

The Illicit Trade in Tobacco Products and How to Tackle It



Second Edition



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The purpose of this publication is to serve as a resource guide and best practices reference for tax, customs, and law enforcement officials to improve their efforts to combat the illicit trade in tobacco products.

ITIC received supplemental contributions from tobacco companies to help underwrite the cost of this publication. However, ITIC retained full editorial control and takes full responsibility for the content and any errors or omissions.

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The Illicit Trade in Tobacco Products and How to Tackle It, Second Edition

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Introduction



Given the strong demand around the world for the first edition of *The Illicit Trade in Tobacco Products and How to Tackle It*, ITIC is pleased to be publishing a second edition. Over 7,000 copies in five languages of the first edition have been distributed. The second edition of this *guidebook* includes new data and information on the recent developments relating to combating illicit trade in tobacco products, including key issues for governments to consider when implementing the Protocol to Eliminate Illicit Trade in Tobacco Products (ITP).

Since our founding in 1993, ITIC has worked on excise taxes, which if designed and implemented correctly, can be a stable and predictable source of government revenues. However, we quickly learned that illicit trade of excisable products, most notably cigarettes, resulted in large budget losses for many governments. Therefore, we expanded ITIC's programs to focus on the tax, customs, and law enforcement elements of excise taxation. Early on, we recognized that there was an "appetite" by policymakers to learn more about the practical elements of tax administration and enforcement. In 2009, ITIC joined with the World Customs Organization (WCO) to organize an interdisciplinary conference integrating all aspects (tax, customs, law enforcement, and health) on how to best fight the illicit trade of cigarettes.

The purpose of the 2009 conference, and the subsequent publications, including this new edition of our *guidebook*, is to raise the awareness and understanding of the growing problem of illicit trade in tobacco products, and to share best practices on how to effectively combat it.

We hope that this booklet will serve as an effective educational resource to contribute to the fight against the illicit trade in tobacco products and the increase of budget revenues around the world. We hope it can make a positive impact in your country.

Daniel A. Witt

President, International Tax and Investment Center

Foreword



We live in an extremely fast moving world where global trade is fundamental to the way we live and to our economic development and prosperity. Customs play a significant part in ensuring that global trade conforms to international requirements and that the taxes due are paid to governments to fund public services. Where goods are highly taxed and easily portable criminals, terrorists and insurgents will take advantage of any weaknesses in customs and revenue controls to amass profits. They do not care whether laws are flouted, consumers' health is damaged, governments lose revenues or legitimate

businesses lose trade.

Challenges associated with the illicit trade in tobacco products are becoming more complex. Successful law enforcement interdiction efforts have prompted perpetrators to develop ever more sophisticated smuggling techniques. Customs all over the world have witnessed growth in illicit trade of tobacco products over recent years. Governments are facing increasingly well-networked and organized traffickers whose activities are harder to detect and disrupt. Consequently, we need to step up our efforts to tackle the problem.

New ideas, questioning, forward planning, learning from others and greater collaboration across enforcement agencies, other national agencies and with the legitimate trade will enable us to modernize and optimize the use of the expensive and scarce resources in tackling the illicit tobacco trade. We need to make governments and the public aware of the implications of illicit trade and gain their full support. An innovative approach, creating and building on partnerships will enable us to transform our efforts and achieve significant reductions both in illicit trade and the number of criminals who benefit from it.

This publication builds on the successful first edition of the ITIC publication, *The Illicit Trade in Tobacco Products and How to Tackle It* in 2011 with new material reflecting the ever-changing world we live in. It brings together principles and good practice from across the world which I hope will lead to improved partnerships and working practices.

Kunio Mikuriya

Secretary General, World Customs Organization

Executive Summary

The second edition of this publication aims to raise awareness of the growing and evolving nature of the illicit trade in tobacco products. It is a compilation of facts and views from a wide range of sources, including respected academics, private sector consultants, journalists, international enforcement organizations, government revenue authorities and industry. It defines the different aspects of illicit trade and provides information on ways of measuring its size. It analyzes the nature of the problem, its causes and consequences, and offers authorities best practice guidance on implementing anti-illicit trade strategies. Examples and case studies are used to provide evidence of good practice and global efforts to tackle this serious problem.¹

What is the Illicit Trade in Tobacco Products?

Illicit trade manifests itself in two major ways: illicit imports and illicit domestic production. Illicit imports include counterfeit and genuine products, and increasingly, “cheap” or “illicit whites.” These are brands produced legally in one country specifically for smuggling into another country where they have no legal market. Studies and experience show that the illicit trade in tobacco products is a global phenomenon, covering all continents, including high and low income countries alike. Cigarettes, being highly taxed, easy to transport, and possessing a lucrative risk to reward ratio, are among the most illegally trafficked goods in the world. According to Euromonitor International, “*Illicit trade in cigarettes is the biggest illegal trade in a legal product in terms of value and second only to illegal drugs in terms of revenue generated by smugglers.*”²

Size and Measurement

The overall consensus is that the global illicit trade in tobacco products is unacceptably large. Data published by Euromonitor International for 2012 suggest that one in ten cigarettes smoked around the world is illegal, representing about 600 billion cigarettes

a year and resulting in annual government revenue losses of between US\$40–\$50 billion.

Most governments do not attempt to measure the problem on a regular basis and remain unaware of the many negative effects the illicit tobacco trade can have on their economy and society. Without a robust means of measuring the extent of the problem, it is difficult for authorities to assess the effectiveness of strategies to combat it.

Global Nature and Dynamics

In recent years, the dynamics of illicit trade have evolved rapidly and present a continuous challenge for policymakers and enforcers. The explosive growth in “illicit white” cigarettes, made specifically for smuggling, has continued worldwide. There has been an expansion in distribution networks used by criminal organizations for the illicit trade in a wide range of products including tobacco and narcotics as well as human trafficking. Criminologists, enforcement authorities, and the Organisation for Economic Co-operation and Development (OECD) report that illicit trade in tobacco products has become a major security challenge in different environments around the world and is used increasingly to fund terrorism.³

The Impact on Society

Illicit trade has a huge impact on the economic and social fabric of society. In addition to the lost revenue which undermines the tax base of economies, it obstructs economic development, undermines government health policy objectives such as youth access prevention and the rule of law. It supports corrupt practices, funds organized crime and terrorism and encourages the expansion of criminal activity. It undermines investment in manufacturing, innovation, trade and distribution by legitimate industry and negatively impacts employment. Societies where illicit cigarettes make up a significant proportion of total consumption, are seeing

growing normalization of illicit products. This is especially true in areas of economic deprivation. Some believe that increasing taxation on tobacco products is the most effective method of reducing consumption. But tax hikes frequently lead to legitimate and taxed tobacco consumption being substituted by illicit and untaxed product, which is more affordable to the smoker.

Causes and Facilitators

The primary drivers for this illicit trade are twofold:

- Consumers to save money; and
- Criminals to make money.

Factors contributing to the problem include:

- An unbalanced fiscal policy with a high tax burden on tobacco products;
- Disparities in tax driven prices between jurisdictions;
- Protectionist policy measures;
- Corruption;
- Weak enforcement;
- Lack of robust official controls in free trade zones and on goods in transit;
- Inadequate legislation and sanctions;
- Affordability by those on low incomes;
- Growth in illegal distribution networks; and
- Public tolerance of the illicit trade in tobacco products.

How to Combat the Problem

In developing comprehensive anti-illicit trade policies, governments need to pay particular attention to the involvement and effective coordination of all relevant government agencies (e.g. Customs, Police, Ministries of Finance, Health, Justice, Trade and local authorities) to ensure alignment and commitment to achieving the same goals. In addition, enforcement authorities need to be allocated adequate resources and encouraged to work closely with the other domestic stakeholders to combat the problem.

Exchange of information with authorities in other countries and international enforcement organizations must be the norm. At the same time, legislation should be based on balanced policies with deterrent penalties administered by an efficient functioning judiciary. Public awareness needs to be strengthened and citizens must be provided with information on the implications of purchasing illicit products, such as unwittingly supporting organized crime and terrorism.

Article 15 of the FCTC Protocol to Eliminate Illicit Trade in Tobacco Products (ITP)⁴

The critical importance of tackling the illicit tobacco trade on a global scale is recognized in the WHO FCTC whose governing body negotiated an Illicit Trade Protocol with over 170 governments. The new Protocol introduces more detailed binding obligations aimed at curbing the illicit trade in tobacco products. In particular, it sets out international guidance for national action on supply chain security, offenses and enforcement and international cooperation.

1. What is the Illicit Trade in Tobacco Products?

1.1 Main Forms of Illicit Trade in Tobacco Products

The illicit trade in tobacco products is defined in Article 1 of the WHO FCTC 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.”⁵

The illicit trade in cigarettes and other tobacco products takes two main forms:

- **Illicit imports – known as “Smuggled” or “Contraband”:** the unlawful movement of tobacco products (genuine, counterfeit or “illicit whites”) from one tax jurisdiction to another without the payment of applicable taxes or in breach of laws prohibiting its import or export; and
- **Illicit domestic production:** tobacco products manufactured for consumption in the same jurisdiction, which are not declared to the tax authorities. These products are sold without tax and may be manufactured in approved factories or as part of illegal covert operations. They may be genuine products or counterfeit.

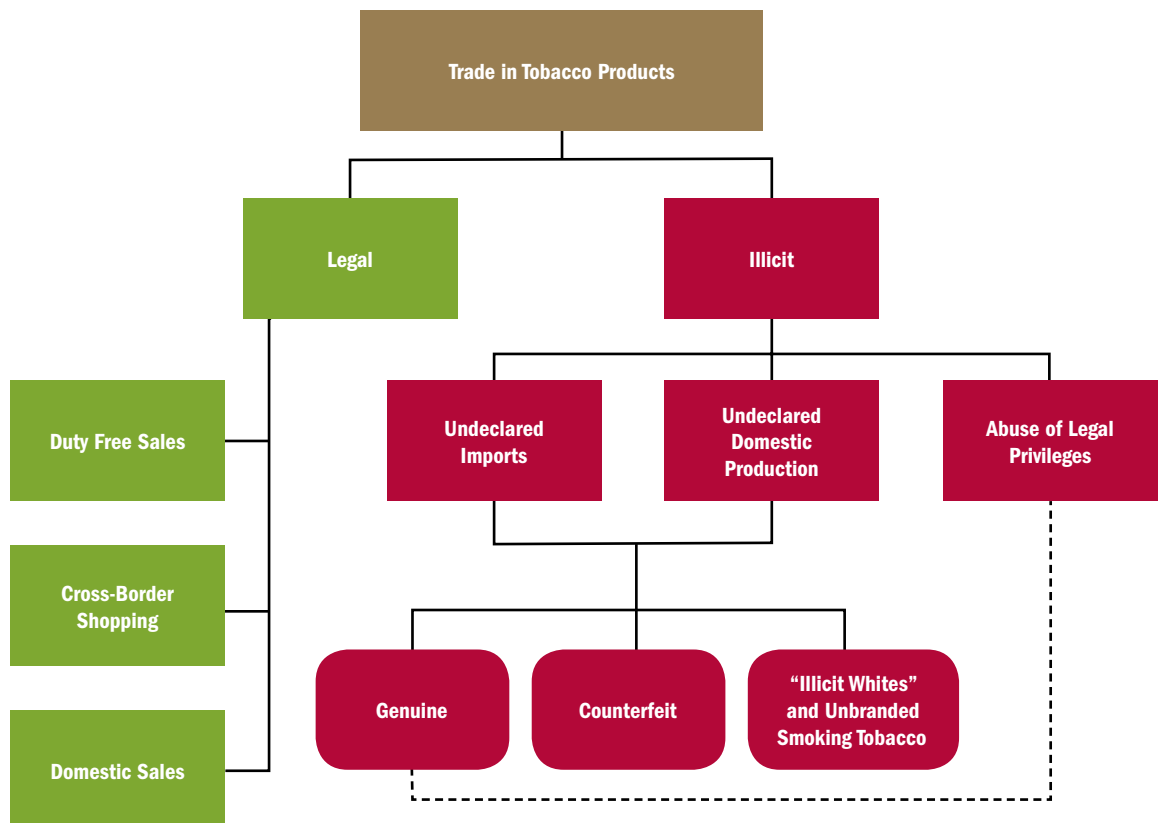
There is also a comparatively small incidence of:

- **Abuse of legal privileges:** duty free purchases and cross-border shopping are legal practices of avoiding higher domestic tax whereby the individual purchases tax paid cigarettes within the legal allowance for consumption in another jurisdiction. Abuse of these legal allowances and privileges, such as those accorded to diplomats and military organizations, is another form of illicit trade. The levels of these practices depend on the tax and price differentials, as well as the distance and cost of traveling between jurisdictions.⁶

1.2 Bootlegging

Bootlegging involves individuals or small groups who smuggle lesser quantities of cigarettes, taking advantage of tax differentials, for resale. Examples of this practice are laborers who cross the European Union (EU)–Eastern Europe border daily for work and bring in cartons (200 cigarettes)⁷ to make some extra income; or couriers who fly back and forth between high and low tax jurisdictions using low cost airlines. These cigarettes are bought and consolidated by organized crime groups who

Trade in Tobacco Products



Case Study: Tackling Counterfeit Cigarettes in China

China is the world's largest tobacco market with an estimated consumption of approximately 2 trillion cigarettes (around one third of global cigarette consumption). The market share of international brands is negligible in China.

