From cigarette smuggling to illicit tobacco trade

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ABSTRACT

Background Tax policy is considered the most effective strategy to reduce tobacco consumption and prevalence. Tax avoidance and tax evasion therefore undermine the effectiveness of tax policies and result in less revenue for governments, cheaper prices for smokers and increased tobacco use. Tobacco smuggling and illicit tobacco trade have probably always existed, since tobacco's introduction as a valuable product from the New World, but the nature of the trade has changed.
Methods This article clarifies definitions, reviews the key issues related to illicit trade, describes the different ways taxes are circumvented and looks at the size of the problem, its changing nature and its causes. The difficulties of data collection and research are discussed. Finally, we look at the policy options to combat illicit trade and the negotiations for a WHO Framework Convention on Tobacco Control (FCTC) protocol on illicit tobacco trade.
Results Twenty years ago the main type of illicit trade was large-scale cigarette smuggling of well known cigarette brands. A change occurred as some major international tobacco companies in Europe and the Americas reviewed their export practices due to tax regulations, investigations and lawsuits by the authorities. Other types of illicit trade emerged such as illegal manufacturing, including counterfeiting and the emergence of new cigarette brands, produced in a rather open manner at well known locations, which are only or mainly intended for the illegal market of another country.
Conclusions The global scope and multifaceted nature of the illicit tobacco trade requires a coordinated international response, so a strong protocol to the FCTC is essential. The illicit tobacco trade is a global problem which needs a global solution.

INTRODUCTION

Tax policy is considered the most effective strategy to reduce tobacco consumption and prevalence.[1] Tax avoidance and tax evasion therefore undermine the effectiveness of tax policies and result in less revenue for governments, cheaper prices for smokers and increased tobacco use.[2 3] Tobacco smuggling and illicit tobacco trade have probably always existed since tobacco's introduction as a valuable product from the New World, but the nature of the trade has changed. This article clarifies definitions (table 1), reviews the key issues related to illicit trade and describes the different ways taxes are circumvented, the size of the problem and its changing nature, the difficulties of data collection and research, the causes of illicit trade, the policy options to combat illicit trade and the negotiations for a WHO Framework Convention on Tobacco Control (FCTC) protocol on illicit tobacco trade.

Clarification of definitions

Tax avoidance is, for instance the purchasing in lower tax jurisdictions of tobacco products by individual tobacco users residing in high tax jurisdictions for their own consumption, within customs constraints. In the European Union, one-third of EU citizens who made a trip in 2008 to another EU country brought home lower-priced cigarettes.[4] In cases where the cigarettes are bought within the European Union for the use of the traveller or his/her family and transported by himself/herself[5] this buying behaviour is legal and can be defined as tax avoidance, otherwise it is illegal (if eg, the cigarettes are resold). This article does not deal with legal activities to pay less or no taxes, only with tax evasion and illicit tobacco trade.

Tax evasion includes the purchase of smuggled and illicitly manufactured tobacco products. The most common term in this context is smuggling. However, smuggling, tax evasion and illicit trade do not cover the same type of activities. Smuggling is one type of illicit trade. The illegal crossing of borders between jurisdictions is a key characteristic of smuggling (see table 1).

Illicit trade is a much broader concept than smuggling and is defined in Article 1 of the WHO FCTC.[6] Illicit trade includes smuggled and illicit manufactured tobacco products. Illegally manufactured products can be sold on the domestic market or smuggled into another jurisdiction. In their communication on illicit trade, the tobacco industry often highlights the importance of counterfeit tobacco production, which is one form of illicit manufacturing. Public health experts would argue that most smuggled and illicit manufactured products undermine tax policies and lead to cheaper products and more sales.

THE CHANGING NATURE: FROM SMUGGLING TO ILLICIT TRADE

The main type of illicit trade 20 years ago was large-scale cigarette smuggling: containers of cigarettes were exported, legally and duty unpaid, to countries where they had no market, and where they then disappeared into the contraband market. In Canada, for example, the key to smuggling at the beginning of the 1990s was the export by Canadian manufacturers of Canadian cigarettes to New York State (where there is no market for them as US smokers mainly smoke US brands), from where they were smuggled back into Canada.[7] Similar large-scale smuggling operations take place in other regions of the world, such as Europe,[8] Hong Kong[9] and Brazil.[10] Most smuggled cigarettes were well known brands that got 'mysteriously lost' during their international transport under the transit regime. To encourage trade between countries, a so-called transit system operates that temporarily

