
Illicit Trade in Malaysia: Causes & Consequences

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Introduction

Trade integration offers opportunities for economic growth. However, high domestic taxes, lax border enforcement, and supply constraints can lead to an increase in illicit trade flows thus, reducing benefits of trade openness. As Malaysia becomes more integrated as a result of existing and prospective free trade agreements, it also faces the risks of an increase in illicit trade flows barring significant domestic reforms.

The World Health Organisation (WHO) defines illicit trade as “any practice or conduct prohibited by law and which relates to production, shipment, receipt, possession, distribution, sale or purchase, including any practice or conduct intended to facilitate such activity”.¹

High domestic taxes, lax border enforcement, and supply constraints can lead to an increase in illicit trade flows thus, reducing benefits of trade openness.

Meanwhile the Organisation for Economic Co-operation and Development (OECD) has estimated the cost of illicit trade to be around USD250 billion while the International Anti-Counterfeiting Coalition estimates the figure to be USD600 billion per annum as of 2015. Illicit trade, in different forms, is growing in scope and magnitude due to increased globalisation, free movement of goods and internet usage.²

According to the Economist Intelligence Unit³, Malaysia scored 71.8 out of 100 and ranked No. 6 in the Illicit Trade Environment Index 2016 of countries engaged in preventing illicit trade. The report is an acknowledgement of the efforts by the Malaysian government in taking measures to reduce illicit trade activities in Malaysia.

¹ World Health Organization. (2003). Part I: Introduction. WHO Framework Convention on Tobacco Control (p. 4). Geneva: World Health Organization.

² Mashiri, E., & Sebele-Mpofu, F.Y. (2015). Illicit trade, economic growth and the role of Customs: a literature review. World Customs Journal, 38-50.

³ The Economist Intelligence Unit. (2016). The Illicit Trade Environment Index. London: The Economist.

Studies on the illicit trade in Malaysia are rare. A paper on illicit trade in Penang lists five top smuggled commodities are: food and beverages, tobacco, non-electrical machinery and motor vehicles, firecrackers, and illegal VCD/DVDs.⁴ This paper analyses the factors behind illicit trade in Malaysia and provides policy recommendations to tackle this problem. It also examines the impacts of illicit trade on the economy and its significance on general welfare.



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⁴ Masron, T.A., Amir, A., & Ibrahim, H. (2011). Underground Economy in Malaysia: Evidence from Smuggling Activities in Penang. *International Journal of Current Research*, 107-110.

Why Illicit Trade Takes Place?

High Tax Burden

High taxes imposed by the government in its efforts to discourage demand for a particular product often encourages illegal trade in it. For example, in Malaysia, tobacco control is regulated under the Food Act of 1983 which restricts tobacco advertising, its promotion and sponsorship, and governs its packaging and labelling. The annual increase in excise duty on cigarette seen as a way to reduce the number of smokers has evidently failed as can be observed from Figure 1 and 2 below. Due to the population growth each year, the number of smokers is steadily actually increasing and reached as high as 5 million smokers in 2015 from 4.7 million in 2011. The efforts to discourage smoking via higher taxes have backfired as smokers turn to readily available contraband cigarettes.