China is the leading source of counterfeit cigarettes in the world. It is estimated that up to 190 billion counterfeit cigarettes are produced in China annually. Most of these counterfeits are of cigarette brands sold in China for the domestic market. About 15%–20% of the counterfeit cigarettes are exports, mainly to Europe and North America.

Most counterfeit cigarettes in China are manufactured in the southern provinces of Fujian and Guangdong. From there they are transported either to cities within China or, if they are destined for export, to the major ports of Xiamen, Shenzhen, Guangzhou and Shanghai.

The State Tobacco Monopoly Administration (STMA) has prime responsibility for controlling the tobacco market in China. This includes taking action against people who contravene China's strict tobacco control laws by manufacturing, transporting or distributing counterfeit cigarettes. China's penalties for dealing in counterfeit cigarettes are amongst the world's toughest, with heavy fines and long jail terms for those convicted. There have been some successes in tackling the problem, but China remains the largest single source of counterfeit tobacco products.

The STMA has built up strong working relationships with the Ministry of Public Security (MPS) and the

General Administration of Customs China (GACC). These relationships have increased pressure placed on counterfeit cigarette traders. Every year, thousands of arrests are made and billions of cigarettes seized in raids conducted by police and STMA officials.

The manufacture, trading, export, and smuggling of counterfeit cigarettes from China are controlled by highly organized criminal syndicates. These syndicates have operatives all around the world who attempt to organize the smuggling of counterfeit cigarettes into the destination or transit market.

Given the international nature of the counterfeit cigarette trade, global cooperation between industry and law enforcement authorities is essential. The GACC, through its networks of global customs agencies, is able to support the work of Customs in Europe and North America in stopping shipments of counterfeit cigarettes. In August 2010, the European Union and GACC held a joint conference in Shanghai with one of the key topics of discussion focusing on stopping the flow of counterfeit cigarettes from China.

The STMA also cooperates closely with the major international manufacturers, British American Tobacco (BAT), Imperial Tobacco Limited (ITL), JT International (JTI), and Philip Morris International (PMI). This cooperation extends back more than a decade and is based on the sharing of information and intelligence to allow the STMA to take action in China against identified counterfeiters and for the manufacturers to take actions to protect their trademarks in jurisdictions outside China.

distribute them in target destination markets. At the lowest level, smuggling is undertaken when an individual imports cigarettes in excess of national legal allowances for personal use.

1.3 Types of Illicit Products Involved

Illicit whites: in less than a decade, across the world, large scale smuggling of so-called "cheap" or "illicit whites" has increased exponentially. These cigarettes are usually produced legally in one country, specifically for smuggling. They may be exported legally from some countries. They are smuggled across borders during their transit to point of sale (often in a country levying high rates of tax) utilizing legal and informal distribution chains without payment of tax.

Counterfeit products are manufactured illegally bearing a trademark without the owner's consent. These can be sold in the source country or smuggled into another country. Tax is not paid on counterfeit products.

Unbranded smoking tobacco is sold as loose or cut/shredded leaf of tobacco (known in Australia as "chop chop"). It carries no labeling or health warnings and is consumed in roll-your-own (RYO) form or inserted into empty cigarette tubes. Unbranded tobacco is also sold illegally in the form of loose cigarettes contained in clear plastic resealable bags (commonly known as 'baggies').

2. Size and Measurement

2.1 Size

Given the very nature of illicit trade, it is difficult to provide accurate global statistics on the size of the worldwide illicit trade problem. The World Bank Tobacco Toolkit,⁸ published in 2005, estimated the scale at 6%–9% of total tobacco consumption. Studies in 2008/9⁹ estimated that approximately 11% of the global cigarette market is illicit, representing over 600 billion cigarettes a year. However, these numbers are not based on an independent single methodology or process but are simply compilations of existing estimates from different sources, covering various countries and points in time until 2008. Euromonitor International estimated that, for 2012, approximately 10% of the global cigarette market was illicit.¹⁰

Studies estimating illicit consumption on a country-by-country basis are usually more accurate. One such study by KPMG has estimated that, in 2012, illicit cigarette consumption in the European Union rose to a total of 65.5 billion cigarettes, which equated to 11.1% of total cigarette consumption. This resulted in an estimated €12.5 billion in lost tax revenues to Member States. This is the highest ever recorded level in the European Union and constitutes the sixth consecutive yearly increase. This estimate is based on an identical research methodology applied to each of the 27 Member States. The KPMG Project Star study is described in more detail under section 2.3.

2.2 Measurement

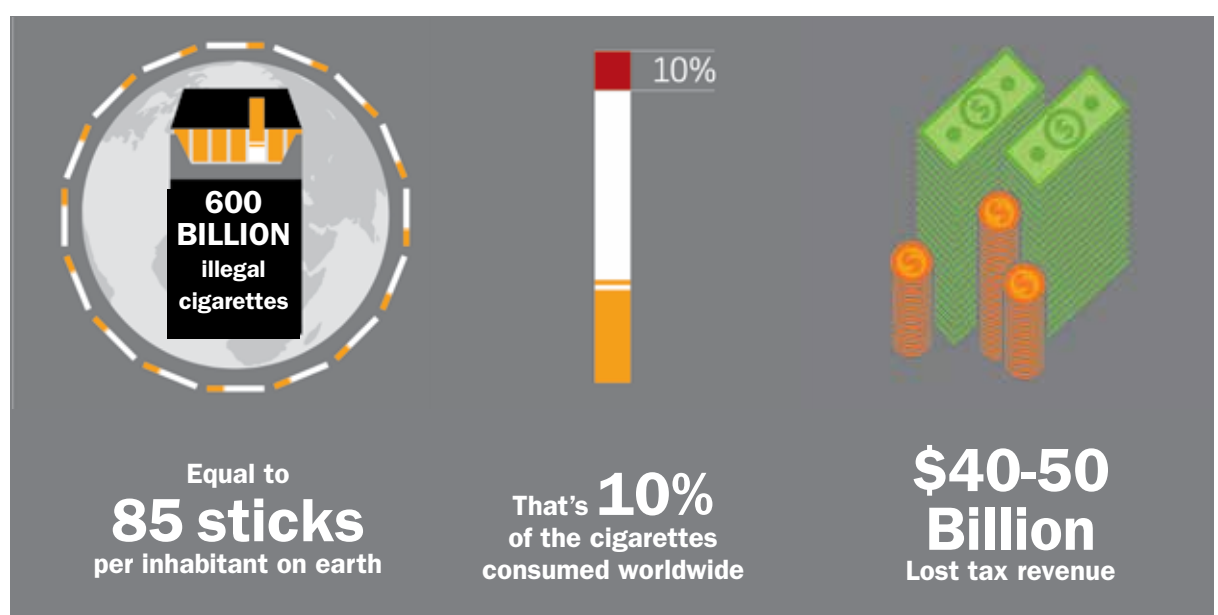
While there is general agreement that tobacco products are among the most illegally trafficked goods in the world, measuring quantities is very difficult. However, it is important that individual governments attempt to establish the scale of illicit tobacco use and tax avoidance to enable informed policy decisions and provide a baseline against which to assess the success of anti-illicit trade strategies.

The objectives of an illicit trade measurement tool are to:

- Measure the incidence and relative share of illicit tobacco products, including consumer usage, purchasing behavior and empty pack surveys;
- Enable analysis of trends over the long term and evaluate their development; and
- Ensure consistency across time, country and population, independently from smoking behavior or consumers' acceptance of illicit trade.

The application of a robust methodology is the first crucial step in the process as it needs to stand up to independent scrutiny and be accepted by all parties concerned.

Estimated Annual Size of the Global Illicit Tobacco Trade



2.3 Methodologies

There are a number of methodologies used by revenue and customs authorities, regional and international organizations, and the industry to measure the illicit trade size on a national or regional basis. Ideally, studies should be carried out on a large scale because the complex underlying mechanisms of flows from source to destination markets are best captured in a regional manner. The 2013 United Nations Office on Drugs and Crime (UNODC) report on transnational organized crime in East Asia and the Pacific region stresses the importance of understanding the nature and dimensions of the threat in order to devise strategies and measures to adequately protect societies from them.¹¹

There is no universally recognized methodology to assess the size of the illicit tobacco trade and different approaches might be required to meet potential budget restrictions, particularly in developing countries. Multiple methods can be used concurrently to establish a more accurate picture.

At its most basic, customs seizure data can be an indicator of a problem, even though seizures are generally believed to represent only a small portion of the illicit trade volume. Seizure statistics cannot do more than represent a percentage of the illicit goods smuggled into a country because not all cargo enters through legal border points. At these border points, only a small proportion of the cargo is scanned and physically examined, even where countries have invested in state of the art scanners.

Kevin McAleenan, the Acting Assistant Commissioner, US Customs and Border Protection Office of Field Operations, testified before the House Homeland Security Border and Maritime Security Subcommittee on Feb. 7, 2012, that “over 95%” of cargo goes unscanned. Europol stated at a conference in Stockholm in October 2012 that, in Europe, about 2% of all container traffic is physically examined.*

* Europol presentation by Howard Pugh, Focal Point Smoke, AWF Serious Organised Crime.

Containers are scanned, usually on the basis of risk assessment/intelligence, to detect a number of illicit products. Whatever the driver for scanning, even in the USA, only a small proportion of containers arriving at the ports are subjected to scanning and physical inspection.

KPMG’s Project Star estimated that, in 2011,¹² illicit cigarette consumption in the EU rose to 65.3 bn. sticks¹³ and the European Anti-Fraud Office (OLAF) reports that the total EU seizures for the same year totaled around 4.5 bn. sticks.¹⁴ This indicates an average EU seizure rate of under 10%. This is hardly surprising given the volume of traffic at busy international ports and the need to facilitate trade against a backdrop of constraints on space and customs facilities.

Seizure statistics do, however, provide valuable information on trends and changes in the smuggling methodologies and routes adopted by the smugglers.

Case Study: The KPMG PROJECT STAR Report

The KPMG PROJECT STAR report^{CS-1} is an annual study produced by KPMG for Philip Morris International (PMI). Since 2005, the STAR report has measured the levels of counterfeit^{CS-2} and contraband in the European Union, and is the first study of its kind. The STAR Report is part of the cooperation agreement between PMI and the European Commission to implement tools to better understand the illicit trade problem in the EU and all 27 EU Member States. The results are shared each year with the European Anti-Fraud Office (OLAF).

The STAR Report provides information about the size and scale of the illicit trade across the EU and in each Member State. The STAR report also provides valuable data about illicit product flows and on the explosion of “illicit whites” in the EU.

The most recent report issued for the year 2012 shows that 11% of consumption is counterfeit and contraband, a new record high for illicit trade in the EU. It is also the sixth consecutive year of increase demonstrating that, despite the best efforts of law enforcement throughout the EU, the illicit trade problem continues to grow. The

rapid expansion of “illicit whites” in the EU is even more alarming. In 2006, levels were below 2% of the total illicit trade. In recent years, they represent nearly 25% of all illicit products. The first “illicit whites” to be found in the EU were Jin Ling and American Legend. These products have shown a decrease, according to the 2012 report, but have been replaced with new brands flooding in from Belarus.

The methodology of the STAR Report has been validated by OLAF. The primary research consists of an analysis of legal or taxed sales, collection of discarded empty packs and consumer research. Since 2005, over 300 surveys have been conducted, over 850,000 people interviewed, and more than 1.5 million empty packs have been collected.

Before results are finalized, 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 fighting the illicit trade.

Other methods of measuring illicit trade include smoker surveys, empty pack and cigarette butt collection analysis, comparisons between household survey estimates of tobacco products consumption, government statistics of tax-paid tobacco products, and trade monitoring. Samples should always be representative of the situation in the actual market/country/region with appropriate proportions to enable volumes to be estimated, preferably by brand.

