Policy failure: the accomplice of illegal trade

Illegal timber trade is driven as much by national economic and policy failures as it is by the deeds of a much-maligned trade

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This article starts by examining some of the more common ways that illegal trade can be perpetrated. But its purpose is more ambitious than that: it sets out some of the underlying policy issues—many outside the forestry sector—that help create the conditions in which an illegal trade can flourish and argues that reforming these is equally important to strengthening forest policy and law enforcement.

Under-invoicing

Under-invoicing is a common way of increasing profit—illegally—in international trade. It may take the form of under-declared prices, under-declared volumes, mis-declared grades, or a combination of these. The overriding purpose is to avoid the high tax regimes in the exporting country and any restrictive foreign exchange regulations that may apply (in general, traders prefer be paid in hard, convertible currencies such as US dollars, pounds sterling, euro or yen).

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The seller and buyer will have previously agreed the price differential and/or to a re-measurement or re-grading of the product at the final destination. The difference between the true value of the contract and the value declared in the supply country can be shared—tax-free—outside the country.

Under-declared volumes

At first glance it might seem that timber would be a particularly difficult commodity to trade illegally, purely because of its size. In fact, the size and bulk of logs and other timber products often facilitates illegal practices because it is impractical for customs officials to check measurements and grades effectively.

The task of customs officials is further complicated by the inexactness of log volume measurement. Many log volume measurement systems are in use around the world and often even within the same country and the same log measured by different systems will give different volumes. For example, mid-girth measurement systems give consistently higher estimates of log volume compared to systems based on end-diameter.

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Another source of variation in log volumes derives from the so-called 'call-down' in girth, diameter and length. To facilitate the use of log volume tables it is common practice to call down the length (this could be to the nearest four, six or ten centimetres or even the nearest six inches) and to round down the diameter. The difference between the real and recorded log volume due to the rounding down of diameter alone can be as much 6–7% on an 85-cm diameter log. If the variation caused by the length call-down and the occasional sap allowance for some heavy sap species is added to this then the real volume and the *legal* declared volume could vary by as much as 35%. And this is before any under-declaration.

Similar difficulties are encountered with sawnwood measurement. Abuse by shippers of length, width and thickness over-measure or cutting tolerances offers an opportunity to under-declare sawnwood volumes.

Mis-declared grades/species

Price differences for different species or grades of the same product can be significant and this can be exploited in the under-invoicing of logs, sawnwood, veneer and plywood. For example, the difference in price between grade A and grade B mouldings is as much as US$150 per m^3. Since it is impossible for timber inspectors or customs officials to inspect all export shipments, under-declaring the grade of a packaged parcel of mouldings (for example) by an exporter is likely to go undetected. With the collusion of such officials, under-declaration or mis-declaration of grades or species is even easier.

Grade is even more subjective for logs than it is for processed timber products. Log grading rules have been established in many countries and there are well-respected international log grading rules but, for the unscrupulous trader, the opportunities for deliberate under-grading—on the understanding that the buyer will re-grade and pay on the results—are numerous. There is little risk in recording grade A logs as grade B because it is rarely feasible for inspectors to undertake a full re-grading exercise in a company log yard, log pond or at the export port. Additionally, it is possible for the unscrupulous trader to alter the composition of a log parcel. For example, the normal 40% grade A, 40% grade B and 20% grade C mix of logs that go into a FAQ parcel can be 'adjusted' and it would be very difficult for an inspector to spot the change.

Under-declared prices

Under-declaring price is a means by which additional payments can be received by exporters outside the country from which goods are exported to compensate for an artificially low price being declared on export documents. In this case the contract price between the buyer and seller is false and is below the real agreed price. The two parties share the difference in price outside the country of export after the goods arrive. This method of transferring value is most common in exporting countries where foreign exchange regulations are strict and taxes are high (see also 'transfer pricing' below).

Transfer pricing and costing

Transfer pricing is a profit-transfer and tax-avoiding practice commonly but not exclusively associated with multinational companies. A company in a country with high taxation, tough foreign exchange regulations and/or tough profit repatriation regulations, for example, sells a product to a subsidiary in a second country with a lower tax structure and records an artificially low price for the sale. By this means, revenues that should have been declared in the supply country are transferred to the subsidiary company and result in higher profits to the subsidiary.

