

The Illicit Trade in Tobacco Products and How to Tackle it

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The following is an overview of the content of a booklet published in 2011 by the International Tax and Investment Center (ITIC), a non-profit research and education foundation that provides information on best practices in taxation and investment policy.

The booklet is intended to inform policy makers and administrators in tax and enforcement organisations in less developed countries and help them improve efforts to combat the illicit trade in tobacco products. It brings together facts and views from respected academics, private sector consultants, journalists, international enforcement organisations, government revenue authorities and industry. It analyses the nature of the problem, its causes and consequences, and offers authorities best practice guidance on implementing anti-illicit trade strategies. Case studies are used to provide evidence of good practice and global efforts to tackle this serious problem.

The booklet was written by a former tax administrator in a style intended to make it accessible to those for whom English is not their first language.

The booklet includes a foreword by Kunio Mikuriya, the Secretary General of the World Customs Organization (WCO), and photographs and illustrations courtesy of the WCO, revenue and customs authorities and the industry. As a result of growing interest in the subject, the booklet has already been reprinted and translated into French, Arabic and Russian.

1. Definition and context

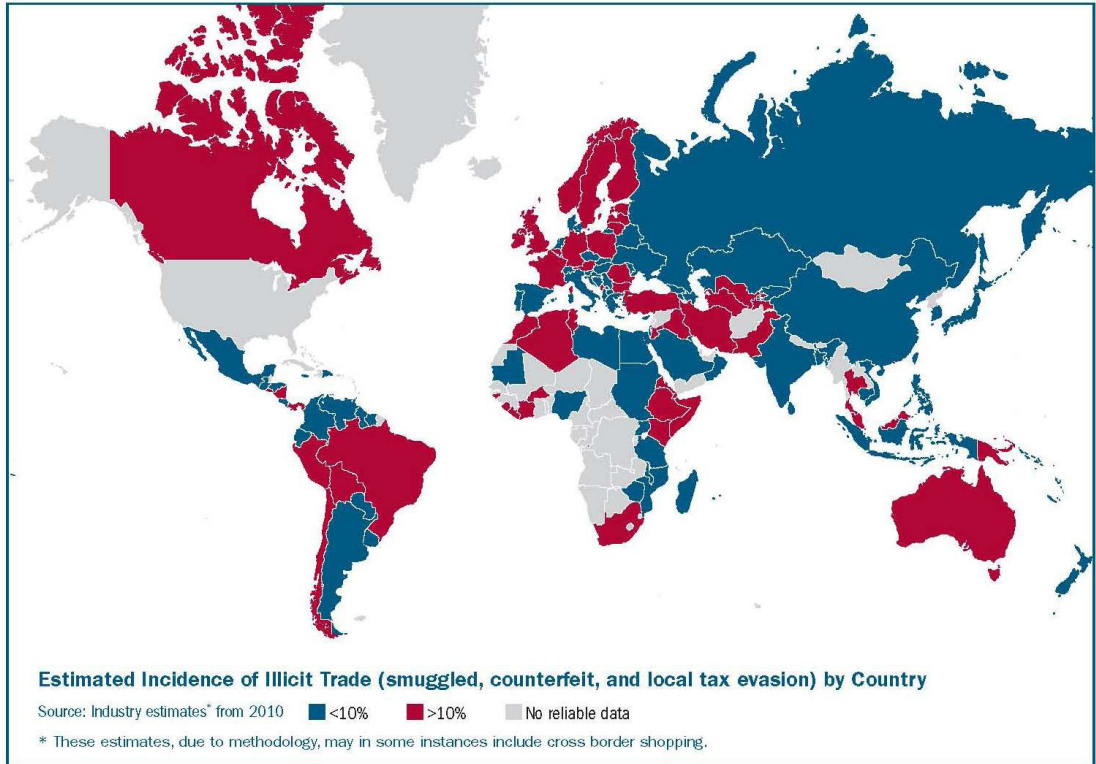
The illicit trade in tobacco products is defined in Article 1 of the World Health Organization's (WHO) Framework Convention on Tobacco Control (2003, p. 4) as 'any practice or conduct prohibited by law and which relates to production, shipment, receipt, possession, distribution, sale or purchase including any practice or conduct intended to facilitate such activity'.