In order to achieve robust results, it is critical to acknowledge the inherent strengths and weaknesses of the chosen method, such as:

- Primary data collection needs to be undertaken in a scientific, systematic and structured manner that ensures a representative sample and stands up to close scrutiny. For pack collection, this must include physical checks to confirm their nature (counterfeit/genuine) and source country, if possible.
- Consumer surveys – there is extensive evidence that smokers underreport their smoking levels to a significant degree. Therefore, consumer reporting cannot be relied upon to

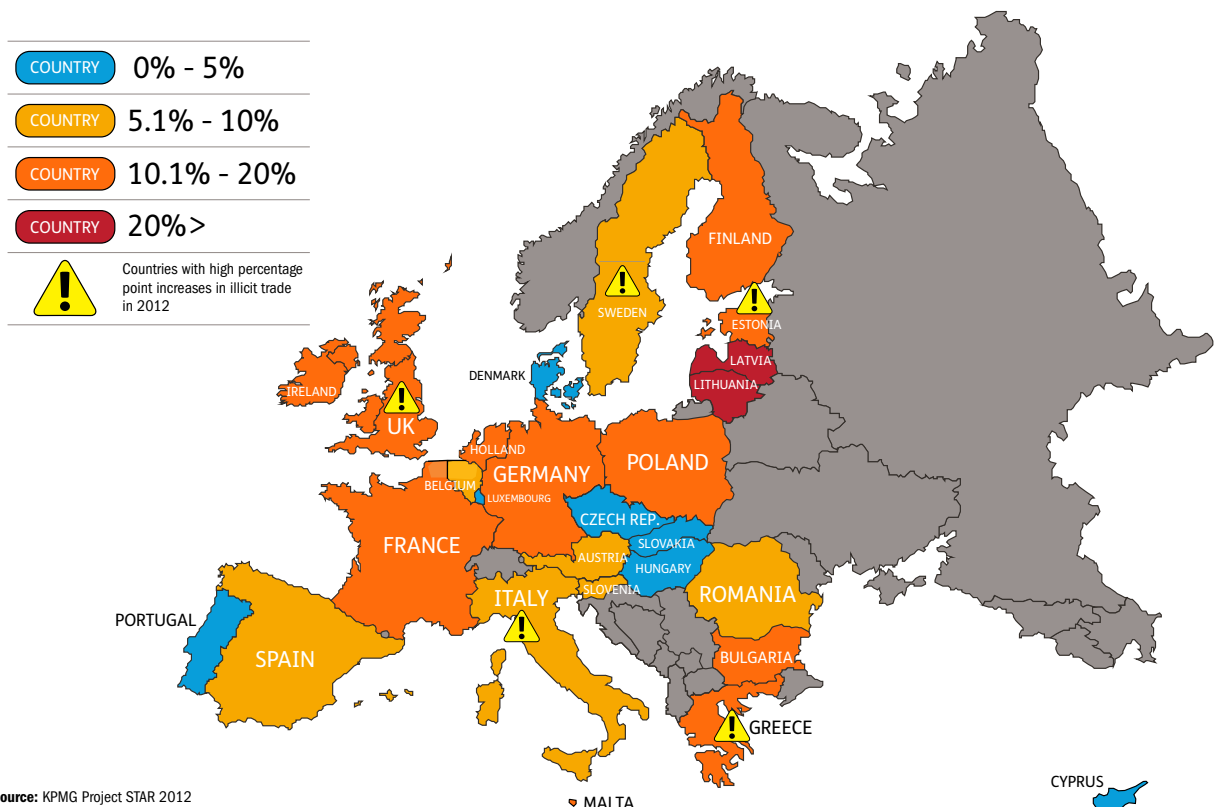
determine accurately the overall consumption levels, although it gives reliable smoking prevalence data.

- International trade data is usually unreliable as import and export statistics are not readily available in electronic format and can be subject to data entry mistakes when compiled.
- Government/industry statistics – the quality of estimating illicit trade is dependent on the quality of existing data on legal cigarette consumption and/or sales in the country. In many countries, these statistics are not readily available, accurate or verifiable.

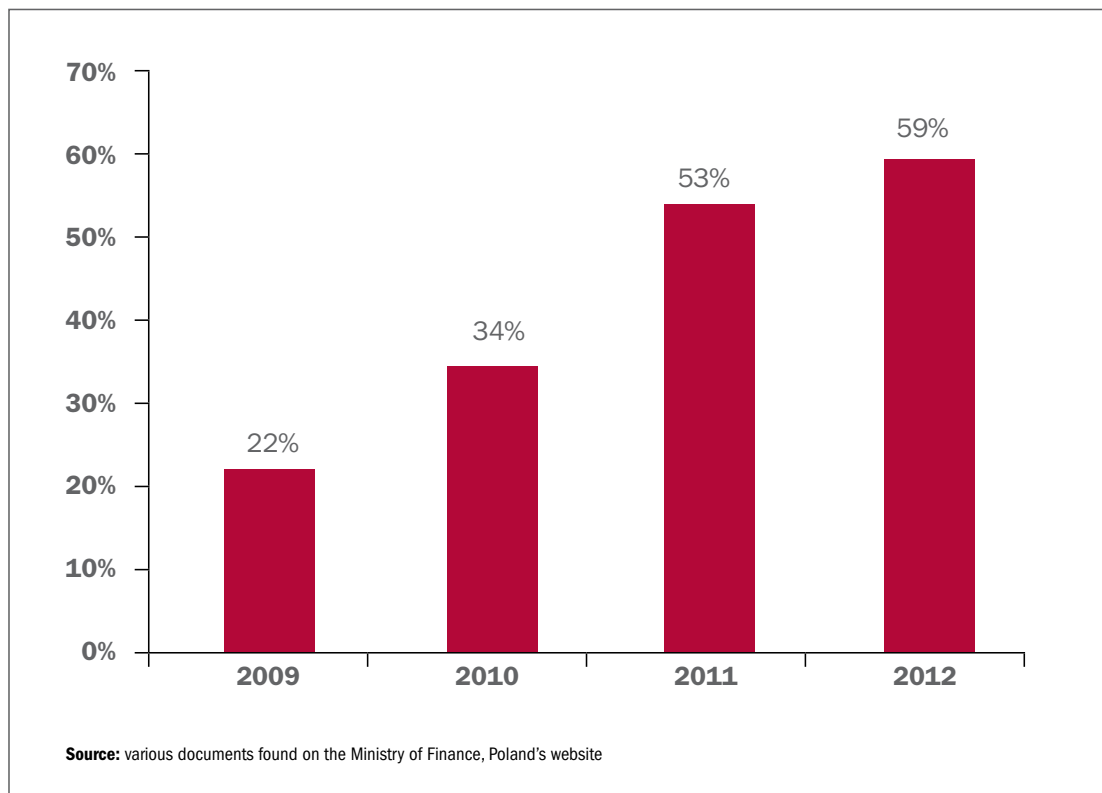
The most developed methodologies combine several of the stated approaches. Irrespective of the methodology, applying repetitive annual or biannual studies provide the best analysis of long term trends, which in turn serve to validate whether the methodology is indeed effective.

The KPMG STAR Report is a good example of a combination of methodologies aimed at capturing the most accurate overall picture through time series.

European Illicit Tobacco Hotspots in 2012



Growth of “Illicit Whites” as Percentage of Seizures of Illicit Cigarettes in Poland



2.4 A Constantly Changing Picture

Regular comparison and analysis of seizure statistics provides an indication of the continuous changes in illicit trade. Comparisons of seizures made over recent years by Polish enforcement authorities show how quickly the illicit trade can change. In 2009, 74% of seizures in Poland were genuine or counterfeit cigarettes. With increased cooperation between the authorities and the cigarette manufacturers since then, this share decreased to 40% in 2012. At the same time, “illicit whites” have filled the gap with seizures increasing from 22% to 59%.¹⁵

The WCO analyzes seizures to identify changing methods, routes and players in illicit trade. Their 2012 report describes the discovery of “mobile” cigarette factories in Paraguay which operate in specially conditioned trucks making them very difficult to trace.¹⁶

Over recent years, several customs authorities have found illicit products being shipped in small packages through the postal service to evade taxation in the destination country.¹⁷

Research by Dr. Louise Shelley suggests that the share of the world trade in developing countries is expected to grow in coming decades and the problem of the trade in counterfeit cigarettes and “illicit whites” will grow alongside it.

3. Global Nature and Dynamics

3.1 Global Movement Characteristics

As tobacco is a highly taxed consumer good, the threat of illicit trade can arise almost anywhere. There are countries which are mainly a source of the illicit product (both for domestic consumption and for export), others which play a part as transit routes, and finally destination countries where consumption occurs. In many cases, a country may be in more than one of these categories.

3.2 Source Countries

Cutting off illicit trade at the source is, in theory, the most effective means of tackling the problem. It is also the most difficult to achieve as illicit trade is a global phenomenon and no country is immune to being a source for illegal activity. Common features identified in many source countries are:

- **Lack of political will to fight illicit trade** – it is not seen as a priority;
- **Ineffective cooperation and coordination** of efforts between different government authorities;
- **Inadequate legal regimes – non-existent laws**, including those which protect intellectual property, lack of prosecutions, and weak penalties for offenders;

- Under-funded, poorly trained police forces and customs officials;
- Oversupply – tobacco products produced and released for consumption in the source market in excess of domestic demand;
- Poor quality data – inaccurate import and export declarations often due to keying or transcription errors, incomplete and inaccurate seizure records;
- Lack of capacity;
- Corruption; and
- Availability of key components (i.e. acetate tow or ready-made cigarettes filters), secondhand cigarette making machinery or counterfeit machinery.

Regular comparison and analysis of seizure statistics provides an indication of the global changes in illicit trade sourcing. The WCO has published an annual Customs and Tobacco Report which analyzes seizures reported by its member countries.¹⁸

In 2012, the WCO recognized the linkages between illicit trade in different commodities and published a combined Illicit Trade Report.¹⁹ China remains the source of the largest number of seizures of counterfeit cigarettes. However, a modest decrease

Case Study: The Jebel Ali Free Zone and Port

The UAE is known as both a manufacturing source and the transit or transshipment location for consignments originating in Asia. In addition to China, North Korea, the Philippines and Vietnam are known Asian sources of illicit cigarettes.

The Jebel Ali Free Zone (JAFZA) in Dubai is not only one of the largest Free Trade Zones in the world; it is also one of the world's largest transshipment and manufacturing points for illicit tobacco products. Over 80 companies, including 9 manufacturers are licensed to trade in and manufacture tobacco products in JAFZA. Many of these smaller tobacco manufacturers produce "illicit white" cigarettes. These cigarettes are sold by the manufacturers to criminals and traders who export them from JAFZA and smuggle them into foreign markets, often through Free Trade Zones in other countries. Cigarette brands, produced in JAFZA are seized as illicit products frequently all over the world, including Egypt, South Africa and the EU.

Despite some successes by enforcement authorities, illicit trade from JAFZA continues to flourish. Political disruptions in North Africa and the Middle East during the recent "Arab Spring" have reduced customs, border and police enforcement capacities in these markets, resulting in an upsurge in illicit cigarettes originating from JAFZA. Unscrupulous manufacturers, cigarette traders and criminal syndicates are exploiting this

opportunity to supply "illicit white" brands without scrutiny by the authorities.

The Libyan tobacco market provides a striking example of how opportunistic criminal networks have exploited Free Trade Zones such as JAFZA to evade Libyan taxes and undermine Libyan sovereignty. Libya was previously categorized as a well-regulated cigarette market with shipments entering through its northern sea ports. Once civil unrest began, the market changed and inbound tobacco products began to transit from JAFZA through additional Free Trade Zones in Egypt and onward into Libya. Records show that during a six month period, while Libya was at the peak of its unrest, 82% of all tobacco shipments entering Egypt passed through the Port Said Free Zone and transited to Libya. Of these shipments, 57% originated in JAFZA.^{CS-3} These massive flows of "illicit white" cigarettes from JAFZA into Libya did not remain contained in one country. Bordering markets also fell victim quickly to smuggling activities, damaging their economies in turn. Egypt was previously a well-controlled market with a small illicit tobacco problem. But a surge in cross-border smuggling from Libya, combined with the impact of protracted political unrest within Egypt, has led to a sharp increase in the market share of illicit tobacco. Illicit tobacco now accounts for 20% of total cigarette consumption in Egypt, further reducing government tax revenues during a time of economic hardship.