Excise increase on cigarettes in Malaysia over the years

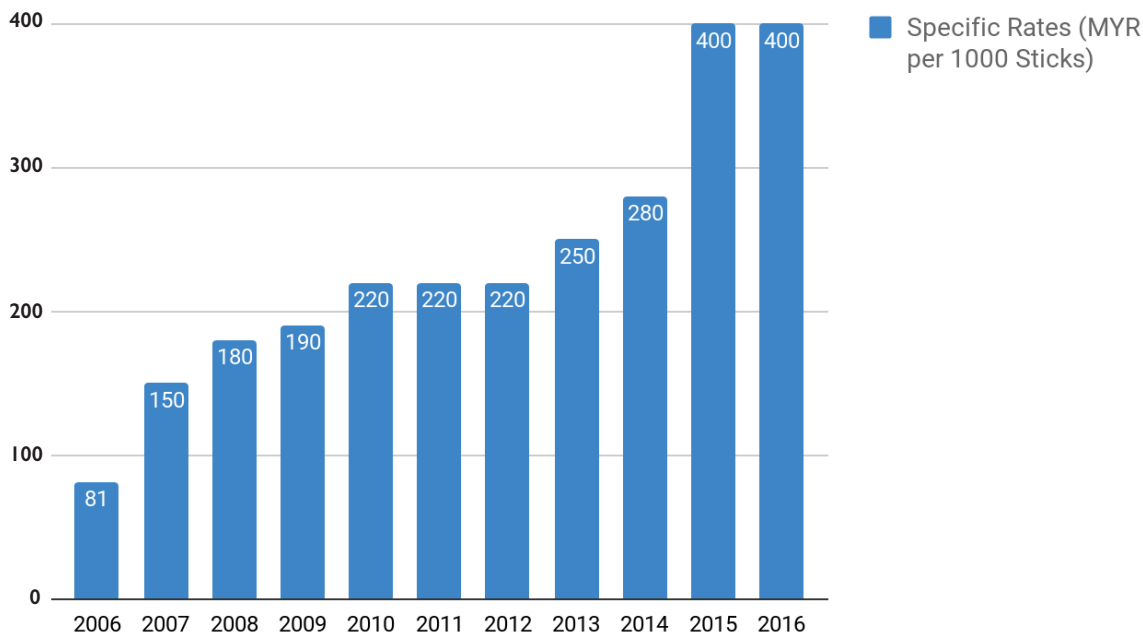


Figure 1: Excise duty increase on cigarettes in Malaysia between 2006 and 2016

Source: Policy IDEAS No.38. Malaysia's Tax System: Friend or Foe to Prosperity? Dan Mitchell

Prevalence of Smokers in Malaysia

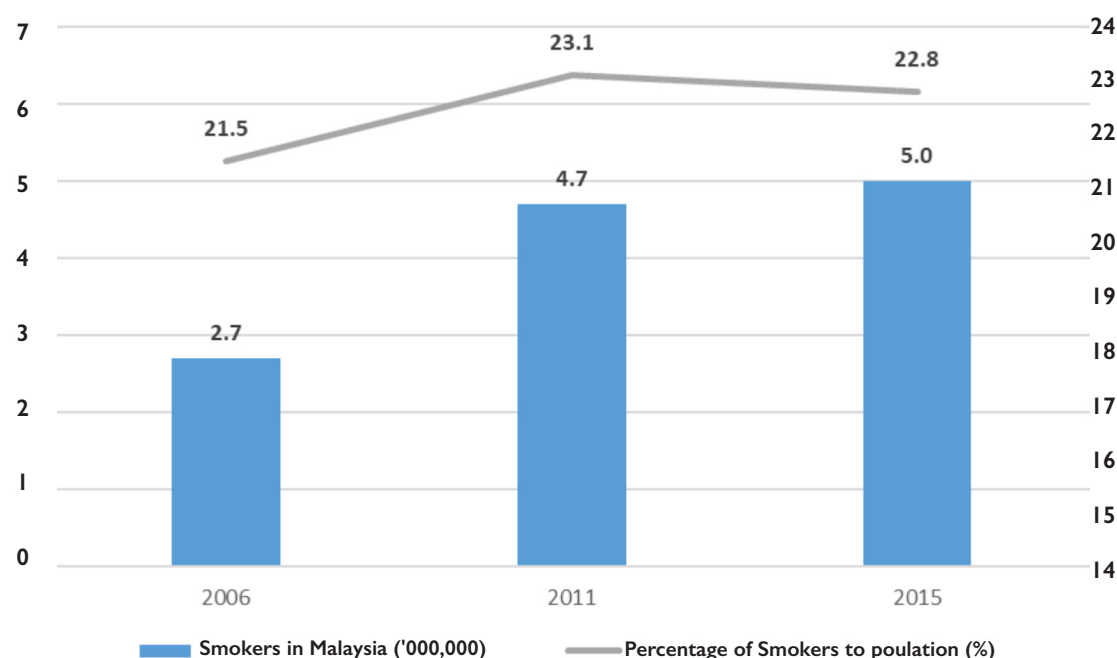


Figure 2: Prevalence of smokers in Malaysia in 2006, 2011 and 2015

Source: National Health and Morbidity Survey 2006, Global Adult Tobacco Survey 2011, National Health and Morbidity Survey 2015, Ministry of Health Malaysia