Illicit trade manifests itself in three major and interrelated ways: smuggled, counterfeit and local tax evaded products. It is a global phenomenon, covering all continents and high and low income countries alike. Cigarettes, being highly taxed, easy to transport, and possessing a lucrative risk to reward ratio, are among the world's most illegally trafficked goods.

2. Size and nature of the trade

Despite the lack of robust global data, the overall consensus is that this worldwide illicit trade is unacceptably large and changes rapidly. Figure 1 shows the estimated global incidence of illicit trade in 2010.

Figure 1: Estimated global incidence of illicit trade in 2010



Source: Allen 2011, p. 6.

As countries, such as the United Kingdom (UK), have taken steps to tackle illicit trade in legitimate products there has been an explosive growth in ‘illicit white’ cigarettes made specifically for smuggling and in counterfeit cigarettes. Internet sites selling and shipping cigarettes worldwide in small quantities by post to evade taxation have proliferated. Shelley (2009, pp. 1-10) demonstrates that this trade has become a major security challenge around the world and is used increasingly to fund terrorism.

3. The impact of illicit trade in tobacco products

In addition to significant amounts of lost revenue in excise and value added or general sales tax, this illicit trade has a huge impact on the economic and social fabric of society. It obstructs economic development by legitimate manufacturers, suppliers and distributors. The Royal Canadian Mounted Police (2008, p. 17) report that this illicit trade in Canada resulted in a 30% revenue loss to convenience stores.

Illicitly traded tobacco products are outside the regulatory framework for strict health warnings, maximum tar/nicotine levels, and sales prohibition to minors. Campbell (2010) reports in The Guardian newspaper that ‘Counterfeit tobacco has also been found to contain arsenic, rat droppings and far more tar and

carbon monoxide than legal products'. Sincovich (2009) says that the World Customs Organization (WCO) receives reports of counterfeit cigarettes seizures containing mites and unprecedented methods of concealment posing serious health risks for law enforcement officers, for example, in barrels of titanium sponge containing toxic chlorine gas. Illicit cigarette sales focus on minors who cannot buy products legally and on those on low incomes. Illicit distributors also often supply other illicit products such as alcohol, drugs and firearms. Where there is a good distribution chain and a ready market for illicit products, the rule of law is undermined and corrupt practices thrive.

4. Drivers for this illicit trade

Illicit trade is demand and supply driven. Consumers want to buy cheap products and save money (demand); criminals want to take advantage of high taxes which they do not pay to make high profits with low risk of being caught and penalised. Contributory factors include unbalanced fiscal policies, disparities in tax-driven prices between neighbouring jurisdictions, protectionist policies, corruption, weak enforcement, porous borders, lack of official controls in free zones, poor transit controls, inadequate or out-of-date legislation and sanctions, growth in illegal distribution networks, and public tolerance.

5. How big is the threat? Is it really worth focusing on?

There is no robust estimate of global consumption of illicit tobacco products. Philip Morris International (2011), report the KPMG estimate that the counterfeit and contraband share of cigarette consumption in the European Union (EU) in 2010 reached almost 10% based on identical research methodology applied to each Member State. This estimate is accepted by the European Anti-Fraud Office (OLAF). The estimate of annual losses to national and EU revenues in 2010 amounts to about 10 billion Euros a year.

In the UK, HM Revenue and Customs (HMRC) (2011, pp. 25-6) estimates the size of illicit consumption of cigarettes as between 4% and 16% and of Hand Rolling Tobacco as between 41% and 50% of total UK consumption in 2009-10. According to the Tobacco Institute of South Africa (TISA), the incidence of illicit cigarettes in South Africa has almost doubled over the past three years and, in 2012, accounts for about 25% of the total cigarette market.