Case Study: Paraguay – Source Country for Smuggling and “Illicit Whites” in South America

Smuggled cigarettes and “illicit whites” produced in Paraguay have been found across Latin America. The illicit traffic involves major criminal organizations and local tax evasion. The magnitude of the problem is illustrated by an industry estimate that 44% of licensed retail outlets in Brazil stock illicit brands from Paraguay.

Paraguay produces an estimated 65 billion cigarettes per year, although domestic consumption is estimated at only 2.5 billion sticks per annum or less than 3% of domestic production. There are approximately 30 manufacturing sites, of which 12 are currently active, with an estimated capacity of 100 billion cigarettes. The Paraguayan north-eastern frontier is 650 km long with more than 1,000 km of river banks and lake shores in the Ciudad Del Este / Itapúa ‘Tri Border’ area. Organized crime groups have been identified as involved in the illicit trade in cigarettes. “Illicit whites” and counterfeits are transited through Bolivia by road into Chile and Peru then transported by sea to other countries in South America,

Panama and the Caribbean or along the Rio Parana and smuggled into Argentina and Brazil.

The Paraguayan Government has been improving the regulation of internal cigarette production, introducing an electronic industrial registration and licensees for tobacco companies and developing a digital verification system and electronic invoices with support from the International Monetary Fund (IMF). Recently, there has been some success in enforcement as a result of cooperation both with the industry and cross-border authorities, although these have not caused a marked reduction of contraband being smuggled to surrounding markets such as Brazil.

In addition, the Bolivian Customs Authority has restructured its resources to improve the effectiveness of interventions in stemming the flow of smuggled and counterfeit products from Paraguay transiting Bolivia to Chile and Peru.

in Chinese consignments from the previous year was noted, and the 2012 report indicates that countries of departure are becoming more and more diversified.

Through profiling and supply chain mapping, the following countries have been identified as main sources of “illicit whites” – Belarus, Vietnam, Indonesia, Philippines, India, Cambodia, Paraguay, Ukraine, Russia, UAE, Brazil, Kenya and, of course, multiple Free Trade Zones.

While the traditional destination markets for “illicit whites” in Europe continue to show significant growth, the WCO Illicit Trade Report 2012 indicates that the markets in the Eastern and Southern African region and, to a smaller extent the West African region, have become infected by “illicit whites.”

Ingenious methods are being used to transport the goods to the final destination countries. The lengths that criminals are prepared to go to is illustrated by the long secret tunnel²⁰ dug beneath the Slovak-Ukraine border which officials believe was being used several times a week to smuggle illicit cigarettes into the EU.

Sophisticated mining technology appeared to have been used to dig out the tunnel which was fitted out with tracks and a trolley to transport the goods. The cargo was loaded onto a small train with 16 wagons and a battery-powered engine on which the driver rode.

Egypt features as a key source of contraband for the Middle East. Zimbabwe is a main source of

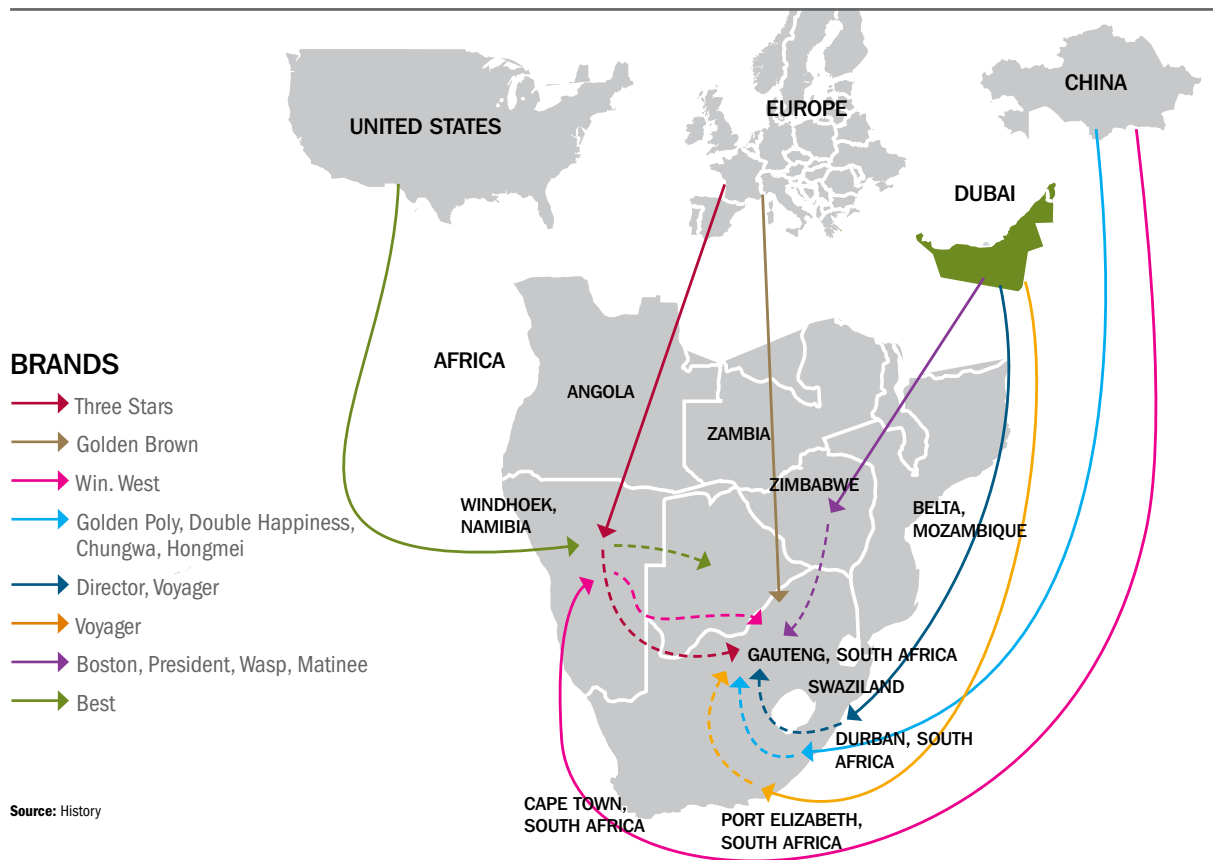


Secret tunnel below the Slovak/Ukraine border used for smuggling illicit cigarettes. Photo courtesy of Slovak Customs.

contraband detected in East and Southern Africa and Paraguay remains the source for the illicit consignments destined mainly for Brazil.

In a working paper on the illegal trade in tobacco in MERCOSUR countries, the main findings reveal Paraguay as the main producer and hub of Caribbean regions.²¹ This illegal trade consists mainly of “illicit whites” with counterfeit having a less important role. Key distributing hubs were identified as the Free Trade Zones in the Caribbean (Colon, Aruba and Belize). There are also reports that illicit cigarettes are taking a hold in the Russian market. According to SNS, a tobacco distributor in Russia, the share of counterfeit products in

Southern African Development Community Region Showing Illicit Tobacco Trade Routes



regions adjoining to Belarus already amounts to 2%; in North Caucasus 15% and the share of Belarusian cigarettes in Dagestan already reached 30% of the market.²² In recent years, many illicit factories have been detected and dismantled within the EU, showing that criminal gangs are bringing their production sources within their final destination markets. These developments undermine past beliefs that only lower income, corrupt countries with weak legal structures are the source of illicit manufacturing.

3.3 Transit/Transshipment

Illicit trade shipments are very often deliberately transited via several ports in order to make detection more difficult. The transit countries play a key role in the smuggling supply chain as this is often where the preparation for, and most of the facilitation for smuggling, occurs. During transit, documentation is changed and goods can be transhipped into other vessels through some of the largest and busiest ports in the world.²³ In these days of fast moving global trade, ports compete for speed in processing cargo and the turnaround time of vessels. This means minimizing controls and potentially illicit consignments which are in transit

are often given low priority in official controls. Due to the difficulties in tackling illicit trade at the source, international enforcement efforts can focus on intercepting consignments in transit when they reach a “friendly” port where officials are willing to investigate containers and act on tip-offs. Panama, Belize, Singapore, Greece, the UAE and Russia are examples of commonly used transit countries for illicit trade. However, this is a dynamically changing situation. As soon as one country improves controls, the criminals switch to another route. New transit routes are exploited as countries invest in better road and rail infrastructures and inland destination markets.

3.4 Final Destination Countries

Most countries face a problem with “illicit whites.” Canada, Vietnam, Malaysia, Turkey, South Africa, Mexico, Brazil, Argentina, Poland, Italy, and Greece are some examples of the countries most affected. Illicit tobacco products are available throughout the world in high income and low income countries alike. Some common characteristics of final destination markets are:

- A tobacco taxation policy that has resulted in high retail prices relative to consumer

Case Study: Cross Border Tobacco Smuggling into South Africa

South Africa is a prime destination for smuggling tobacco products from neighboring and other countries. A significant source of “illicit whites” is Zimbabwe, where there are six factories manufacturing more than 20 brands of cigarettes. The majority of these factories are situated in an export zone with concessions given to improve foreign currency flows and a minimum of 80% of finished goods must be exported. There are no controls over the movement of the finished product or the influx of foreign currency. The situation is compounded by a lack of political commitment to address the illicit trade issue effectively in the country.

Industry estimates that annually, more than 4 billion cigarettes are manufactured in Zimbabwe for export destined for Zambia, South Africa, Mozambique, Malawi and the Democratic Republic of Congo. The majority of this product enters South Africa. A portion of this was imported, historically, under warehousing for export or sale for local consumption. With the implementation of the South African Revenue Service (SARS) Customs Modernization Program, a marked change in the use of the above import purpose codes has been seen, with quantities declared for warehousing and domestic consumption reducing from 600 million cigarettes in 2011, to 250 million in 2012. Likewise, in the usage of the warehousing for export code, the quantity decreased

from 600 million to 150 million cigarettes.

This indicates a change in methodology from administrative exploitation to outright smuggling through concealed consignments and mule trafficking across the various borders between Zimbabwe and South Africa, as well as Zimbabwe via other neighboring countries. Corruption at borders is high, where up to US\$50,000 per container can be offered to officials to let concealed cargo through. Effective enforcement actions within Zimbabwe are rare.

To combat this problem, the Tobacco Industry of Southern Africa (TISA) works in close cooperation with the authorities. Monthly review meetings are held with the South African Revenue Services Strategic Stakeholder Forum, with an appointed “cigarette champion” from South African Police Service (SAPS) directorate of priority crimes, presentations to and workshops with the South African Customs Union, the National Treasury and various other national and provincial key stakeholders. Furthermore, cross-border forums have been established between countries neighboring Zimbabwe – Mozambique, Swaziland, Botswana, Angola, Namibia and Zambia – and a memorandum of understanding was signed with all the Southern African Customs Union (SACU) countries.

income (low affordability) or higher than those prevailing in neighboring countries;

- Other tobacco control regulations such as a ban on flavors;
- Low law enforcement focus on the illicit tobacco trade due to other priorities or a general lack of resources
- An inadequate legal regime (e.g. one in which either the legislation or judicial system do not properly enforce intellectual property rights, and/or penalties for smuggling are too weak to be a deterrent, and/or are simply not effective in condemning smugglers); and
- A culture of accepting illicit products or a lack of knowledge that the product is illicit.

Developments in recent years show that organized crime will supply any country in the world as long as there is a demand for illicit product and the potential for profit exists.

In 2010/11, the author led an EU-funded study of illicit trade in excise products across the Southern African Development Community²⁴ (SADC). The study was initiated as a result of concerns about illicit trade across the region. Several Member States have introduced improvements in legislation and administrative practices following the study. The study findings also resulted in the creation of an

Excise Subcommittee within the SADC structure with a Working Group of technical officials from Member States who have been tasked with devising excise guidelines for adoption across the region.

3.5 The Explosion of “Illicit Whites”

Typically, “illicit whites” are manufactured specifically for export and may be sold legally to a first purchaser in the country of manufacture.²⁵ First or subsequent customers then smuggle them across international borders for sale through legal and informal distribution chains without payment of tax. They do not infringe the trademark rights of other manufacturers, although some “illicit white” brands successfully replicate the packaging of the more popular international brands. The product can be of reasonable quality compared to counterfeit cigarettes.