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Table 1 Definitions

Term	Definition
Tax avoidance	Legal activities to pay less tax or no taxes
Tax evasion	Illegal activities to pay less tax or no taxes
Smuggling	The illegal trading of products across borders
Illicit trade	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[6]
Illicit manufacturing	The production of tobacco products contrary to law
Counterfeit production	Production of manufactured products which bear a trademark without the consent of the owner of the trademark
Free zone	A part of the territory of a Contracting Party where any goods introduced are generally regarded, insofar as import duties and taxes are concerned, as being outside the Customs territory.[42]

suspends custom duties, excise and VAT payable on goods originating in country A and bound for country B while they are in transit through other countries. However many cigarettes simply fail to arrive at their destination, having been bought and sold by unofficial traders.[11] Billions of cigarettes were legally produced and exported but would never appear in official import statistics because they were smuggled into their final market (not country B).

The gap between global exports and global imports, which was 42% in 1996,[12] was used to estimate the overall quantity of smuggled cigarettes.[13 14] World cigarette production was fairly well known, and since large quantities of cigarettes are not stored because they do not keep for long, world production was likely to be close to world consumption.[13 14] Global imports should thus be close to global exports, after allowing for legitimate trade usually excluded from national statistics. (These are principally imports for duty free sales to travellers, diplomatic staff and military establishments.)

However, imports have long been lower than exports to an extent that cannot be explained by legitimate duty free sales. US Department of Agriculture (USDA) worldwide data showed that recorded cigarette exports exceeded recorded imports by more than 300 billion in the period 1995–2000, one-third of global exports.[12] Although a cautious approach is needed for the interpretation of the USDA data, the most plausible explanation for these missing cigarettes is smuggling.[13 14]

More recent USDA statistics from the beginning of the millennium show that the gap between recorded cigarette imports and exports has been reduced to around 150 billion cigarettes annually, or <20% of global exports.[15] The reduction probably does not reflect a drop in the illicit trade, but is more likely due to the changing nature of the illicit cigarette trade.[16]

The reduction of the gap between exports and imports occurred as some major international tobacco companies in Europe and the US reviewed their export practices because of tax regulations, and investigations and lawsuits by the authorities. American manufacturers changed their export practices such that cigarette exports from the US to Belgium (a transit country) fell from 49 billion in 1997 to 3 billion in 2001.[17] Brazilian manufacturers reduced their exports by 89% as result of a 150% increase in export tax in 1999[10] and British companies decreased their exports to 'phantom' markets such as Moldova, Latvia, Kaliningrad, Afghanistan and Andorra at the beginning of the millennium.[17]

In Europe and the Americas, while large-scale smuggling of well known brands decreased, other types of illicit trade emerged. In Paraguay, a whole range of legal and semilegal small manufacturers were targeting the illegal market in the MERCOSUR countries (mainly Brazil).[18] On the US/Canada border, illicit manufacturers in the Native American (First Nations) reserves fuelled the illicit market in those countries,[19] and counterfeit cigarette manufacturers, mainly from China, were targeting Europe and Asia.[20] The size of the counterfeit market might be overestimated as customs officials often rely on the industry to determine whether cigarettes are counterfeit or not and as the industry has an incentive to classify seized cigarettes as counterfeit.

Another type of illicit manufacturing is undeclared production. In 2008 the big international tobacco companies manufactured and imported into the Ukraine nearly 130 billion cigarettes: 30% in excess of what the local market can consume. These 'extra' cigarettes disappear in the Ukraine and fuel the black market in the rest of Europe.[21] Undeclared production is a major problem in many regions[22] and is often due to inadequate control of manufacturing by the authorities. The nature of illicit manufacturing means that the trade is not registered in the official export or import data.

Besides illegal manufacturing, another change in the illicit trade was the emergence of new cigarette brands, produced in a rather open manner at well known locations, which are only (or mainly) intended for the illegal market of another country. As manufacture is apparently in accordance with national legislation and not or minimally subject to national controls, the manufacturers can buy sophisticated machinery without risk of confiscation. Under these conditions a certain standard of quality in the production process can be achieved. Not counterfeiting international brands gives the advantage of avoiding legal action by the international cigarette companies.