Transfer costing is the loading of off-shore operational costs or management fees onto subsidiary companies in countries with high tax regimes or onto companies in producer countries which benefit from tax breaks offered by governments to encourage investment. This practice helps reduce apparent profit (or increase apparent loss) and therefore to maximise off-shore profits.

The question is, is transfer pricing or costing a legal (but ethically questionable) avoidance of laws in the supply country, or an illegal evasion of those laws? The answer can only be determined on a case-by-case basis after review of the laws in the respective countries.

Smuggling

Smuggling is a very old profession. In the timber sector it involves the secret export and/or import of wood products without notification to any authority in the exporting or importing country, without any legal documentation and without payment of any taxes or duties.

One might imagine that trying to smuggle a bulky product such as timber would be nearly impossible, but the loading and shipment of vessels with logs, sawnwood or plywood in remote parts of a country is perfectly feasible. Another form of smuggling occurs when species banned from export or those requiring special documentation such as CITES certification are included in bundles of otherwise legally produced and exported timber. Such banned or restricted species are often sufficiently valuable that smugglers are prepared to risk arrest to ship them out of the country. Smuggling involves an exporter, a shipping company to supply the vessel—or it can be done across land borders on trucks—and a buyer in the importing country. Often, it may also require the collusion, secured through bribes, of customs and other officials.

Of course, smuggling (or other forms of illegal trade) is not confined to the timber sector. For example, in July 1999 the Italian authorities were informed about a large quantity of Ecuadorean bananas that were being smuggled into the European Community through the Italian port of Catania. A customs team first searched and then seized a vessel carrying 4000 tons of bananas; later investigations revealed that some 160 000 tons of Ecuadorian bananas had been fraudulently imported into the Community.

A common thread

The illegal trade of timber is undoubtedly a significant impediment to sustainable forest management. However, while many are pointing fingers, few have come up with useful suggestions about what to do. The international community cannot hope to change the business ethics of rogue timber-men but it can help address the problem by tackling some key policy issues.

Many countries in which the illegal timber trade is thought to exist to the extent that achieving sustainable forest management is threatened appear to have some features in common that favour this trade. It's a long list *(see box)*.

What is important about this list is the implication that addressing fiscal, economic and institutional issues as part of a progressive industrial development policy can have a significant effect on reducing illegal trade. Traders in some countries currently see so little encouragement for fair-trading in government policies that they are tempted to cheat the system. By creating a fiscal and macroeconomic environment conducive to investment, the timber sector will be more confident that investments made in processing and forest management infrastructure and capacity will pay off. As investments are made, the trade gains a greater long-term stake both in ensuring access to the resource and in its sustainability. 'Weeding out' rogues and illegal practice then becomes a prerequisite for the sector's development.

Fiscal reform, therefore, is essential. At the same time, the basic groundwork to strengthen the institutions responsible for forest law enforcement and monitoring must still be done.

Ghana: a model

Ghana is one country in which economic and fiscal reforms have removed many of the conditions conducive to the illegal timber trade. Since 1983 the government's economic program has focused on the development of the private sector, which historically has been weak. Privatisation of state-owned enterprises continues, with about two-thirds of 300 enterprises sold to private owners.

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Other reforms adopted under the government's structural adjustment program include the elimination of exchange

Conditions favouring illegal trade

Fiscal

- inconsistent and/or frequently changing fiscal regulations;
- high export taxes/royalties etc;
- tough exchange controls;
- non-convertible currency;
- restrictive profit repatriation rules;
- high corporate tax levels;
- limited domestic credit sources;
- restrictive rules on the ability of banks to service international trade;
- high import duties on essential goods and services; and
- inappropriate policies on foreign exchange allocations.

Institutional

- weak marketing support, including a lack of grading rules etc;
- insufficient and under-trained forestry professionals;
- inadequate resources provided to the forestry administration;
- low wage levels for those monitoring the sector;
- lack of attention to institutional strengthening;
- inattention to production and trade statistics and market transparency; and
- lack of transparency in the sector (especially regards concession policy).