The increase in quantity of confiscated illicit cigarettes from 0.5 billion sticks in 2015 to 0.8 billion sticks in 2016⁵ indicate it is the most smuggled commodity in the country. A packet of contraband cigarettes 'retails' at RM3.50 per pack compared with RM17.00 per pack in the formal market. There is evidence that contraband cigarettes account for approximately to 57.1 % of cigarettes consumed in 2016.⁶ This would mean that 1 out of 2 packs of cigarettes sold are illegal, questioning the effectiveness of prevailing government's regulation to check the illegal market.

⁵ New Straits Times. (2017, May 14). Customs Department wages all-out war against illicit trade. Retrieved from New Straits Times: <https://www.nst.com.my/news/exclusive/2017/05/238994/customs-dept-wages-all-out-war-against-illicit-trade>

⁶ New Straits Times. (2017, May 14). 'It's an enforcement issue'. Retrieved from New Straits Times: <https://www.nst.com.my/news/exclusive/2017/05/238987/its-enforcement-issue>

Studies have attributed the illegal trade to high taxes, and which according to a 2015 report entitled “Tax: A Break on European Spirits Growth” by Spirits Europe, a trading body, failed to fulfil its purpose to generate revenues as well as reduce harmful effects of alcohol consumption. The restriction in fact, is an incentive for the black market to flourish. The fact that 70% of what European consumers pay when buying a bottle of spirit is tax, nevertheless has not had an effect on alcohol-related harm.

In Bihar, India, Chief Minister Nitish Kumar banned the sale of liquor in 2016 which ultimately resulted in the expansion of a black market trade in alcohol. On top of that, the alcohol prohibition has also led to a spike in substance abuse and drug addiction. Thus, a 2015 study in India reported that while criminalising alcohol sales may reduce domestic violence, the creation of black markets and alcohol substitution as a result of the ban could lead to an increase in mortality and socially undesirable outcome.⁷ It is a fact that the alcohol ban in India has not reduced the consumption of alcohol and this is due to lax enforcement and corruption by the authorities themselves. This lucrative industry will lure more illegal traders, hence, defeating the effectiveness of supply-side restrictions by the government.

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Data suggests a correlation between the size of the illegal market and the level of tax/excise burden as a portion of disposable income.
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⁷ Luca, D. L., Owens, E., & Sharma, G. (2015). The Effect of Alcohol Regulation on Violence against Women: Evidence from India. 11-50.

Weak Enforcement

Another critical factor that causes illicit trade to flourish is the lack of rigorous enforcement by the authorities. The customs authorities play a crucial role through its dual mandate of facilitating formal trade while also preventing illicit trade. The Malaysian Customs director-general Dato' Sri T. Subromaniam acknowledged that there had been enforcement gaps in combating smuggling and that harsher penalties need to be implemented to deter illegal traders from this unlawful activity.⁸

Lack of transparency and corruption at the borders are also among the issues associated with weak enforcement by the authorities. The weak rule of law motivates smuggling as it becomes more profitable to trade illegally when the expected costs such as the penalties imposed are small compared with expected profits.