The best known brand of this category in Europe is Jin Ling, a cigarette brand with a Chinese name, manufactured in Russia, in appearance in accordance with Russian domestic law, with the look and the taste of an American blend (Camel) but destined for the illegal market in the EU. Jin Ling rapidly became one of the most seized cigarette brands in the European Union.[23] Jin Ling is produced in the Free Zone of Kaliningrad and profits from the Free Zone regime, which generally is characterised by a relief from Customs duties, formalities and procedures[24 25] Jin Ling is traded outside the control of customs and materials for the production of cigarettes are imported without the payment of customs duties. They are produced according to domestic requirements but illegally imported into the European Union and thus not registered in official import statistics. 'Cheap whites' is the tobacco industry term for such cigarette brands, and is a term that is also used in some international enforcement agencies reports.[26 27] The European Commission uses the term 'illicit whites', which are defined as 'brands manufactured legitimately in one market, either taxed for local consumption or untaxed for export, and sold knowingly to traders who transport them to another country where the products are sold illegally without domestic duty paid'.[28]

In Taiwan a similar phenomenon has been observed. In order to avoid problems with trademarks and investigations of the multinational tobacco companies, smugglers no longer copy (counterfeit) international brands, but create their own brands such as 'Mo-Shen', 'Fu-qi' (good fortune) and 'Shan' (the Chinese fir), to suit the needs of illicit buyers in Taiwan.[29]

In Africa counterfeit cigarettes and 'illicit whites' have become more prominent in recent years in the illicit market. Libyan 'illicit whites' (where an estimated 80% of cigarettes consumed are illegal) are produced in Luxembourg and Bulgaria and imported

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through Dubai to Togo and Benin.[26] Most smokers in Africa cannot afford more expensive international brands but are eager to buy new brands at a low price.[26] The production of 'illicit whites' is not limited to Europe: another source country for 'illicit whites' for instance is the United Arab Emirates, like in Russia manufactured in a Free Zone, outside the control of customs.[27]

HOW BIG IS THE ILLICIT CIGARETTE TRADE?

Measuring the illicit cigarette trade is methodologically challenging for many reasons. It is an illegal activity, and illegal traders are unlikely to record their activity as legal traders do. For security reasons data on illicit trade is usually difficult to collect, as law enforcement agencies often prefer not publicise the scope of their activity. All methods to estimate illicit trade have their limitations and not all studies clearly describe their methodology or their limitations. Also, the data source may bias the estimate. For example, tobacco industry experts may have an incentive to exaggerate the smuggling problem in order to lobby for reduced taxation of the product, while public health advocates may have an incentive to understate the size of the smuggling problem in order to argue for tax increases. In 2009 we collected data on estimates of illicit market share based on academic articles, official government publications, estimates from market research companies, tobacco trade journal articles, newspaper articles and sometimes estimates from personal contacts in customs organisations. They vary greatly in their rigour. Some, for example, express the size of the illicit market as a percentage but without defining what it is a percentage of. Nor is there a clearly defined methodology for assessing if an estimate is accurate. It has to look reasonable in terms of the country's population, smoking prevalence, legal infrastructure and so on. Thus a combination of methods (including informed expert judgement), and when possible sources, is often necessary to cross validate estimates.[30] The International Agency For Research On Cancer (IARC) handbooks *Methods for Evaluating Tobacco Control Policies*[16] and *Tobacco Taxation*[31] describe the different methods to measure illicit trade.

Bearing in mind these considerations, we updated estimates of the illicit cigarette trade from 84 countries around the world using the latest available estimates from 2007. Our analysis showed that 11.6% of cigarette consumption in these countries is illicit, 16.8% in low-income countries, 11.8% in middle-income countries, 12.7% in low-income and middle-income countries combined and 9.8% in high-income countries, and that the total annual illicit consumption in these 84 countries is about 657 billion cigarettes a year, 533 billion in low-income and middle-income countries and 124 billion in high-income countries.[30]

THE CAUSES OF ILLICIT TOBACCO TRADE

Illicit trade is the outcome of classic demand and supply: demand by smokers for cheaper or specific tobacco products, which are perceived as better quality and not available on the domestic market, and supply by legal and illegal tobacco manufacturers looking for more profit, more sales, increasing market shares or to penetrate new markets, facilitated by corruption, the presence of criminal networks and weak government enforcement capacity.

Smokers' use of illicit tobacco is related to price and availability.[32] The demand for illicit tobacco products is strongly influenced by reduced price, often 30% to 50% cheaper than legal products.[30]

Supplying the illicit market is attractive to companies and traders because of the low cost of manufacturing, as low as 5 US cents a pack in Paraguay,[18] and to the potential gains of selling without tax.