“Illicit whites” are made by smaller low-profile businesses and sold through criminal syndicates. As with other forms of illicit trade in tobacco products, there have been a number of cases reported by law enforcement agencies relating to the illicit trafficking of these cigarettes by, or on behalf of, terrorist groups. For the criminal, “illicit whites” provide excellent profits and have the advantage of not attracting the attention of a trademark owner. They are much cheaper in the illicit market than legal products and their branding gives them the

Case Study: Poland's Illicit Smoking Tobacco

In recent years, Poland has experienced annual tax increases on all tobacco products driven mainly by the need to meet EU excise tax requirements. In particular, these impacted on smoking tobacco and the alignment of pipe and fine-cut tobacco taxation. The non-duty paid share of the smoking tobacco market increased to 50% in 2012. While the duty paid volume decreased from 5.272 tons in 2009 to 4.081 tons in 2010 and to 3.546 tons in 2011 (source: DG TAXUD EU Excise Tables), the sales of cigarette paper and tubes grew continuously over the same period. From the non-duty paid part of the smoking tobacco market, some 60% were counterfeit and some of the counterfeit used well-known cigarette brand names for fine-cut tobacco. The remaining 40% of non-duty paid smoking tobacco was sold as "unmanufactured tobacco leaves" not being subject to any excise duty.

The leaves have been sold in specialized premises or convenience shops. The consumers use noodle or tea cutting machines, or simply document shredders to manufacture their own smoking tobacco. Due to the increasing size of the problem, the Polish Government included "dried tobacco" into excisable tobacco products. Unfortunately, due to the misconceived definition, "dried tobacco is dry tobacco," the trade wets the tobacco leaves before sale and offers simple equipment to its customers to re-dry it again.

Similar problems with illicit fine-cut tobacco or tobacco leaves have arisen in a large number of countries where tobacco products are not affordable for many consumers (Greece, Hungary, Australia, Slovakia, Turkey and many others).

appearance of being a legal product. Sales of these goods (without tax or duty payment) have rocketed throughout the world. According to an article in WCO News in 2012, "illicit whites" accounted for 45% of the seizures in Germany in the same year.²⁶

3.6 Features of the Counterfeit Problem

Dr. Louise Shelley's researches indicates that the illicit production of cigarettes occurs in illegal factories in many countries in Asia and in Paraguay, the Balkans, Iraq, Russia, Turkey North Korea and Georgia and state that, *"Many governments are aware of the problems caused by counterfeit goods but are reluctant to crackdown seriously on counterfeit production because of the economic dislocations it would cause.....The networks marketing counterfeit and diverted legitimate goods can reach a larger proportion of the consumer market for cigarettes as many more individuals are ready to buy the products than are ready to purchase narcotics.....Complicating the problems of detection is that, in the developing world, counterfeit goods often travel with legitimate commodities, thereby reducing risk and maximizing the utility of existing distribution networks."*²⁷

4. The Impact of the Illicit Trade in Tobacco Products

4.1 The Impact on Society

4.1.1 National Security and Organized Crime

The infiltration of supply lines by criminal networks and terrorist groups hinders the fundamental building blocks of development, democracy, human rights and the rule of law, and supports corrupt practices among government officials and private citizens alike. These same networks are used to traffic humans, weapons and drugs.

In many countries, enforcement resources and harsh penalties are targeted at drugs and human trafficking, leaving the trade in illicit tobacco products as a high profit but low risk activity. As a result, the high profits available when measured against the risks of being caught and the low penalties handed down, should a prosecution ever take place, make cigarette smuggling a very attractive option for organized crime gangs and terrorist networks. Once an informal supply chain is in place, a high proportion of the distributors use it to supply a range of illicit products.

The Royal Canadian Mounted Police report that, *"The central role played by organized crime in the contraband tobacco trade in Canada means that this illegal activity is inextricably linked with other kinds*

*of crime; most of the organized crime groups across the country involved in the illicit tobacco market are also active in other forms of criminality."*²⁸

Academic research on terrorism, transnational crime and corruption has revealed that the people involved in the illicit trade in tobacco products are also involved in other forms of illicit trade (e.g. in drugs, people, alcohol, diamonds, timber or antiquities). The illicit trade in tobacco products has been growing, in part because of the absence of coordinated control resources focused on illicit trade routes and distribution chains which are often the same for many different products.

Post 9/11, there has been a crackdown on the banking systems, making money laundering through the banks more difficult. Therefore, criminals and terrorist groups now use illicit trade to generate profits and move money across borders.

Cigarette smuggling has been connected with funding the real IRA to obtain firearms in the case involving Republican fanatic Michael Campbell.²⁹ In 2012, the Islamist militants attack on a gas field in Algeria that led to the death of 37 people has been linked with Mokhtar Belmokhtar.³⁰ In his role as a militant Saharan jihadist leader, Belmokhtar was also linked with the 2003 kidnapping of

Case Study: Illicit Trade: "A Security Challenge" (Shelley, 2009)

For decades, the [illicit tobacco] trade has benefited crime groups and corrupt officials, but terrorist organizations have also exploited this illicit trade. The Italian Mafia has been involved in this trade since the early or middle of the twentieth century (Paoli 2003). However, the lure of profits from this commonly smuggled and trafficked commodity has attracted not only the traditional organized crime groups. The U.S. Government and international corporations have documented the manufacturing of counterfeit cigarettes in the Tri-border region of South America by terrorist organizations (Hudson 2003; Sverdluck 2005).

Many other diverse terrorist groups have exploited the cigarette trade to generate financial support for their activities, such as Hezbollah, Hamas, Al Qaeda, IRA, PKK, ETA (Basque Homeland and Freedom), and Egyptian and Palestinian Islamic Jihad, Farc have been identified as participants in this illicit trade (Coker 2003; Billingslea 2004, Willson 2008). Because of the involvement of so many different groups in this activity, the U.S. Government Accountability Office (GAO) (2003) ranks cigarette smuggling among the top fundraising activities used by terrorists, along with illicit drug, weapon and diamond trade. Illustrating the lucrative nature of the trade, the combined total profit from cigarette trafficking for the three primary factions of

the IRA (the Provisional IRA, Real IRA, and the Continuity IRA) reached approximately \$100 million between 1999 and 2004 (Billingslea 2004).

The links between crime and terrorism continue to be identified. Recently, the International Consortium of Investigative Journalists has shown that trafficking in illegal cigarettes is a major revenue source for terrorists in Pakistan (Center for Public Integrity, 2009; Willson, 2009). Russian researchers in Southern Russia, in the conflict ridden North Caucasus region, are also finding that trade in counterfeit goods, including cigarettes, is a funding source for terrorism.

The illicit tobacco trade is a crime of choice among terrorists because it commands limited attention from law enforcement in comparison with other crimes that are less socially acceptable. Terrorists seek to secure funding in ways that draw the least attention to themselves. Terrorists smuggle cigarettes because the risks of apprehension are low and the profits are sufficiently high to fund terrorist groups and purchase arms and even dual use equipment with the proceeds of this criminal activity.

Terrorists are turning increasingly to cigarette smuggling for funding. Among the groups are the Taliban, for whom cigarettes are now second only to heroin as a funding source, and al Qaeda.



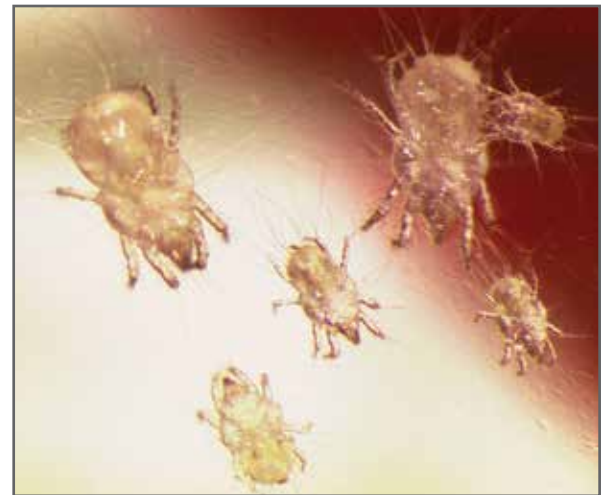
Illicit cigarettes are often disguised and transported in unsanitary conditions. Photos courtesy of German Customs.

32 European tourists, the 2008 negotiations for the release of two Austrian captives, and 2009 negotiations for the release of two Canadian hostages. Hostage-taking and smuggling, from cigarettes to guns, people and drugs, form part of a multi-million dollar criminal economy in the Sahara. He has carved out a reputation as one of the most important “gangster-jihadists” of the Sahara. Besides his involvement in kidnappings, he has gained prominence as a supplier of arms to Islamist groups and as a trafficker of cigarettes, part of a mosaic of criminal activities.³¹

Research by Dr. Louise Shelley and other renowned criminologists provides an overview of the link between the illicit trade in cigarettes and the funding of terrorism. Tobacco smuggling as a source of income for terrorist and criminal organizations is not new.³² It has been the source of funding both for terrorist and criminal organizations for over a decade.³³ There are a number of press articles³⁴ referring to terrorist involvement in cigarette smuggling.³⁵

The UNODC reported that tobacco products are taking their place among the most trafficked commodities which threaten the security and economic development in West Africa.³⁶

Further evidence comes from the Group of Experts – the United Nations Security Council’s investigative body, who reported that, “Millions of dollars in illicit tobacco revenues are reaching Al-Qaeda, the Taliban and other terrorist organisations.” A press article³⁷ asserts that the report went on to state that illicit tobacco funds are financing Congolese rebels for the recruitment of child soldiers, mass rapes and murders. Finally, the OECD’s Financial



Action Task Force’s guidance on the Illicit Tobacco Trade (June 2012) provides detailed information about the smuggling methodologies used, the economics of tobacco smuggling, the involvement of transporters and hauliers, distribution points, point of sale, money laundering methods used, and the connection with other criminal activities involving excise goods and drugs and with funding terrorism.³⁸

Other reports^{39, 40} also indicate that the Taliban militants in Pakistan now use tobacco smuggling to help fund their activities.

4.1.2 Respect for the Rule of Law

When the general public becomes aware that laws are not being complied with and no consequences arise, there is a gradual erosion of respect for legislation and enforcement authorities. If people

rarely hear of arrests and successful prosecutions of those involved in illicit trade, then the perception will spread both that enforcement authorities are ineffective and that the law doesn't really matter. People who habitually break the law without suffering any consequences can influence others, thus lowering the standards of acceptable law abiding behavior.

4.1.3 Public Health

The illegal trade in tobacco undermines public health policies and, in particular, the prevention of youth access by making cheaper cigarettes available in an unregulated environment. Smuggled tobacco is mostly sold on the illicit market typically for half the price of legitimate products. People on lower incomes are more likely to be tempted by cheaper prices, and access to smuggled tobacco therefore undermines efforts to quit smoking exacerbating health inequalities. Unlike legal tobacco products which are manufactured and sold in compliance with strict regulatory requirements, such as health warnings, maximum tar and nicotine levels and reduced ignition propensity, illicitly traded products, (especially counterfeit), are partly or fully outside this regulatory framework.

Research conducted by the Dutch National Institute for Public Health and the Environment (RIVM) demonstrates that counterfeit cigarettes contain cadmium levels that are five times higher and lead levels that are six times higher than in genuine cigarettes.⁴¹

The Center for Public Integrity, in its report, *Tobacco Underground*,⁴² states, "Many of the smokes are made from the lowest quality tobacco, full of stem and sawdust, and spiked with unusually high levels of nicotine. Tests reveal that counterfeit cigarettes carry a bevy of products that could further shorten even a heavy smoker's life: metals such as cadmium, pesticides, arsenic, rat poison and human faeces."

The WCO has reported seizures of counterfeit cigarettes containing mites and identified unprecedented methods of concealment (e.g. in barrels of titanium sponge containing toxic chlorine gas which posed serious health risks for the law enforcement officers charged with inspecting and seizing the illicit cigarettes from inside these containers and which therefore could have been extremely hazardous if smoked by a consumer).

4.2 The Impact on the Economy

4.2.1 Lost Government Revenue

The illicit trade in tobacco products obstructs economic development, undermines the rule of law and weakens the tax base, costing governments vast amounts of lost revenue. Illicit trade means there is less money available to governments for public services such as health care, education, defense, transport, and environmental concerns.

In South Africa, the revenue lost to illicit trade in tobacco products has been estimated by industry in 2013 as the amount needed to fund 74,000 new homes.

In 2012, Euromonitor International estimated the global tax lost to governments between \$40–\$50 billion. The European Commission estimates that the EU and Member States lose €10 billion in tax revenue a year as a result of the illicit trade in tobacco products.⁴³ In the EU, the average loss of customs duty, excise duty and VAT on a smuggled 40 foot container containing 10 million cigarettes is about €1.5 million.⁴⁴ Tackling the influx of smuggled excisable goods, especially cigarettes originating in Moldova, Ukraine, Russia and Belarus has therefore become a priority for the European Commission.