Political and economic immaturity

- an economy heavily dependent on timber exports;
- highly politicised forestry sector;
- politicians with timber business interests;
- corruption in high places; and
- corruption un-prosecuted or weakly punished.

rate controls and the lifting of virtually all restrictions on imports. The establishment of an interbank foreign exchange market has greatly expanded access to foreign exchange. The elimination of most local production subsidies is further indication of the government's intention to move toward a market-based economy. Over the years, Ghana's investment code has been changed to guarantee free transferability of dividends, loan repayments, licensing fees and the repatriation of capital; provide guarantees against expropriation or forced sale; and delineate dispute arbitration processes. At the same time, local banking and financial institutions have been encouraged by changes in industrial policy to be more supportive of trade development and access to foreign exchange and credit has improved. In addition, there has been an attendant emphasis on transparency in the forestry sector and, with ITTO and other assistance, the country has strengthened its ability to monitor and report on its timber trade.

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Trade needed

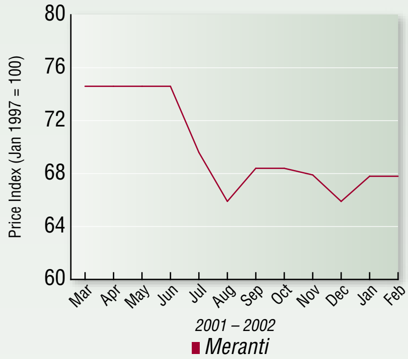
Trade is widely acknowledged as a vital engine for poverty-reducing growth. Evidence suggests that those countries that have strengthened links with the global economy through trade and investment have tended to grow faster. Unfortunately, in the last decade many low-income countries have lagged behind in trade growth and in the policies and institutions conducive to benefiting from the growth in global trade.

If sustainable and legal, the timber trade can make a significant contribution to local and national development objectives, so it should be fostered. As well as supporting institutional strengthening and law enforcement, the international community should therefore increase its support for national efforts to create the economic, fiscal and institutional environments needed for the trade to flourish. Given the right business environment, the trade will be in a better position to marginalise its rogues and to take steps to eradicate fraudulent practices.

Timber trends

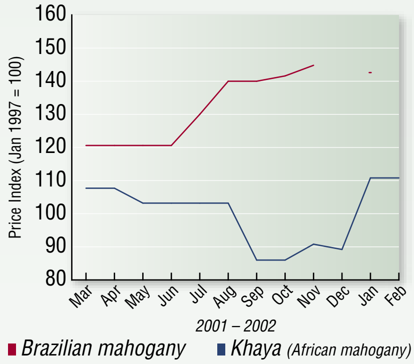
Saw point

Tropical sawnwood FOB price trends for Southeast Asian meranti *(12 months to February)*



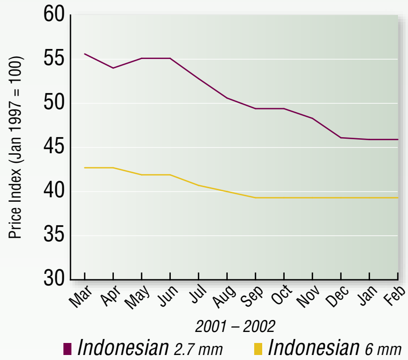
Mahogany moratorium

Tropical sawnwood FOB price trends for African and Brazilian mahogany *(12 months to February)*



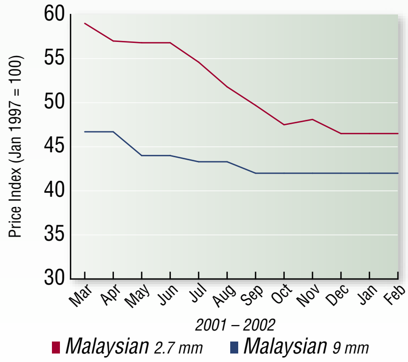
Flat as a board 1

Price trends for Indonesian plywood
(12 months to February)



Flat as a board 2

Price trends for Malaysian plywood
(12 months to February)



Source: ITTO Market Information Service; itto-mis@itto.or.jp