Evading tax by diverting tobacco products into the illicit market (where sales are largely tax free) generates a considerable profit margin for illicit traders. Organised smugglers can buy a container of Jin Ling cigarettes in Russia (on which they pay no taxes) for US$100 000.[23] The value of such a container in the EU is on average US$2 million, an enormous profit margin. In the UK the potential profit is as much as three times higher.[33]

It is crucial to note however that the solution to this problem is not to lower tax levels, as the tobacco industry frequently claims. The tobacco industry has claimed that high taxes drive smuggling[14] and has sometimes argued successfully to governments that they should not increase tobacco tax because this will increase the level of smuggling. The argument is that smugglers will smuggle into a country where they can make the highest profit, and that these are the countries where tax is a high proportion of the price, leaving a large margin to reduce the price (by evading tax) and still retain a profit. In fact the overall level of smuggling is generally higher in countries that have lower cigarette prices (generally also countries also with a lower tax rate) than in countries that have high prices. Although a high tax margin may provide the initial incentive to smuggle, the data show that it is not the only factor. Other important factors include the ease and cost of operating in a country, industry participation, how well organised crime networks are, the likelihood of being caught, the punishment if caught, corruption levels and so on.[34]

While illicit trade is an outcome of demand and supply, the tobacco industry has consistently focused on the demand side to explain the illicit trade and argues that illicit trade arises because of high taxation. Analyses by the World Bank have shown that high levels of illicit tobacco products are linked more closely to corruption and tolerance of contraband sales.[35] The global trade in illicit tobacco products occurs in low tax as well as high tax jurisdictions, results from a lack of control on cigarette manufacturing and the movement of cigarettes across international borders, and is run by criminal organisations with sophisticated systems for distributing smuggled cigarettes. Illicit trade is more common in low-income than in high-income countries.[30] Research in Central and Eastern Africa suggests that cigarette smuggling in this region is not caused by difference in tax levels but more by weak state capacity, high levels of corruption and the activities of rebel groups. Although cigarette prices in those countries are low (60 US cents per pack for the most popular brand), the easy evasion of taxation fuels the smuggling by traders and explains the high levels of smuggling in these low-income countries.[36]

POLICIES TO COMBAT THE ILLICIT TRADE

Sweeting and colleagues[37] conducted an extensive review of the effectiveness of policy measures to combat illicit cigarette trade. The authors identified four types of illicit trade:

1. Legal products, illegally distributed at national level (for example, the legal production of leaf tobacco and its sale to users who do not pay taxes in Australia).[38]
2. Legal products, illegally distributed across borders (for example, legal manufactured cigarettes in Europe destined for the illegal market in Africa).[26]
3. Illegal products destined for the domestic market (for example, undeclared cigarette manufacturing destined for the illegal domestic market in Brazil).[18]
4. Illegal products destined for a cross border market (for example, illicit manufactured cigarettes in China destined for the illegal market in Europe).[20]

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According to the authors, the type of illicit trade and means of distribution influence the effectiveness of different policies and the unintended consequences of action. For example, policy measures that were effective in the 1990s for legally manufactured cigarettes smuggled across borders are less effective for the illicitly manufactured and counterfeit cigarettes that dominate contraband activity today in many countries.

Case studies described by Sweeting and colleagues indicate that while illicit trade sources often emerge domestically, given the ease of transport and manufacture, sources can be easily displaced to neighbouring or overseas jurisdictions. Interagency cooperation (domestic and international) emerges as a vital component of all successful anticontraband strategies. The dynamic nature of illicit trade supply requires a comprehensive approach that focuses on immediate and future threats. Policies designed to ensure that contraband tobacco products do not appear in the legitimate retail sector (such as tax-paid markings, licensing, record keeping) and measures to ensure that counterfeit products are easily identified (such as enhanced taxation stamps) are vital. Adequate investment in enforcement is also essential to the success of anti-illicit trade measures. Given the global scope of the phenomenon greater international cooperation and information sharing is absolutely critical.[37] More case studies can be found in a forthcoming IARC Handbook on tobacco taxation.[31]

A central theme in the research findings is the multifaceted nature of successful anti-illicit trade tobacco policies, which require combinations of regulation, fiscal/taxation policy, enforcement and public awareness campaigns.

NEGOTIATIONS FOR AN FCTC PROTOCOL ON ILLICIT TOBACCO TRADE

The report *The Globalization of Crime: A Transnational Organized Crime Threat Assessment* by the United Nations Office on Drugs and Crime looks at major trafficking of products such as illicit drugs (cocaine and heroin), firearms, counterfeit products and stolen natural resources. The issues described in this report are similar to those in the illicit tobacco trade.[39] One of the main conclusions of the United Nations Office on Drugs and Crime report is that because transnational organised crime markets are global in scale, strategies to address them should also be global. The report outlines principles to combat transnational organised crime, which also apply to tackle the illicit tobacco trade: the global scope and multifaceted nature of the illicit tobacco trade requires a coordinated international response. The FCTC illicit tobacco trade protocol is the global response of the global tobacco control community.