The lack of transparency and efficient enforcement has earned Malaysia the blemished 4th spot as the biggest online piracy hub in the world.⁹ The International Federation of the Phonographic Industry (IFPI) believes it is incredibly hard to put the guilty party out of business as it would take about five years for the case to come to court at which time they end up just paying the fines from the profit gained. On top of that, pirate CD sellers admit to paying off the authorities in return for a fake raid favouring the offenders.¹⁰

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Nevertheless, Malaysia is doing relatively well compared with other ASEAN countries. Southeast Asian nations rank at bottom in the fight against illicit trade according to the illicit trade environment index.¹¹ The highly integrated Southeast Asia region makes it easier for businesses to obtain illegal products from neighbouring countries illegally. The United Nations Comtrade Database showed that the top two destination countries for smuggled cigarettes in Malaysia are Singapore and Indonesia with a share of 96.9% of total smuggled cigarettes in 2010.

⁸ New Straits Times. (2017, May 14). Customs Dept. wages all-out war against illicit trade. Retrieved from New Straits Times: <https://www.nst.com.my/news/exclusive/2017/05/238994/customs-dept-wages-all-out-war-against-illicit-trade>

⁹ GO-Globe.com. (2011, November 01). Online Piracy in Numbers - Facts and Statistics (Infographics). Retrieved from GO-Gulf: <https://www.go-gulf.com/blog/online-piracy/>

¹⁰ BBC News. (2002, August 26). Malaysia faces CD piracy fight. Retrieved from BBC News: <http://news.bbc.co.uk/2/hi/business/2217367.stm>

¹¹ The Economist Intelligence Unit. (2016). The Illicit Trade Environment Index. London: The Economist.

Unfriendly Business Regulations

For businesses, complex customs procedures, obtaining quality standards and certification translate into cost.

The Global Enabling Trade Report 2014 by World Economic Forum listed tariffs, burdensome import procedures, domestic technical requirements and standards as well as corruption at the border as the most problematic factors for Malaysia. Hence, the lower cost and high accessibility prompt businesses to indulge in illegal trading.



World Economic Forum: Tariffs, burdensome import procedures, domestic technical barriers and corruption at borders are most problematic factors in enabling trade in Malaysia.

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Enterprise Surveys by the World Bank Group in 2015 observed that in Malaysia, almost half of the companies surveyed expect to give gifts to officials in return for an import license.
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According to the World Bank Report¹², Malaysia's Ease of Doing Business 2017 ranking dropped by 53 ranks in terms of starting a business (See Figure 3). The starting a business indicator measures the number of procedures related to start and operate a company, number of days required to complete each procedure, costs required to complete each procedure in terms of percentage of income per capita, and paid-in minimum capital in terms of percentage of income per capita. Data from the report shows that business owners require 8 to 9 procedures which takes 18 to 19 days and costs 6.2% of income per capita.

