

Illicit trade in tobacco

Scale of the problem

A 2009 study for the US organisation “Campaign for Tobacco-Free Kids” estimated that 11.6% of all internationally traded cigarettes were illicit, equivalent to 657 billion cigarettes a year, causing losses to government revenue worldwide of US\$40.5 billion.¹ Euromonitor International estimated the level of illicit trade at 11.2% in 2013 (excluding China).²

Illicit tobacco reduces the public health impact of tobacco tax rises and increases demand for tobacco products.

In the UK, during the 1990’s illicit tobacco rose to a very high level: Customs & Excise (now HM Revenue and Customs) (mid-range) estimates were that in 2000 21% of cigarettes in the UK market were illicit and 63% of hand rolled tobacco was illicit.³ However, following co-ordinated enforcement action in the UK and at European level, the level of illicit trade in the UK has subsequently fallen sharply. HM Revenue & Customs (mid-range) estimates for 2015/16 were that 13% of cigarettes in the UK market were illicit, and 32% of hand-rolled tobacco in the UK market were illicit. The tobacco tax gap is made up of the illicit markets in cigarettes and hand-rolling tobacco and was estimated to be £2.4 billion in 2015-16. Of this £1.9 billion was lost in tobacco duties and a further £0.5 billion in VAT. The cigarette tax gap was estimated to be £1.6 billion and the hand-rolling tobacco tax gap was estimated to be £0.8 billion.⁴ Meanwhile, tobacco tax revenues have stabilised at around £9.5 billion a year.⁵

The tobacco industry routinely uses the threat of illicit trade in lobbying against tobacco control measures, including rises in taxation and the introduction of standardised “plain” packaging. Its publications focus on counterfeit tobacco products, rather than other forms of illicit trade described in the next section. Independent analyses suggest that tobacco industry funded surveys and studies such as Philip Morris International’s Project Star overestimate levels of illicit tobacco compared to UK Government data as a result of flawed methodology.^{6,7,8}

Different types of illicit trade

In relation to tobacco products, “illicit trade” can cover a wide range of activities. Key categories include:

- a. **Smuggling.** This covers the unlawful movement of tobacco products from one jurisdiction to another, without applicable tax being paid. Therefore, smuggling may involve the movement of otherwise lawfully manufactured tobacco products, as for example when cigarettes are “diverted” from their stated target market to another. A special category of tobacco smuggling involves **Cheap/Illicit Whites**: cigarettes are lawfully produced in one country, with tax often paid in that country, but are intended for smuggling into countries with higher tax rates. “Cheap whites” commonly have brand names and pack designs, but the brands produced have no lawful market in the destination country.
- b. **Counterfeiting.** This covers the illegal manufacturing of an apparently lawful and well-known product, with apparent “trademarks”, but without the owners’ consent. As might be expected, tax is rarely, if ever, paid on such products.

- c. **Bootlegging.** This covers cases where tobacco products are legally bought in one country and then transported to another with a higher tax rate, in amounts beyond those reasonable for personal use.
- d. **Illegal Manufacturing.** This covers cases where tobacco products are manufactured without declaration to the relevant authorities. In some cases, they may be manufactured in approved factories, unrecorded and/or produced out of normal hours; in others they will be manufactured in unlawful covert operations

Relation between tobacco prices and illicit trade

The UK has high levels of tobacco taxation, since high prices are known to be the most effective policy instrument to encourage smokers to quit. In the absence of effective counter-measures, high prices could provide an incentive to engage in the illicit tobacco trade. However, the difference between the cost of manufacture of illicit tobacco products and the price at which they can be sold in specific markets is not the sole, or even primary, driver of illicit trade. Other relevant factors include the ease with which products can be smuggled into the target country, the law enforcement resources in a country available to fight illicit trade, the extent to which there is an integrated strategy on enforcement in that country, and the level of corruption. These can be considered as additional non-monetary “costs” to smugglers, and a key purpose of action against illicit trade by government and public agencies is to increase these costs and hence reduce the incentive to smuggle.

The table below shows that in 2007 the proportion of tobacco consumption that was illicit was higher in low income than in high income countries – despite the fact that the price of legal cigarettes was much lower in such countries.¹

Relation between Legal Price and Illicit Trade in 2007

World Bank Income Group	Average Legal Price (\$)	Average percentage of illicit consumption
Low Income	1.13	16.8%
Middle Income	1.89	11.8%
High Income	4.91	9.8%

Action to tackle illicit trade

In March 2000, the UK Government announced a package of measures designed to curb illicit trade.⁹ These included: the deployment of 1000 additional Customs officers; additional specialist investigators and intelligence staff; additional x-ray scanners; tougher sanctions and penalties; and a public awareness campaign. In 2000, HM Customs and Excise, as it then was, together with the Treasury, launched an action plan “Tackling Illicit Tobacco Smuggling” which was updated in 2006,¹⁰ 2008,¹¹ 2011,¹² and 2015 (a joint strategy of HMRC and Border Force).¹³

In 2006 the strategy was reinforced by supply chain legislation, making it a legal duty for manufacturers not to facilitate smuggling, with fines of up to £5 million if they fail to comply. In 2008 the Government announced that the UK Border Agency and HM Revenue & Customs would work together on a new strategy to tackle smuggling.¹¹ While HMRC retained overall responsibility for the collection and enforcement of tobacco duties and for the detection and disruption of illicit tobacco inland, the UK Border Agency is responsible for detecting and seizing smuggled tobacco at the UK border and for arresting those suspected of tobacco smuggling. The two agencies share responsibility for reducing revenue losses.