6. Measuring the trade

Several methodologies are in use. According to Cartwright and Stephens (2009), KPMG use the most sophisticated and expensive methodology in arriving at their annual estimates for the EU. This involves three primary sources of data: empty pack surveys; legal domestic sales; and consumer interviews with subsequent refinements to account for product flows between EU countries and into and out of the EU as a whole.

Data is cross referenced with all available alternative data sources, together with anecdotal observations of trends and developments by Customs and other experts involved in countering illicit trade. Seizure data may also provide good corroboration of results and is particularly useful to monitor trends and identify new routes, methods and players.

7. Combating the threat

All too often, the response of revenue, customs and other enforcement agencies is reactive, serving only to eliminate a small number of 'foot soldiers'. For tobacco smuggling, legal or counterfeit, organised by criminal or terrorist gangs, the response is to recruit replacements and, possibly, to change the

method, route or means of transport. Criminals do not have to worry about legislative compliance, seeking departmental expenditure approval or behaving in accordance with the requirements of publicly accountable bodies.

But, all is not lost. Some countries, for example, UK (HM Revenue and Customs and UK Border Agency 2011) and Hungary (ITIC, Nagy 2012) have reduced levels of illicit trade by adopting a strategic and comprehensive approach. Such an approach requires acknowledgment and understanding of the nature and extent of illicit trade combined with strong political will to tackle the multi-faceted threat. Then, adequate financial resources need to be made available, joint outcome-based targets set, and progress monitored and reported.

8. Key components of a comprehensive strategic response

As in any war, 'know your enemy'. This means understanding the size and changing nature of this trade, of which the main indicators are:

- unexplained fall in legal market sales – usually noticed first by manufacturers and retailers
- reduction in the government revenue flow
- increase in illegal product seizures – either in frequency or quantity
- emergence of brands not displaying correct markings or not legally distributed and sold in the country
- changes in anti-illicit trade survey results.

Results from robust sizing methodologies can raise awareness of authorities and public alike about the seriousness of the threat, influencing allocation of resources.

Next, identify and evaluate illicit trade facilitators. This means examining and addressing weaknesses in:

- tax and administration policies and processes
- import/export and transit policies and processes
- relevant health, labelling and contents requirements that increase opportunities for fraud
- enforcement capabilities and tools
- penalties and the use of compounded settlements
- public awareness/acceptance of the illicit trade.

9. A balanced tax policy and effective tax collection

Governments setting tax rates should take into account levels of economic development, the average consumer's purchasing power and tax rates in neighbouring countries. Experience shows that sudden tax hikes are likely to lead to emergence or growth of illicit trade (for example, in Ireland from 2001 to 2003 and 2006 to 2009).

Tobacco products can be addictive. Research for the Health Education Council by the National Network on Tobacco Prevention and Poverty (2004, p. 1) indicates that cigarette smoking among adults is associated with social disadvantage as defined by educational attainment, income and occupational class, that is, people most likely to have a low income. Tax or price increases or disposable income reduction can make the legal product unaffordable or inaccessible to addicted consumers, thus creating a market for illicit products.

10. Necessary revenue control techniques

Modern excise administrative systems are based on licensing/registration of all excise operators and their premises. Controls combine audit and physical techniques.

Audits examine overall credibility of declared business operations in comparison with components purchased, machinery usage, declared losses and financial transactions. Audit controls should include customs and VAT/sales tax declarations and, for complex multinational businesses, can include tracing financial transactions between related companies across continents. Physical controls provide essential checks that operations are conducted in line with legislation and accurate records kept of inputs, stocks and outputs. Physical inspections should be unpredictable and made 24/7 to detect any undeclared 'nightshift' production.