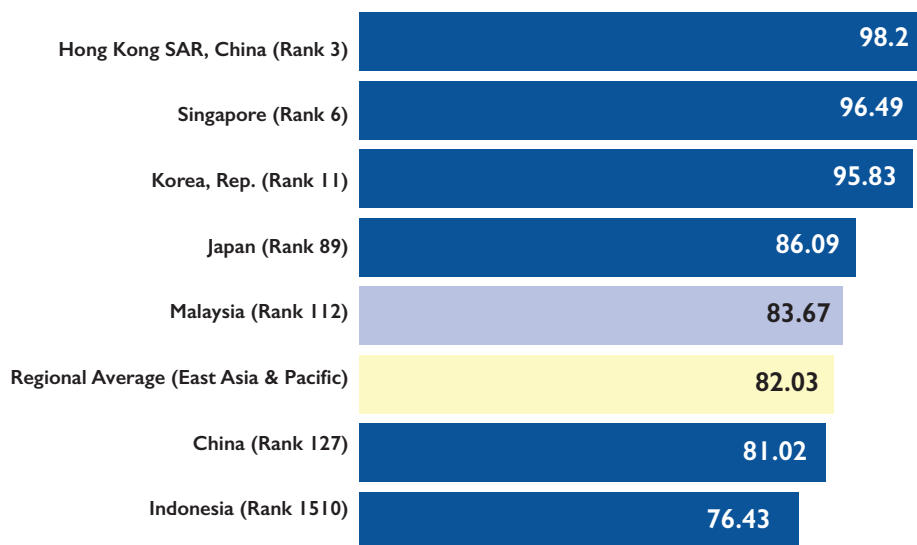


Figure 3: Ranking of Malaysia in Ease of Doing Business 2017

Source: Doing Business database

¹² <http://www.doingbusiness.org/data/exploreeconomies/malaysia>

Existence of Demand for Illicit Goods

Curbing supplies is usually the first knee-jerk reaction adopted by governments by way of law enforcement. However, curbing supply without tackling demand will only lure new suppliers into the black market because wherever there is a market, there are profits to be made and allow businesses to expand.

The existence of illicit trading in Malaysia proves that there is indeed a demand for smuggled goods. These markets are driven mostly by those in the low and middle-income category. The smaller the income, the higher the demand would be for inferior goods, in this case, smuggled products which are of an inferior quality such as cheap contraband alcohol, cigarettes and rice which are among the favourite commodities illicitly traded at the borders. Rice smuggled from neighbouring countries such as Thailand, Vietnam, Cambodia and Indonesia are not only cheaper but also of high quality such as the fragrant rice variety of Thailand which has high local demand in Malaysia.

Unemployment and the rising cost of living has also led to an increase in both demand and supply of illicit goods. Piracy in the film industry in Malaysia in 2016 alone recorded 120 million total number of BitTorrent movie and TV downloads.¹³ On top of that, the page views at pirated sites are 2.07 times higher than those at legitimate sites, and is a reflection of the demand for illegal entertainment. A study on the socio-economic influence of piracy found that higher per capita income correlates with lower piracy levels, with the highest piracy rates to be found in countries with the lowest incomes, and vice versa¹⁴. Hence, a combination of consumer demand, technical capacity and pricing strategy stimulate demand for pirated media, in developing markets like Malaysia.¹⁵

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¹³ Motion Picture Association. (2016). Malaysia's Piracy Landscape. Motion Picture Association. Retrieved from <http://www.mpa-i.org/wp-content/uploads/2017/07/Msia-Piracy-Landscape.pdf>

¹⁴ Bezmen, T.L. and C.A. Depken. 2006. "Influences on Software Piracy: Evidence from the various United States," *Economics Letters*, 90, 356-361.

¹⁵ Yar, M. (2005). *The global 'epidemic' of movie 'piracy': crime-wave or social construction?* Sage Publications.

Impact of Illicit Trade

Economic Cost

One of the main economic cost of illicit trade is its role in inhibiting fair and open markets from reaching their full economic potential. Businesses in the formal sector will be severely affected if illicit trade keeps increasing, causing their sales and revenue to be affected and possibly even lead to closures. Religiously observing the law can lead to higher costs which one operating illegally is able to avoid. Thus we observe how three of the largest multinational tobacco companies had shut down their operations in Malaysia due to the flourishing illicit tobacco trade in the country, which had already accounted for 57% share of the market share for cigarettes. The biggest pull factor for the thriving of illegal trade in cigarette is the cost; the ability of the illicit trade in tobacco to evade excise tax has led contraband cigarettes to be almost 5 times cheaper than their legal counterparts.

Media piracy is a form of illicit trade where creative content is illegally downloaded and circulated, with an attendant loss of millions of ringgit to the Malaysian entertainment industry. A study projected a 15% increase in box office if piracy is completely stamped out¹⁶ (See Figure 4). A local box office filmmaker once suffered loss of projected revenue of up to RM15 million due pirated DVDs before the movie was released. The movie when released officially only managed to earn RM5 million in revenue¹⁷. Therefore, it is not surprising that producers are reluctant to produce movies due to the flourishing of the illegal market.

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¹⁶ Ma, L., Montgomery, A. L., & Smith, M. D. (2016). The Dual Impact of Movie Piracy on Box-Office Revenue: Cannibalization and Promotion.