In addition to the loss of indirect taxes, governments will collect less income tax, social contributions and corporate taxes as the legitimate industry and trade lose legal volume and subsequently jobs.

4.2.2 Financial Loss to the Legitimate Industry and Trade

Legitimate manufacturers and suppliers of tobacco products are heavily impacted by illicit trade. In addition to lost income, illicit trade distorts competition in the market, it undermines investments in innovation, distribution, brand equity and employment.

Small tobacco retailers are among those worst hit by easily available illicit cigarettes. In Ireland, the growth of illicit tobacco threatens the livelihoods of legitimate retailers whose shops are at the heart of communities. Retailers' profits are severely affected by tobacco smuggling. In 2011, "Retailers Against Smuggling" (RAS) found that at least 700 retail jobs had been lost in the previous year as a result of declining cigarette sales, and that 74% of respondents believe they would have to let more staff go in 2012.⁴⁵ Giving evidence to the Irish Parliament, Vincent Jennings, CEO of the Convenience Stores and Newsagents Association said, "We are legitimate traders; we pay our taxes and should be entitled to sell this product in a responsible fashion but we are being denied the opportunity to do so by the demand for products on sale outside shops."⁴⁶

Research⁴⁷ in Canada by the Canadian Convenience Stores Association and the Canadian Tobacco Manufacturers' Council found that the illicit trade resulted in a 30% revenue loss to convenience stores. The Canadian press reported in April 2010 that, "Illegal tobacco sales continue to cost stores more than CAD\$260 million in profits last year.... The industry is heavily dependent on cigarette sales. Two out of every three cigarettes sold legally in Canada are purchased in convenience stores."⁴⁸

5. Causes and Facilitators

5.1 Economic Drivers of the Illicit Trade

The illicit trade in tobacco products is a global phenomenon, covering high and low income countries alike. The primary drivers for illicit trade are:

- Demand: A desire by consumers to save money; and
- Supply: The potential for criminals to make high profits.

Consumers create demand when they choose to buy illicit cigarettes because their financial situation makes legal products unaffordable.

Even in countries with a perceived low absolute tax rate, smuggling can be very profitable if the tax level is high relative to income. The tax evaded is shared between the consumer in the form of cheaper cigarettes and higher profits for the smuggler. For example, individuals in Eastern Europe are content to make a profit of just \$100–\$150 per week by smuggling small quantities of cigarettes since this far exceeds the income from a regular job. At the other end of the spectrum, criminal gangs smuggling container loads into the European Union can make millions in profit per consignment.

Australia

According to a report by Deloitte,* the Australian illicit market peaked at 15.9% at the end of 2010. This followed a 25% excise hike which drove a number of consumers to seek the cheaper illicit products. The illicit market has subsequently declined to 10.5% after a period of relative pricing stability and a number of successful seizures by Australian authorities. This is significant progress, but manufacturers and legitimate retailers still lose significant income while the Exchequer loses around \$775 million in excise revenue.

The largest component of the Australian market is “chop chop” which accounts for over 80% of the Australia Illicit market estimated at 1.8 million kg. Chop chop is sold loose in bags of 250g or 500g. There has been a growing trend in pre-made tubes filled with chop chop that sell in boxes of 100 for between AUD \$25–\$30. According to their annual report, the Australian Customs & Border Protection Service made seizures of illegal tobacco amounting to 175 tons in 2011-12.

* Deloitte – Illicit Trade of Tobacco in Australia: <http://www.yourhealth.gov.au/internet/yourhealth/publishing.nsf/Content/Phillip-Morris-Limited-Annex-10#.UeKIPjvVBJQ>

5.2 Factors Facilitating Illicit Trade

In addition to the primary economic drivers, there are a number of other factors that have significant bearing on the incidence and scale of illicit trade. Factors contributing to the problem are an unbalanced tobacco taxation policy, protectionist policy measures, inadequate enforcement, exploitation of free zones, inadequate legislation and sanctions, as well as public tolerance.

Some countries are well aware that their manufacturers, Free Zone operators, transporters and others are knowingly facilitating the illicit trade but do nothing. There have been instances where these countries have ignored official requests for assistance from other countries or from international enforcement organizations.

5.2.1 Tobacco Taxation Policy

In most countries, tobacco is considered to be an ideal candidate for taxation revenues: demand is relatively inelastic and the negative externalities are seen to justify taxation. Indeed, tobacco has been subject to special taxes since the 17th century, and today all countries impose at least one tax on tobacco products (e.g. excise, import duty, VAT/sales tax or other related taxes). With a few legal exemptions, such as duty free traveller allowances and diplomatic/military privileges, all these taxes are due to be paid in the country of consumption.

Excise is usually the main tax and it often accounts for the majority of the final retail price. Besides providing governments with a secure, predictable and easy to collect source of revenue, tobacco taxes are applied by governments to discourage tobacco consumption.

According to the EU overview of cigarette excise revenues,⁴⁹ in 18 Member States (out of 27), the excise duty on cigarettes collected dropped between 2008 and 2012, indicating that in many of the EU Member States, excise revenues decreased three times over that period. In five Member States, excise revenues decreased twice over that period. The 2012 Euromonitor report⁵⁰ states that, “*There was a correlation between price growth and price level – prices can rise faster from a lower base. More significantly, in developed countries with high prices, like Germany, only a comparatively low level of price growth is necessary to cause a significant rise in illicit trade.*”

Tax increases are not the only driver for increased illicit trade. An economic downturn decreasing cigarette affordability can have the same effect. Consumers, on reduced incomes, faced with a choice between purchasing necessities and legal cigarettes are likely to turn to the illicit market for their cigarette supplies. Once consumers have a regular source of supply of illicit tobacco products it becomes extremely difficult to get them to return to purchasing legal tax-paid goods.

The World Bank has stated that, *“The potential for smuggling tobacco can limit increases in tobacco tax rates. When setting tax rates, consider the risk of smuggling, the purchasing power of local consumers, tax rates in neighboring markets, and the ability and effectiveness of the tax authorities to enforce compliance.”*⁵¹

It is critical that governments balance their approach to the setting of excise rates with the aim of optimizing tax revenues in the long term and avoiding the emergence or expansion of the illicit market. In applying a principle of optimization, tax policy needs to reflect:

- Consumer affordability – tax levels on cigarettes should be benchmarked against consumers’ purchasing power;
- Location of the country and tax rates in neighboring countries or within a trade bloc – to minimize incentives for cross-border shopping and smuggling; and
- Ease and capacity of administration and enforcement both at the borders and inland – to minimize bureaucracy, tax compliance costs and the enforcement costs of tackling illicit trade.

International experience – such as from Ireland, the EU accession countries, Malaysia, Ireland, Turkey and Singapore – show that the implementation of steep tax increases has led to a sharp rise in illicit trade in tobacco products, which damages the long-term tax base and undermines public health objective.

Malaysia increased excise duty on cigarettes by 430% between 2002 and 2010. The increase in the price of legal cigarettes prompted consumers to switch to illicit sources of supply. In 2002, Malaysian smokers consumed 19.5 billion legal cigarettes. By 2010, this had declined 31% to 13.5 billion. The decline in legal sales was mainly driven by the surge in consumption of illicit cigarettes, which reached 8.8 billion in 2010. As a result, the illicit market share rose from 21% in 2002 to 39% in 2010. Acknowledging the massive illicit trade problem and the impact of excessive cigarette taxation, the Government decided to freeze excise in its 2012 budget. The Malaysian Prime Minister made the following statement on 8 October 2011, the day after the budget announcement:⁵² *“We can’t increase the price of cigarettes sharply when the use of illegal cigarettes has reached 40%. This level is too high. If there*

Case Study: Effect of Sharp Increases in Excise Duty on Cigarettes in Ireland

Ireland experienced two periods of sharp increases in the excise duty paid on cigarettes during 2001–2003 and 2006–2009. The total increase in cigarette excise duty rates from 2000 to 2009 was 76% in the most popular price category – three times higher than the corresponding rate of inflation (26.2%).

From 2000–2005, cigarette prices increased by 31% and duty-paid volumes decreased by 16%. During the second period of steep duty excise increases (2006–2009), prices increased by 33%, reaching €8.45 a pack – almost €2 more than the EU country with the highest prices.

By 2012, Government figures show that at least 20% of all cigarettes consumed in Ireland were not duty paid and the majority of them (14%) were illicit. The proportion of illicit cigarettes in Dublin in 2011 was estimated at 1 in 3.^{CS-4} The KPMG “Project Star” (conducted on behalf of Philip Morris International and based on detailed empty pack surveys) 2011 results suggest that the level of non-duty paid cigarettes was higher in Ireland than in any EU country not on the EU’s Eastern border and well above the EU average. Ireland has the second highest cigarette prices in the EU as a result of sustained increases in tobacco excise duty, which has risen by almost 40% in seven years from 2005–2012. The fall of 10.25% in terms of GDP based personal purchasing power between 2007–2010, resulting from the economic downturn in Ireland, is likely to have made illicit tobacco products more attractive to consumers. The Irish Government has also increased the scope of tobacco regulation significantly

with restrictions on advertising, display, vending machines and a requirement for retailer registration.

The policy of sharp excise increases seems also to have been counter-productive from a revenue perspective, as the massive rise in excise duty from €155 in 2001 to €274 per thousand cigarettes did not result in any fiscal benefits for the Irish Government as revenues remained virtually flat. A November 2010 report by the Tax Policy Unit of the Irish Department of Finance shows that, though duty on a pack of cigarettes was increased by €2.47 from 2000 to 2010, annual revenue from tobacco excise was €50 million lower in 2010.

The report, “Modelling the Market for Cigarettes in Ireland,” published in February 2011 by the Irish Revenue Commissioner states, *“It (illicit trade) is driven by several factors but the main cause is the price differential between cigarettes on the Irish market and elsewhere. Given the current high cigarette price level in Ireland, the incentive for substitution to untaxed tobacco is greater in Ireland than it otherwise would be. This probably explains the high price elasticity estimate – higher prices will likely increase untaxed consumption.”*

Although limited by the data and requirements of the model, further analysis finds some evidence that cigarette tax levels have moved beyond a critical point at which increases in tax rates lead to lower, rather than higher, tax revenue. Further tax (price) rises will reduce smoking somewhat but they will also greatly encourage more untaxed consumption.”^{CS-5}

is a sharp increase in the price of cigarettes, the percentage of those who smoke illegal cigarettes will continue to rise."

ITIC has published a number of research papers on tobacco excise taxation; for further information on tax policy see the publication list on page 44.

5.2.2 Corruption - Facilitator, not Driver

In 1999, the World Bank agreed with some academic researchers that the most important determinant in tobacco smuggling was the level of corruption in a country (as measured by the Transparency Index).⁵³ The estimates revealed that each one-point increase in a country's transparency index is associated with a 2% decrease in estimated tobacco smuggling.⁵⁴ This finding is challenged by Adrian Cooper and Daniel Witt where they comment that, *"The experiences of the UK, Germany, France, Canada, Ireland and Singapore – some of the least corrupt countries in the world with very effective law enforcement and administration (Transparency International 2011) demonstrate that high excise tax burdens which lead to a decline in affordability can generate a serious problem with illicit trade."*⁵⁵

The 2012 KPMG study demonstrates that corruption cannot be the main cause of illicit trade in tobacco products as the highest increases in illicit trade were noted in the UK, Ireland and Finland – countries which do not rate as badly as many other EU countries in the Transparency Index, but which do have high rates of taxation on tobacco products.

Undoubtedly, while corruption and other factors described in this chapter facilitate, the key drivers of illicit trade are the balance between rewards or profit potential (for the smugglers), the level of demand (determined by affordability and ease of access), and the risk of detection and effective punishment.

5.2.3 Protectionist Policy Measures

In countries where consumers demand for international brand exists, protectionist measures, import restrictions and prohibitive duties rates aimed at imposing technical barriers to trade, constitute an additional economic impetus for illicit trade. An example of this is China, where imports of foreign brands are limited by strict quotas making them legally inaccessible to the vast majority of consumers.

5.2.4 Inadequate Enforcement

In many instances, laws are enacted that attempt to address illicit trade. However, once in place, they are not properly enforced for a number of reasons.