More than 160 Parties to the FCTC met four times between 2008 and 2010 to negotiate an international treaty to combat the illicit trade in tobacco products. The illicit trade treaty is being negotiated as a supplementary treaty, or protocol, to the FCTC. Article 15 of the FCTC states that the Convention should deal with all forms of illicit trade in tobacco products, including smuggling, illicit manufacturing and counterfeiting. An overview of the status of negotiations on each article of the draft protocol can be found in a report of the Chair in 2010.[40] The fifth meeting of the International Negotiating Body on the Protocol, INB5, starts in Geneva in March 2012.

Enforceable measures to control the supply chain and international cooperative measures, including information sharing and cooperation in the investigation and prosecution of offences, should be at the heart of the FCTC protocol on illicit tobacco trade. These measures should facilitate investigations into smuggling operations and make the industry liable for controlling the supply chain.

The FCTC Protocol should introduce measures including:

- Licensing all participants in the tobacco business.
- Tracking and tracing systems from the points of manufacture to all points of sale, which would help identify the point of diversion from the legal to the illicit market.
- Traceable methods of payment.
- Control of Free Zones.
- Strict scrutiny procedures in the selection of contractors during the supply process ensuring, for example, that they are all genuine companies with real addresses, and employees do not have any criminal record.
- Significant financial penalties for infringements.

An important challenge is the large difference in technical capacity between customs and enforcement authorities in different regions of the world. Technical assistance to low-income countries will be necessary for a successful implementation of the protocol at global level.

In the near future it might be necessary to monitor the import and export of raw tobacco and materials (such as cigarette papers and filters) globally in order to control illicit manufacturing, including undeclared production and manufacturers of cheap whites.

DISCUSSION

Transparent, public data on illicit tobacco is limited and, in many countries, non-existent. One major recommendation which Sweeting and colleagues made was to make statistics and information regarding the tobacco trade and illicit tobacco much more available to the public, in order to evaluate the effectiveness of the policies to combat contraband.[37]

Illicit tobacco is a serious concern. The best available data suggest that globally one out of nine cigarettes (11.6%) is illicit.[30] This figure could increase as the production costs for a pack of cigarettes can be as low as 5 US cents a pack and the price with tax still provides a large profit in low-income countries (for example, 60 US cents a pack in Central Africa), and a potentially huge profit in countries such as Norway where the price is US$16.[41]

Illicit tobacco undermines the effectiveness of tax policies, leads to over US$40 billion in lost revenue globally, and increases the availability of cheap cigarettes thus increasing consumption and tobacco related deaths in the future.[30]

If the global illicit trade were eliminated, governments would gain at least US$31 billion in income and from 2030 onwards over 160 000 lives a year would be saved. The experience of the last 20 years has taught us that eliminating illicit trade is difficult: success in combating one type of illicit trade often leads to a new type emerging.[30 31 37]

Case studies around the world[31 37] show that a combination of measures such as international cooperation, legislative measures to control the supply chain and more investment in enforcement and dissuasive penalties can lead to positive results in tackling large-scale smuggling. The only real option for international cooperation is the Framework Convention on Tobacco Control.

The FCTC protocol on illicit tobacco trade, which is now being negotiated, is likely to be effective in 8–10 years time, taking into account time for adoption (possibly 2012), time for ratification by the parties (possibly 2014–2015) and time for implementation (possibly 2019–2020). Thus decisions taken in 2012 are needed to resolve problems in 2020. A protocol might

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What this paper adds

- This work is an updated review of key issues related to illicit tobacco trade, including policies to combat it, such as the WHO Framework Convention on Tobacco Control protocol on illicit tobacco trade.
- This work provides a description of the changing nature of illicit tobacco trade during the last 20 years, from large-scale smuggling of well known brands to illegal manufacturing, counterfeiting and the development of cigarette brands made for smuggling.
- This work also provides a description of illicit trade as the outcome of classic demand and supply: demand by smokers for cheaper or specific tobacco products, which are perceived as better quality and not available on the domestic market, and supply by legal and illegal tobacco manufacturers looking for more profit, more sales, increasing market shares or to penetrate new markets, facilitated by corruption, the presence of criminal networks and weak government enforcement capacity.

lead to more control of the legal trade (licensing, record keeping, due diligence, tracing etc.), enhance international cooperation and facilitate investigations. Illicit tobacco trade is a global problem that needs a global solution.

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