11. Supply chain controls

The challenge is to secure the legitimate supply chain, to detect illicit trade more easily. Some countries require paper tax stamps, others covert fiscal markers to help enforcement officials detect tax unpaid goods. However, even the most sophisticated paper tax stamps and markers are not secure against the threat of illicit product providing officials with a false sense of security and counterfeiters with another money-making opportunity. And, revenue officials have to control the paper tax stamps as well as the product. Paper stamps are vulnerable to theft and re-use by criminals.

A more robust approach to supply chain security is digital tax verification using advanced unique digital coding technology printed directly onto packs. It is cheaper to implement than paper tax stamps and the codes are easily readable by officials and consumers. This technology:

- serves as an authentication tool
- provides governments with secure real-time information about cigarettes produced in and for their country
- provides the most cost effective system
- is in line with e-government and e-customs initiatives.

But, it does require sufficient interventions at all stages of the supply chain to detect duplicate 'unique' numbers. Technology cannot solve illicit trade on its own. There will always need to be robust controls and sufficient interventions to check the validity of the codes. Otherwise, what will detect or deter criminals from copying a valid (but already used) code? Digital coding technology makes it easier and quicker for enforcement officials to detect copied codes.

There are a number of digital coding systems in development and in use in different industries to secure the supply chain of their products. There is a prospect of a multiplicity of systems with different formats and access facilities being put in place for the same product in different countries. This will make the work of customs officials and cooperation across borders more difficult. It will also add costs for industry and, thus, for consumers as well as, potentially, discriminating in favour of domestic products. Perhaps it is time for the development of agreed global standards for track and trace systems to facilitate the work of Customs, discourage protectionist policies and minimise additional costs for industry.

Controlling the supply chain should include retail sales. This responsibility often lies outside the revenue authority. It calls for a cross-government approach involving those who issue retail sales licences, control product labelling and enforce restrictions on sales to minors.

12. What about legislation?

To be effective, legislation must be clear, simple and easy for industry to understand and implement as well as cost-effective for revenue authorities. It must provide law enforcement with sufficient authority to act. In addition to administrative requirements (for example, registration of excise operators, their premises and operations and security needed), it must cover:

- clear offences and appropriate penalties
- systematic destruction of all seized illicit tobacco products, raw materials, manufacturing equipment and components
- means to recover tax revenue losses and costs for destruction of seized goods, for example, through asset confiscation
- effective authentication, tax payment validation and supply chain controls (that is, including manufacturing, wholesale and retail licensing and security markings)
- information exchange about ‘suspect’ movements with other appropriate national and international authorities
- strong protection measures for brand owners against International Property Rights violations.

Legislation should stop governments from selling seized items related directly to the manufacture or sale of tobacco products including counterfeit and contraband cigarettes, manufacturing equipment, tobacco and non-tobacco raw materials.

13. The judicial process

This must deal with cases quickly, effectively and cheaply. If there is to be any real preventive effect, penalties must deter.

14. Is effective enforcement the real answer?

Although a key weapon, an effective multi-faceted targeted enforcement strategy is not the total solution.

Effective enforcement requires skilled resources and tools, with officials:

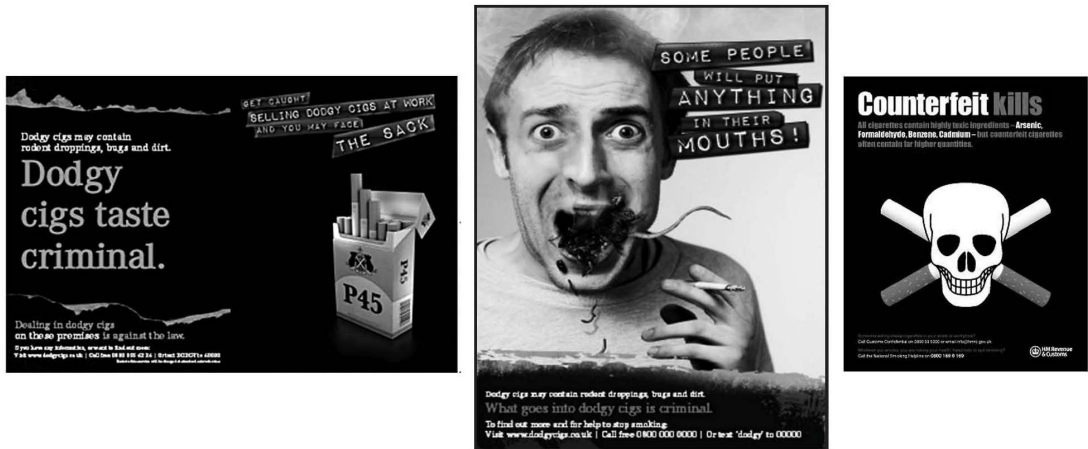
- skilled in audit and investigative techniques
- able to use IT tools and analyse data sources
- able to adopt a credibility approach to declarations.

Leadership, management, appropriate remuneration, ethics training and robust enforcement of an anti-corruption policy can help to counter a culture of corruption.

15. Tackle demand as well as supply

As long as there are willing customers for illicit products, criminals will continue their trade. Revenue, enforcement, health and trade authorities must deliver joined-up, consistent and continuing education and awareness targeting areas of low income. Examples of public awareness advertisements in the UK are shown in Figure 2.

Figure 2: Examples of public awareness advertisements in the UK



Source: Allen 2011, p. 24.

16. Legitimate industry can and do help

The EU has legally binding cooperation agreements with the four major tobacco companies. Details of these are available on www.europa.eu.

Several countries have voluntary Memoranda of Understanding (MOUs) with the Tobacco Industry. Key elements covered are information sharing and assistance in:

- assessing and measuring levels and sources of illicit trade
- exchange of data
- proactively responding
- monitoring movements of (suspected) ingredients, equipment and finished illicit tobacco products
- analysis and destruction of seized goods.

Some revenue authorities, for example, in South Africa, now work with legitimate trade to counter illicit trade providing channels for communication of intelligence and making use of industry resources for counterfeit product awareness training.

17. International cooperation

Highly sophisticated international criminal networks use complex routes and ingenious methods to move illicit goods, making international cooperation in the investigation, arrest and prosecution of offenders essential. Some international and regional organisations (for example, WCO, OLAF and Interpol) and customs authorities (for example, UK and USA) have liaison resources across the world. These work with local enforcement authorities and tobacco manufacturers to detect criminal activities.

18. The World Health Organization (WHO) Framework Convention on Tobacco Control

The World Health Organization (WHO) Framework Convention on Tobacco Control (FCTC) was adopted by the WHO in 2003, entered into force in 2005, and has now been signed by 174 governments. Subsequently, a Protocol has been in development aimed at curbing illicit trade in tobacco products.

This will be binding on signatories only when enabled into national law. The three main elements of the Protocol are supply chain security, offences and enforcement, and international cooperation.

The supply chain security envisaged requires a tracking and tracing regime for all legitimate products. 'Tracking' is the ability to monitor the forward movement of finished goods through the supply chain; 'tracing' is the ability to determine where the product was diverted into illegal channels.

The FCTC has important implications for revenue and enforcement authorities in signatory countries. Health departments have led negotiations in many countries and it is vital that those who must administer and control the new requirements are involved in determining how and when they are introduced.

19. Conclusions

However stringent the requirements on legitimate trade may be, one thing remains certain. As long as the illicit trade in tobacco products provides high profits at low risk and there is a ready market of consumers, criminals will find a way to continue their trade.

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Since retiring from HMRC, Elizabeth has chaired an international conference on illicit trade in tobacco products, authored two tax guidance booklets, made presentations on excise tax administration at international conferences and delivered training on tax administration and change management. She recently led a review of illicit trade in alcohol and tobacco products across the Southern African Development Community. She has also led reviews of 'High Risk' UK Government change programs.