- **Official Border Controls**

Policing millions of movements of goods across borders is resource intensive and requires the involvement of national and international enforcement agencies. The resources required

involve skilled prevention, intelligence, detection and investigation staff, as well as the information technology backup for intelligence, risk assessment, resource allocation, intervention feedback, and mutual assistance across borders. Here, the structural impediments to successful exchange of data and mutual assistance need to be identified and removed. Accurate, timely and secure data, ease of access by authorized personnel to check on declared entries, and up-to-date risk assessment tools should all be part of a modern enforcement toolkit. Comparisons between export declarations from the country of origin, transit declarations and import declarations at the final destination can help identify illicit cargo. Effective risk assessment relies on accurate and timely data available 24/7 to enforcement officials and includes the latest intelligence and analysis of seizure data. In many developing countries, the quality of data is poor, analysis of data patchy and ability to transfer data quickly and accurately to front-line enforcement officials, or to enforcement authorities in other countries, is unreliable. Mobile task forces require transport equipment, mobile scanners and new technologies as they evolve.

For geographical reasons, the borders of many countries are difficult to police comprehensively. In most cases, smuggling takes place through known entry and exit points (ports, bridges, interstate roads, airports and Free Zones). Inadequate controls at such points, sometimes coupled with varying levels of corruption, allow smugglers to move products in large volumes undetected. The situation can be exacerbated due to political instability in a country or region. In many countries, the installation of modern scanners is limited by the infrastructure. Security equipment is expensive and the facilities and resources required for physical examination of cargo can be unaffordable even in developed countries.

In busy international ports around the world, only a small proportion of total cargo is currently subjected to scanning⁵⁶ and/or physical examination. In many developing countries the cost of scanners and the constraints of space, inspection facilities and skilled customs resources mean that even a small proportion of full examinations of containers can create long delays for importers.

- **Official Controls of Licensed Manufacturers**

The practice of stationing one or more revenue officials on the excise operator's premises was replaced decades ago in the UK and USA, both to reduce the danger of familiarity or corruption between excise operators and revenue officials and to reduce administration costs. Control of tobacco manufacturers and storage and movement of tobacco products tax-free under bond is, in most developed countries, subject to audit controls based on the

Case Study: Singapore

Singapore Port is one of the world's busiest ports and an important hub in international trade, handling more than 25 million twenty-foot equivalent (TEU) containers every year and servicing container traffic moving between ports in Asia, Europe, and North and South America. Singapore is also a key transit point in the global illicit tobacco trade^{CS-6}, as cigarette smuggling syndicates exploit Singapore's system of approximately forty Licensed Warehouses to operate their global smuggling transit systems.^{CS-7}

Cigarettes are usually correctly declared on entry into one of Singapore's Free Trade Zones (FTZs), where they are transferred to Licensed Warehouses. Shipments can then be manipulated prior to re-export. While some of these re-exports are legitimately declared, others are exported using false documentation. Often, the cigarettes do not carry the health warnings or other markings required by the destination country.^{CS-8}

Recent seizures of illicit cigarettes in Australia demonstrate how the Singapore Port and FTZs are abused in order to facilitate the smuggling of cigarettes. Cigarettes are brought into the Port of Singapore from countries such as the Philippines, Indonesia and Vietnam and stored in a Licensed Warehouse where they are prepared for re-export. In order to avoid detection upon arrival in Australia, the cigarettes are shipped under false or misdeclared Bills of Lading (BoL) that are only required to be submitted once the vessel containing the cigarettes has departed Singapore. This makes identification of the true nature of the cargo of illicit cigarettes and the intended destination extremely difficult.

Seizures of illicit cigarettes traded through Singapore occur frequently worldwide and neighboring countries are particularly at risk, with hundreds of millions of cigarettes from Singapore being smuggled into or seized in Malaysia alone.^{CS-9} The Singapore Government has made great efforts to tackle the illicit cigarette trade in Singapore, but needs to also address the transit of cigarettes destined to be smuggled into neighboring markets.

operator's compliance history and assessment of risk. The effectiveness of these controls is dependent both on the specialist skills and knowledge of the officials, the integration of customs and excise data supported by risk and intelligence tools, and the partnership relationship with the excise operator. Nowadays, computerized records and modern business processes mean that excise controls can be aligned easily with effective management controls by the excise operator in order to reduce burdens on business. Excise audit needs to be based on an understanding of the revenue risk points in the business process, the supply chain and financial records, and trends in the industry. This also needs to be supplemented with unannounced inspections of the production premises to detect any undeclared production (sometimes known as the "nightshift") and distribution.

• Other Inland Official Controls

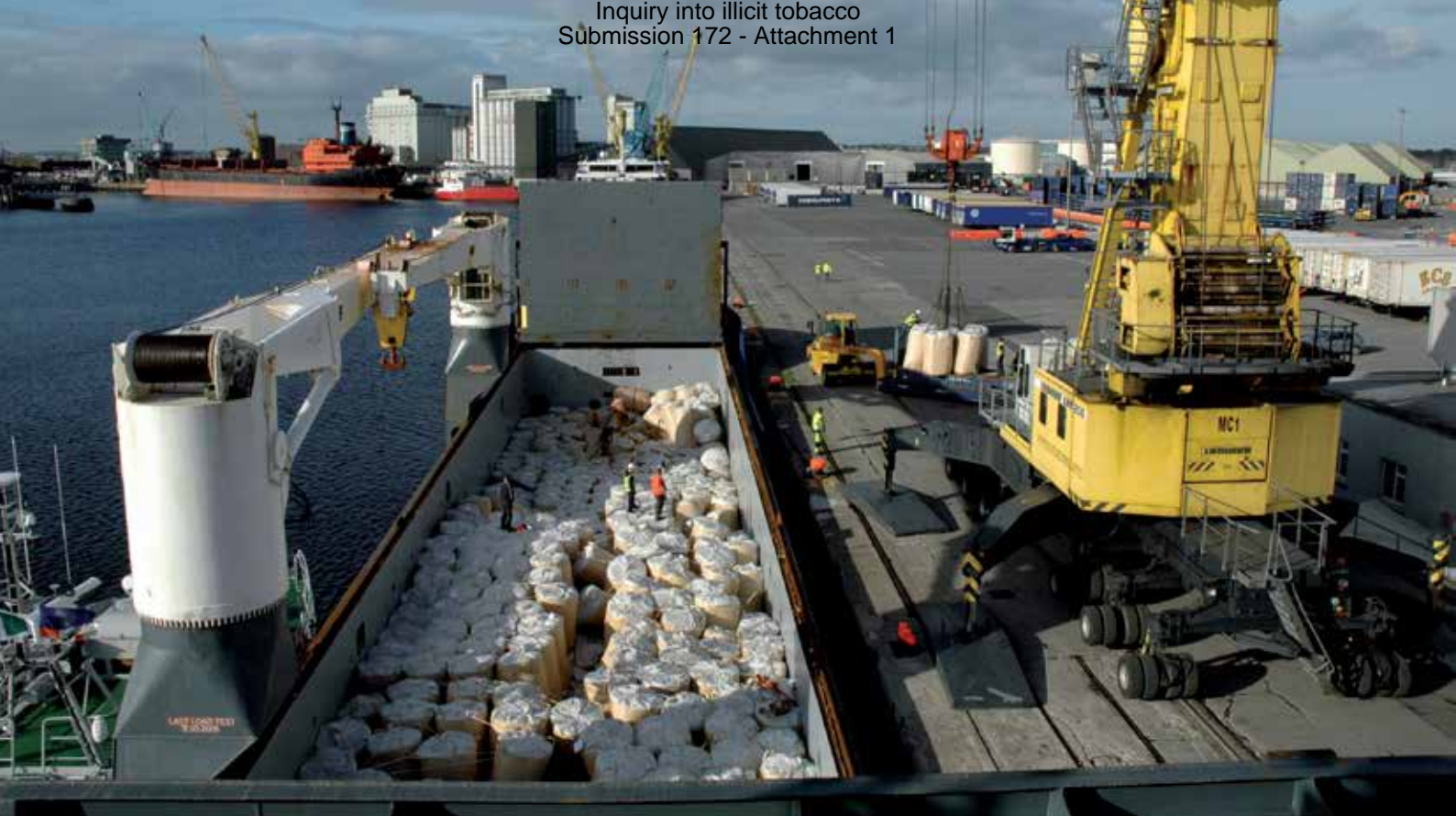
Officials from authorities other than customs or fiscal authorities carry out inspections and other controls on labeling, health and safety and sales to minors at the wholesale and/or retail level. These officials, if made aware of the indicators of illicit trade, can assist in detecting non-tax paid products. Similarly, VAT officials carrying out audits can assist their excise and customs colleagues. Local police and social workers come across informal distribution chains and their customers can provide intelligence to assist in dismantling the distribution network and identifying sources of illicit domestic production. These other sources of official controls inland are often ignored and opportunities to disrupt illicit supply chains lost.

• Corruption

The impact of corruption is accepted as a facilitator (see paragraph 5.2.2),⁵⁷ though not a key driver for illicit trade. Revenue and enforcement authorities who do not take a robust stance against corruption can expect revenue losses and increased crime. A 2012 report on border posts, checkpoints and intra-African trade cites the delays caused by the costs of bribes to officials at borders and checkpoints as one of the main impediments to economic development in Africa. It also gives details of the average level of bribes paid to different agencies at different checkpoints on different routes. The report shows that corruption is widespread across police and customs officials and recommends the development of one-stop shop border posts where facilities and declarations are shared between customs authorities, making it more difficult for officials to seek payments for facilitating under or misdeclaration of goods.⁵⁸ Dr. Louise Shelley's research shows that corruption facilitating illicit trade can reach the top leadership of a country. In Montenegro, the President was indicted in Italy for his role in the illicit cigarette trade.⁵⁹

• Goods in Transit and Transshipment

Goods in transit are those that have departed from the dispatch, loading or shipping point but have not yet arrived at the receipt, offloading or delivery point. Transshipment is the shipment of goods to an intermediate destination and from there to another destination. This is often due to a change in the means of transport during the journey such as from ship transport to road transport. Much international transshipment also takes place in designated



customs areas, thus avoiding the need for customs checks or duties.

Both the OECD and WCO have raised concerns as to the lack of adequate legislation, controls and enforcement governing goods in transit. In its 2007 report on crime the OECD stated that, *"Very often goods in transit are specifically excluded from the prohibitions related to counterfeit goods, which means that they cannot be intercepted."* The WCO, in the introduction to its proposals for model legislation to safeguard against IPR infringements recognized in 1988 that Customs need to have clear authority in law to monitor goods in transit and in free zones: *"The experience of customs administrations in numerous countries has indicated, however, that only by granting certain powers and measures that go beyond the minimum requirement set forth in the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs), Governments can provide an effective and efficient level of IPR protection and enforcement at their borders."*⁶⁰ The models proposed by WCO are still relevant for adoption by many countries.

Movements of excise goods under bond across a customs union can offer opportunities for goods to be diverted during transit. The Excise Movement and Control System (EMCS) is a pan-EU electronic messaging system that has been introduced at great expense to provide timely notification to officials of movements of goods under duty suspension within the EU. However, it has to be combined with effective risk assessment and sufficient interventions to ensure that approval numbers are not duplicated to facilitate the movement of illicit loads. Consistent application of such tax-free movement tracking systems across the region supported by robust internal controls in all countries is still essential if

fraudsters are not to find a way to use the electronic tracking system to their own advantage.

- **Free Zones**

Free Zones⁶¹ are set up by governments in an effort to attract new business and foreign investment. They facilitate trade by eliminating tariffs, quotas, and minimizing bureaucratic requirements (e.g. customs procedures and disclosure requirements).

Increasingly, criminal organizations are using Free Zones to manufacture "illicit whites" for smuggling to their final destination. These Zones are also used to produce counterfeit goods or to misdeclare containers of illicit tobacco product as legitimate goods. Significant numbers of shipments seized in recent years were intended to be transited/transhipped more than once, to hide the true origin of these goods. These shipments underwent as many as five transit/transshipment points before being seized. Reduced customs controls are the key driver. To overcome such deficiencies, the WCO proposes to accede to Specific Annex D2 of the Revised Kyoto Convention which provides guidance on minimum customs control in Free Zones. A report by the International Chamber of Commerce's Business Action to Stop Piracy and Counterfeiting (BASCAP) explores the problems in detail and makes a number of recommendations for action by the WCO, WTO, national governments, and Free Zone operators.⁶²

An examination of Free Zones' controls in 2009,⁶³ suggests that, even where the necessary legislation exists, enforcement can be weak due to pressure on customs authorities to relax controls in order to stimulate economic growth.

5.2.5 Inadequate Legislation and Sanctions

Countries usually have laws against smuggling, tax evasion, selling cigarettes without the correct health warnings, incorrect declaration of imports and ignoring other regulatory requirements. However, there are often difficulties in proving violations of laws in respect of “illicit whites.” It is often difficult to prove any violation of the law at the point of manufacture though it may seem obvious that certain manufacturers do not conduct due diligence on their customers and do not monitor their supply chains.