¹⁷ The Straits Times. (2013, October 3). Ready to hit back at piracy: Gangster 2 producer. Retrieved from Asia One: <http://www.asiaone.com/showbiz/ready-hit-back-piracy-gangster-2-producer>

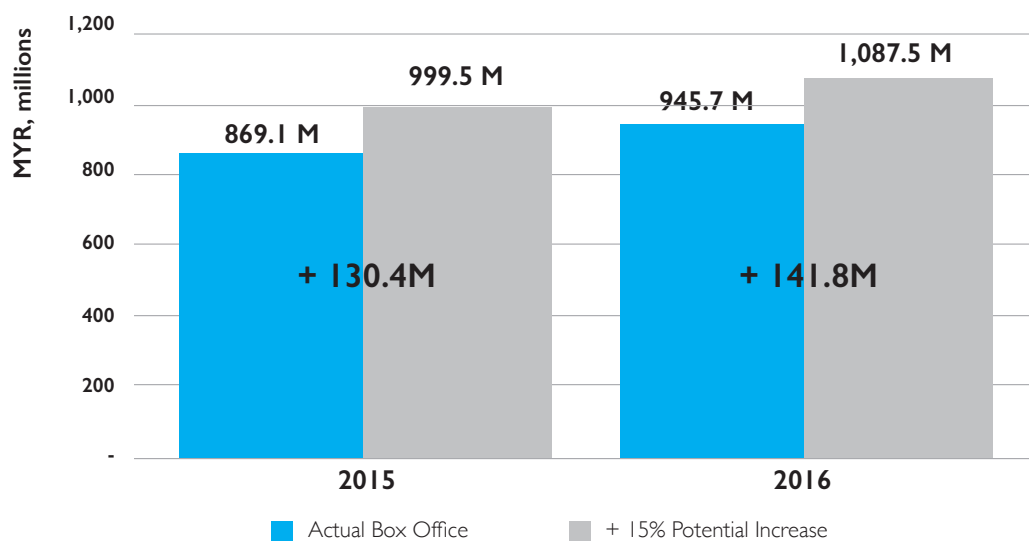


Figure 4: Increase in box office earnings if piracy is completely stamped out

Source: "The Dual Impact of Movie Piracy on Box-Office Revenue: Cannibalization and Promotion", Carnegie Mellon University, February 2016

Illicit trade or the black market also has impacts on government earnings, namely losses in tax revenue. According to a study¹⁸, the Penang government had lost approximately RM16 million in uncollected taxes due to illegal economic activities in the state in a single year. The estimated loss in tax revenue based on confiscated product was RM 9,120,153 for tobacco products, followed by food and beverages at RM 3,903,133, motor vehicles at RM 2,889,002, and non-electrical machinery at RM 362,771.

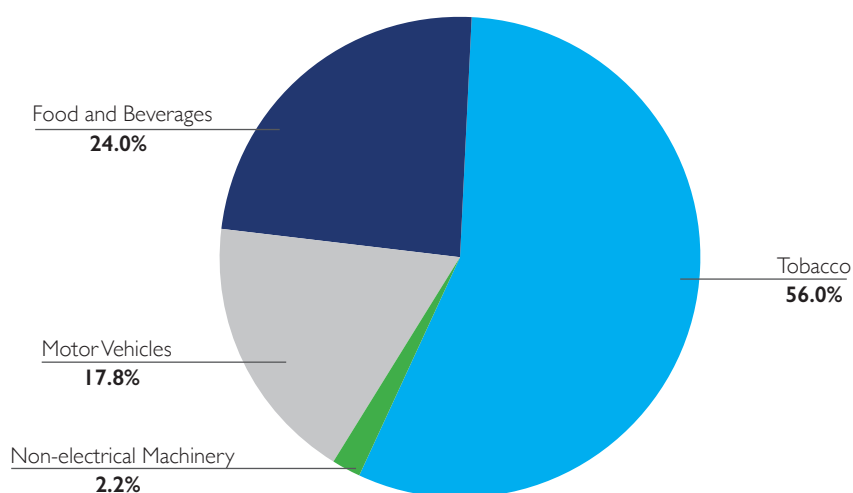


Figure 5: Estimated loss in revenue through confiscated product in Penang

Source: "Underground Economy in Malaysia: Evidence from Smuggling Activities in Penang", International Journal of Current Research, 2011

¹⁸ Masron, T.A., Amir, A., & Ibrahim, H. (2011). Underground Economy in Malaysia: Evidence from Smuggling Activities in Penang. International Journal of Current Research, 107-110.