In April 2011 HMRC and the UK Border Agency launched a new plan to tackle tobacco smuggling, building on the 2008 strategy. Key elements of the plan included: increasing criminal intelligence and investigation resources deployed on tobacco fraud by 20% to prosecute

more of those involved in smuggling at all levels; introducing new technology, intelligence and detection capability; pursuing proceeds of crime and applying new powers of assessment and penalties; and reducing the minimum indicative levels for personal imports to 800 cigarettes and 1 kg hand-rolling tobacco, bringing the UK into line with all other EU Member States.

The effectiveness of the UK Government actions against illicit trade has been reviewed in reports from the National Audit Office in June 2013;¹⁴ the House of Commons Public Accounts Committee in September 2013;¹⁵ and the House of Commons Home Affairs Select Committee in June 2014.¹⁶ All these reports recognised progress since 2000, but recommended that more needed to be done to tackle illicit trade. For example, the Home Affairs Select Committee expressed concern that the number of convictions in organised crime cases involving illicit tobacco had fallen in recent years (from 78 in 2011/12 to 37 in 2012/13). It also stated that: *“It is astonishing that no UK tobacco manufacturer has ever been fined for over-supply of products to high-risk overseas markets, and that only one statutory warning letter has been issued. The penalties available are too weak and enforcement too rare.”* The House of Commons Public Accounts Committee, and National Audit Office reported that total spending on HMRC’s tobacco strategy fell between 2011/12 and 2012/13, from £68.9 million in 2011/12 to £67.4 million in 2012-13, although spending on enforcement is highly cost-effective because of its impact in reducing illicit trade and increasing receipts from tobacco taxation.

In March 2015, the Government issued a progress report and updated strategy, with a medium-term objective to hold the cigarette illicit market share at or below 10 per cent and to contain the illicit market share for hand-rolling tobacco and reverse the recent upward trend.¹⁷ The latest HMRC tax gap estimates suggest that the first of these objectives has not been met.

Eu legal agreements with the tobacco industry

Action against illicit trade has been further strengthened by legally-binding agreements between the European Union and all the major multi-national tobacco companies: Philip Morris International, Japan Tobacco International, BAT and Imperial Tobacco. These agreements arose out of a lawsuit filed by the European Commission against the companies over the smuggling of cigarettes into the European Union. Philip Morris International (PMI) was the first company to enter an agreement with the EU in 2004 in return for the European Commission dropping the legal action.¹⁸ The agreement required the company to approve contractors and provide customs with online information so that Customs could directly trace back any PMI smuggled cigarettes to the purchaser who originally bought them from PMI. Japan Tobacco International signed a similar agreement in 2007¹⁹ while BAT and Imperial Tobacco signed agreements in 2010.²⁰ The UK Government is a party to the binding agreements.²¹ On 6 July 2016, the European Commission announced that it would not renew the agreement with PMI beyond its original expiry date of 9 July 2016.²²

Despite the EU legal agreements, there is continuing evidence of possible tobacco industry involvement in illicit trade. For example, cigarette smuggling to and through Bulgaria continued after the deals reached with the European Union,²³ and Japan Tobacco International (JTI) has been under investigation by the European Anti-Fraud Agency, OLAF, following evidence that its involvement in smuggling, with Russia and the Middle East as hubs, continued until at least 2010.²⁴ In March 2014, it was reported that what was previously regarded as an “illicit white” brand, Classic, was in fact an Imperial tobacco brand produced in its Ukraine factory.^{25,26}

Illicit Trade Protocol

Because the illicit trade is a global problem, concerted action at the international level is also required. The United Kingdom took a leading part, through the European Union, in negotiations under the World Health Organization Framework Convention on Tobacco Control, in the development of an Illicit Trade Protocol, which was adopted at the fifth FCTC Conference of the

Parties in November 2012. The Protocol includes requirements for: overt and covert marking of tobacco products so that they can be tracked from manufacturer to point of sale; obligations on manufacturers to control the supply chain of their own goods; licensing of participants within the supply chain to ensure that they can be monitored effectively and have their licences revoked if they are found to be dealing in illicit products. The Protocol also includes measures to improve co-operation between Parties on investigation and prosecution of offences, information sharing and mutual legal assistance.²⁷ A cost benefit analysis of implementing the Protocol suggested that it could reduce smuggling in the UK by up to 80%, save 760 lives a year and be worth £5.7bn to the UK in net present values.²⁸

Revised EU Tobacco Products Directive

In May 2016, the revised European Union Tobacco Products Directive (2014/40/EU) entered into force.²⁹ This includes a requirement that EU member states must introduce an EU wide tracking and tracing system for tobacco products, based on a “unique identifier” placed on every packet, such as an alphanumeric code.

Standardised packaging and illicit trade

The most commonly employed tobacco industry argument against the introduction of standardised (“plain”) packaging of cigarettes and other tobacco products is that it would lead to an increase in illicit trade. However, the key security features on existing packaging that help identify illicit products will also be present on standardised packaging, specifically:

- a covert mark on each licit pack, which can be read by enforcement authorities using a simple scanner to determine whether or not a pack is counterfeit
- other security marks that vary between manufacturers, for example the configuration of marks on filter paper
- number codes printed on each pack, which will be developed and standardised through the introduction of the tracking and tracing system mandated under Article 8 of the Illicit Trade Protocol.

Under the regulations on standardised packaging, which were approved by the UK Government on 16th March 2015, the Secretary of State has the power to require any features in pack design which the Government considers desirable as a protection against illicit trade. Tobacco industry claims that illicit trade has increased in Australia as a result of the introduction of standardised packaging in December 2012 have been dismissed by the Australia Government³⁰ and a large national cross-sectional survey of smokers found no evidence of an increase in use of illicit tobacco post implementation of standardised packaging.³¹

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