conform to standards and specifications.

Impact of Using Adulterated Diesel

First, a major problem (in addition to the crime of smuggling in itself) in the spread of smuggled diesel that does not conform to specifications and standards is that it leads to a decrease in its price. To summarize:

- Smuggled diesel comes from two sources: first, light oil produced in gas fields in Egypt and the Gulf, which is imported to Israel and then mixed with a specific amount of kerosene, to be used in heating and as fuel for hydraulic machines. Second, industrial oil wastes of Israeli factories that are mixed with kerosene. Blending diesel for these uses and with other substances reduces its cost and price, yet this type of diesel is not suitable fuel for motors. However, on the ground, adulterated diesel is smuggled into Area C and sold as motor fuel. The blending is usually done in Atarot industrial zone near Jerusalem, in addition to other areas, known for illegal trade with the PNA market. Then it is smuggled and sold to Palestinian tradesmen for NIS 3 at best, who sell it for around NIS 4. The final price is NIS 2 /liter less than the market price of diesel. Attracted by the lower price, vehicle users are not aware of the consequences of using adulterated diesel. According to the CP, the continuous rise in fuel prices is another driving factor of smuggling.
- Adulterated diesel poses serious environmental and health risks caused by tailpipe emissions, in addition to direct damages to vehicles -using it even for a short period of time can be harmful to vehicles and passengers, raising maintenance and repair costs.
- Some gas stations in Area C are legal, while others are unlicensed filling stations. Owners of some of these filling stations have approached the General Petroleum Authority (GPA) to obtain a license for their stations. However, their attempts did not meet with success because of the stringent licensing measures they had to go through, or for difficulty in fulfilling the license requirements or for other reasons related to the applicable regulations or laws.

Enforcement and storage issues

Lack of Palestinian sovereignty over Area C precludes CP the authority to operate in the area, which undermines controlling and combating efforts. In contrast, enforcement effectiveness in Area A is around 80%, i.e. only 20% of evasion attempts are not caught.⁶ Therefore, in areas where CP have no authority and work undercover to avoid any intervention by the Occupation, enforcement is 50% at best (UNCTAD, 2014). Nonetheless, CP with the help with other PNA apparatuses has eliminated a number of random stations. Yet, not much progress has been made because of movement restrictions, and weak coordination with the Israeli side, which affects the effectiveness of combating and controlling measures.

⁶ Based on an interview with the CP officials.

In addition, there are a number of logistical impediments to CP work which include: lack of mobile laboratories to check the quantity and quality of fuel carried in tankers in the Palestinian territories, and its conformity to safety standards and specifications, which opens the door for manipulation.⁷ In addition, CP suffers from a shortage in warehouses, having currently two warehouses only; the first is located in Ni'leen, administrated by GPA, and has a limited storage capacity. The second is located in Tarqumiya in a rented open yard where a number of CP and GPA offices are constructed. The seizures are unloaded from one tank to another by tankers until they are delivered to GPA, i.e. there are no warehouses or stationery tanks in it.

According to understandings between GPA and Israeli companies, confiscated fuel should be handed over to Israel, and should not be destroyed because of its impact on the environment. In this respect, no mechanism for handing over confiscated goods to the Israeli side was established. Moreover, there is insufficient storage space in CP's warehouses. According to the CP Director of the Control and Inspection Unit, CP hands over confiscated fuels to GPA, which in turn hands it over to Israel, unless it is useable. Finally, protecting CP teams in these areas is another challenge. Many assaults and confrontations with CP teams have been reported, which necessitates enhancing protection measures.

Present Needs of CP

In terms of smuggling, Palestine struggles from specific enabling conditions as mentioned above. Further to this, and although time consuming, the CP must request permissions from Israel to access area B, because currently once smuggled goods are disposed there, it is very difficult to seize them in these areas. To combat evasion in these conditions, require extraordinary administrative procedures and effort, in addition to strong capabilities in terms of number of recruited teams and their efficiency, logistics, level of coordination among the different PNA departments and apparatuses as well as information tracking and analysis mechanisms. Because of the aforementioned shortages and obstacles, smuggling has seen a steady increase. Alerted to this dilemma, the CP increased its personnel from 200 to 700 during the last two and half years, restructured its operations by adding specialized teams and departments, and intensified training and rehabilitation.

All these efforts were not enough. To curb the phenomenon, training should be intensified and sufficient technical and logistical support should be provided for securing warehouses and storage areas, in addition to mobile laboratories and incentivizing CP personnel's work. In addition, there is a need for greater coordination and cooperation among the relevant authorities and for facilitation of CP's work by providing sufficient information.

Summary and Questions for Discussion

Based on the discussion thus far, it has been established that customs duties and tax evasion severely impact the Palestinian society, Treasury and economic development, resulting in a minimum of USD 120 million revenue losses from diesel smuggling, and more than USD 190 million from smuggling of other goods. Saving these resources and stopping other financial leakages, including net lending, could significantly reduce the Palestinian Treasury deficit, not to mention the potential impact of injecting these funds on developing the economy.

Moreover, there are a number of uncontrollable external factors like the Israeli restrictions and limited space for CP operation in some Palestinian areas, which can only be solved through a political and economic framework that nulls the current setup. Also, domestically certain factors can help in curbing this phenomenon, for instance the introduction of relevant policies, interventions and measures.

⁷ Poor logistical capabilities make it hard to inspect all tanks and test their loads.

The following questions cover internal factors, i.e. Palestinian policies and measures that could curb this phenomenon:

- What measures can be taken to raise traders' and Palestinian citizens' awareness about the ramifications of trading and consuming smuggled goods? Have the relevant authorities designed awareness campaigns? If so, were they effective?
- What are the logistical and other needs that could help the Custom Police in combatting smuggling (e.g. increasing the number of warehouses for storing diesel and other seizures, or provision of a mobile laboratory)?
- Could licensing of illegal fuel stations contribute to curbing diesel smuggling? What are the caveats against issuing these licenses?
- Is it possible that reducing the tax burden could contribute to reducing smuggling?
- Are existing laws and penalties deterrent enough? What impedes law enforcement?