Social Costs

The main social problem triggered by the illicit trade is unemployment, principally in the formal sector.¹⁹ A study on Internet piracy by a Paris-based consultancy in 2010 showed that 1.2 million jobs in European Union could have been lost if internet piracy was not curbed.²⁰ The licit market loses its competitiveness contributing to loss of jobs.²¹ It can be argued the presence of the illicit trade is the outcome of taxation and regulatory measures to reduce smoking in the country (see Figure 2).

The means of obtaining illicit commodities such as food items, cigarettes, alcohol and counterfeit branded products as well as illegal and dangerous goods such as drugs, exotic animals, small arms, human trafficking, human organs and fake medicines, forges close relations with crime syndicates or organised criminals.²² A vast network is required to facilitate the illegal movements of goods and services across countries and continents. Various reports and intelligence gathering show that illegal trade can be a significant and direct source of funding for terrorist groups.²³

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¹⁹ Mashiri, E., & Sebele-Mpofu, F.Y. (2015). Illicit trade, economic growth and the role of Customs: a literature review. *World Customs Journal*, 38-50.

²⁰ <https://www.reuters.com/article/us-eu-piracy/internet-piracy-taking-big-toll-on-jobs-idUSTRE62G3BU20100317>

²¹ The Edge Malaysia. (2017, May 22). The State of the Nation: A bad time to lose jobs. Retrieved from The Edge Markets: <http://www.theedgemarkets.com/article/state-nation-bad-time-lose-jobs>

²² Business Recorder. (2014, March 15). Funding crime thru illicit trade in cigarettes. Retrieved from Business Recorder:

²³ Interpol & United Nations. (2016). Strategic Report: Environment, Peace and Security - A Convergence of Threats. Interpol & UN

How to Combat Illicit Trade



High local taxes make the price of goods more expensive, thus, create a breeding ground for illicit trade. Hence, the government should review its taxation policies to stem illicit trade.



Price gap between legitimate and illicit products is a key factor fuelling the latter. It is therefore important for the government to impose market driven measures to reduce price gap and address the demand for cheap illicit products. The aim is to wipe out the black economy.



It is recommended that the government should set up a committee of policymakers representing different ministries. The aim is to have a public consultation with industry players to address the problem of black market.



The government should step up on its enforcement activities to prevent illegal trade and one way to achieve this is to increase the number of employees and provide them with necessary training and enforcement capabilities.



The relationship between the private sector and Malaysian Royal Customs Department needs to be improved. This can be done by establishing joint working groups with representatives from specific industries.



Product authentication is important to prevent fake or counterfeited goods. Technical solutions via holographic devices and colour-shift toners can detect these products.

Conclusion

Illicit trade is a threat to industries and the economy. Knowledge of the mechanisms and structure of the unauthorised trading, tactics of smugglers, consumer behaviour concerning illicit products and the financial impact on individual companies is still somewhat limited.

There is no 'silver bullet' solution to solve the problem of illicit trade. The answer lies in collaboration between different stakeholders such as the government, industries, supply chain operators, technology providers, and international organisations. Recent initiatives by Malaysia Royal Customs Department in combating illicit trade is commendable. Although there remains a lot to be done, it is nevertheless a step in the right direction.

This paper argues that the future flows of illicit trade will depend on holistic measures to address both demand and supply of illicit trade which include domestic tax reduction, increased supplies from the formal market, market driven measures to reduce the price gap between legitimate and illicit products and better enforcement.



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