Enforcement officials find it challenging to prove illegality associated with export of “illicit whites” that have been manifested correctly. It is easier to identify cigarettes (counterfeit, contraband or “illicit whites”) if the documentation misdescribes/ misclassifies the goods. At import, enforcing relevant laws against smugglers found illegally importing “illicit whites” can mean having to take frequent, resource intensive action in respect of small quantities. At the point of sale, there are enforcement challenges as the only evidence available against the manufacturer may be that the price of the product is so low that taxes could not have been paid.

In many countries, enforcement agencies have insufficient legal powers to enable them to operate effectively as illicit trade of tobacco products is considered a relatively minor offence. This attracts

crime syndicates who see cigarette smuggling as a high profit, low risk activity which incurs lighter penalties than criminal activities like drug trafficking, human trafficking and arms smuggling.

The following statement⁶⁴ illustrates the limited deterrence effect of the law (still in place) in the US: *“Tobacco smugglers’ only fear is losing a load of cigarettes. We do not fear law enforcement. They will pull us over, seize the load, and maybe we get arrested, but most likely we do not. The worst case scenario, we go to jail for a couple of months before returning to smuggling again. Think about it. A small fish like me can make \$50,000 a month working only a few hours each week. The big fish make hundreds of thousands a week, most of which goes to the Middle East in cash or trade transactions.”*

As highlighted in the BASCAP report, countries without strong deterrent penalties, including the power to confiscate the proceeds of crime, automatically put themselves in weak position to tackle the illicit trade in tobacco products.⁶⁵

In addition, as the Russian case study illustrates, the destruction of seized goods and equipment used in the manufacturing of illicit tobacco products should be mandatory. In some countries, goods and equipment are auctioned off with the result that they find their way straight back onto the illicit market.

Authorities have sought to curb illicit trade with legislative measures, but fraudsters have found

Case Study: Russia – Procedures Needed for Obligatory Destruction of Equipment or Machinery used for Counterfeiting

In Russia, despite the provision for destruction of equipment (including machinery) in Chapter 4 of the Russian Civil Code, equipment or machinery used to produce counterfeit cigarettes and seized in raids of counterfeit production factories is often not destroyed. This is because the Russian Criminal Procedure Code does not define the destruction process clearly.

In most cases, courts limit their decisions to the seizure of equipment and do not order its destruction. Similarly, when a criminal case is initiated and later suspended, there is no clear direction to judges as to what should be done with material evidence, machinery and counterfeit products. Right holders, although not prohibited from participating in the destruction process, are not formally required to do so. Nor do right holders receive any official notification of destruction. Russian law does not determine who, in cases where no natural or legal person is identified as the infringer, should bear the costs of destruction, which can be significant in the case of high-tech machinery used for the production of counterfeit products. As a result of the lack of clear procedural provisions regarding destructions, seized equipment or machinery could easily re-enter circulation and be used in future counterfeiting operations.

This problem could be remedied through the introduction of clear provisions in the Criminal Procedure Code that:

- (1) Dictate that courts must order the destruction of equipment and machinery shown to have been used or been intended for use to produce counterfeits;
- (2) Provide courts with the authority and obligation to order the destruction of material evidence in situations where a criminal case is suspended and the material evidence is shown to be counterfeit or, in the case of equipment and machinery, it is shown to have been used to manufacture counterfeit goods;
- (3) Provide for a procedure for the destruction of equipment or machinery used for counterfeiting;
- (4) Provide for the participation of right holders in the destruction process;
- (5) Provide for formal written notification to right holders of destructions; and
- (6) Dictate who should bear the costs associated with destruction where there is no legal or natural person identified as the infringer.



The seizure and destruction of materials and equipment used to manufacture counterfeit cigarettes are critical components of legislation and an effective means to combat illicit trade.

Belize – The Perfect Transit Point for Smugglers?

The **Corozal Free Zone (CFZ)** was established in 1994 with 314 companies registered to date, of which 30 trade in cigarettes. The CFZ provides facilities for manufacturing, processing, warehousing, packaging and distribution of goods and services. Businesses established inside the Free Trade Zone have no foreign exchange restriction; these businesses receive various other benefits that include duty exemption. Goods leaving and entering the Zone are exempt from import/export duties, stamp duties, quotas and revenue replacement duties. Income tax is between 2% and 8%. However, this amount can be reduced through tax cuts from employing Belizean workers. No license is required for import or export. During the first five years of its existence, a CFZ business is exempt from income tax, capital gains tax or any new corporate tax levied by the Government of Belize. Any dividends paid by this business are exempt from tax for the first 20 years of its operation. This relief is reflected in the number of duty free shops located in the area. In 2011, 17 new retail outlets selling tax free products opened in the CFZ.

ways to continue their activities by changing their methods. For example, in July 2010, the Vietnam Government changed the law to make it a criminal offence to be in possession of more than 1,500 packs of smuggled cigarettes.⁶⁶ While initially this resulted in a reduction of illicit trade of more than 20%,⁶⁷ the smugglers soon changed their operations by transporting multiple consignments of less than 1,500 packs.

5.2.6 Inadequate Capacity, Poor Data and Unreliable Information Technology (IT) Infrastructure

The need for sufficient and appropriately skilled resources to fight illicit trade cannot be overstated. Developing countries, in particular, may have resources with insufficient training, inaccurate or incomplete data that may be held on manual systems, and an unreliable internet infrastructure. The criminals rarely lack the resources they need to support their actions.

5.2.7 Public Tolerance

Consumer demand drives the illicit trade. Consumers are often aware that they are purchasing smuggled or counterfeit goods, but still decide to do so to save money. At the same time, the general public is often unaware of the implications of illicit tobacco trade and perceive it as a victimless crime. In a study⁶⁸ of smokers in socially deprived areas in the UK, Wiltshire et al. found that, far from being ashamed of such behavior, they saw this behavior as a way of challenging a perceived injustice; *“Nearly all respondents expressed dissatisfaction with the price of legal tobacco products. It was thought to be unjust and directed against people on low incomes.”*

A 2010 study by the NGO Action on Smoking and Health (ASH) reports similar findings: *“Measures that are perceived by the public as unreasonable have potential to increase tolerance of illicit trade.”*⁶⁹

6. How to Combat the Problem

In this chapter, we list the main elements a comprehensive approach needs to assess and, where required, amend or implement to combat the illicit trade in tobacco products effectively.

6.1 Understanding the Size and Nature of the Illicit Trade

As a first step, governments and their law enforcement agencies need to understand the size and implications of the illicit trade in tobacco products, identify those involved and the links with illicit trade in other goods. There are several indicators of the presence and growth of illicit trade in tobacco products. These include:

- An unexplained drop in legal market sales – usually noticed first by the industry and trade;

- Disturbances in the flow of Government revenues;
- An increase in seizures of illegal product – either in frequency or quantities;
- The emergence of brands which do not display the correct markings or which are not legally distributed and sold in the country; and
- Changes in the results of anti-illicit trade surveys.

The results of solid and robust methodologies are usually instrumental in raising awareness of the authorities and the general public about the seriousness of the problem and can serve to influence the allocation of resources.

Summary of Key Features of a Comprehensive Strategy to Fight the Illicit Tobacco Trade

- Achieve top level political ownership to ensure sufficient prioritization and the necessary resources are made available.
- Understand and monitor the size and nature of the problem.
- Evaluate the main facilitators, including manufacturing and export controls, Free Zones and transit operations, etc.
- Adopt a balanced tax policy and operate effective tax collection.
- Analyze existing legislation and regulations to ensure they work and are enforced effectively and that the penalties are adequate and act as a deterrent.
- Conduct full impact assessments of any proposed tobacco related legislation.
- Ensure the judiciary is aware of the seriousness of the crime and the need to destroy illicit product and equipment in a timely manner.
- Develop an enforcement strategy that includes all relevant national agencies and ensure they possess adequate powers to act effectively.
- Provide sufficient financial resources for adequate law enforcement capacity.
- Tackle demand by educating and informing the public about the implications of the illicit tobacco trade.
- Build and strengthen partnerships between national and international agencies.
- Cooperate with legitimate industry players to make the best use of combined intelligence and resources.

The nature of illicit trade is constantly changing as criminals and opportunists take advantage of all opportunities. Over the past decade, some countries have witnessed an explosion in illicit tobacco products arriving in small quantities by mail from overseas.

6.2 Evaluating the Main Facilitators of Illicit Trade

Please refer to Chapter 5, in particular 5.2.

6.3 A Balanced Tax Policy and Effective Tax Collection

As highlighted in 5.2.1, cigarette excise tax rates should primarily be set to optimize tax revenues over the long term. When setting tax rates, governments need to take into account the level of economic development, the purchasing power of the consumer and the tax rates in neighboring countries. Experience shows that radical excise “shocks” are more likely to lead to the emergence or growth of illicit trade.

Countries use different methods to collect and control tobacco taxation revenues. Excise administrative systems are usually based on checking factory output, bonded warehouse and import volumes. This can be complemented by the use of markers (codes or stamps) printed on or affixed to each individual sale package. These markers can be used either as an additional audit mechanism or as a means of tax payment. They are intended to confirm the actual tax payment for the product to which they are applied.

However, many tax stamp systems have failed to protect excise revenue. Like cigarettes, paper tax stamps are subject to very high quality counterfeiting, often within weeks of appearing, to avoid easy detection. Paper stamps have also been stolen and re-used by smugglers (e.g. in Kenya).⁷⁰

The technology is developing quickly and there are digital tax verification solutions that offer a more secure approach to tax collection and auditing. These are discussed in more detail in Section 7. Some of these systems can provide governments with real-time and secure information about the volume of product manufactured both in and for their country providing transparency on the amount of excise duties to be collected by each manufacturer and importer.

6.4 Effective Legislation and Regulations

To be effective, legislation needs to be clear, simple to administer and should provide law enforcement with sufficient authority to take action. Important

legislative requirements include:

- Clear offences and appropriate penalties;
- The systematic destruction of all seized illicit tobacco products, raw materials, manufacturing equipment and components. In some countries legislation on the disposition of seized goods is non-existent, allowing for seized products and equipment to be sold at auction, creating confusion and the inability to destroy them promptly;
- Means to recover tax revenue losses and costs for destruction of seized goods such as asset confiscation;
- Robust control over duty-free supplies;
- Supply chain controls such as manufacturing licences, registration of wholesalers and retailers, security markings; and
- Strong protection measures for brand owners against IPR violations.

In order to be effective, law enforcement and judicial authorities have to be able to trace, freeze, manage and confiscate the proceeds of crime. The benefit of confiscating the assets from criminals is that it undermines the “commercial” incentive for the crime, reduces profits, and prevents them from being further reinvested to fuel illegal activities. Governments who have not already done so are urged to put in place legislation to enable seizure of criminal assets. Guidance on developing legislation to provide for effective confiscation of the proceeds of crime on the basis of international best practice is set out in the BASCAP report on “Confiscation of the Proceeds of IP Crime.”⁷¹ The recommendations fall into three categories (i) developing the legal framework to implement proceeds of crime legislation; (ii) setting up the institutional framework to administer the legislation effectively; and (iii) supporting international cooperation mechanisms.

To be in the best position to combat illicit trade, customs powers may need to be strengthened and clarified so that there is no ambiguity regarding jurisdiction. The success of the anti-illicit trade strategies adopted by Hungary, Romania and the UK has been attributed, in part, to the strengthening of legislation to support enforcement.⁷²

Authorities should ensure that any measures being developed to reduce the legal accessibility, visibility and availability of tobacco products to consumers are considered carefully by enforcement authorities before implementation so that no unintended impetus is given to illicit trade by:

- Impeding the ability of appropriate agencies to identify illicit products;
- Making it more difficult for government agencies

Case Study: Corruption Investigation “Operation Heritage” in Australia

An interim report by the Australian Commission for Law Enforcement Integrity^{CS-10} sets out the facts that led to the arrest of four Customs and Border Protection officers from Sydney International Airport earlier in 2013. One of those arrested pleaded guilty to the charges he faced and, in April 2013, was sentenced by the New South Wales District Court to seven years in jail with a four-year non parole period. The others were charged with corruption-related offences, including abuse of office, offering a bribe to a Commonwealth public official, and receiving a bribe, as well as conspiracy to import a commercial quantity of border-controlled precursors.

An officer from the Department of Agriculture, Fisheries and Forestry (DAFF) was also arrested on charges of abuse of public office, prohibited disclosure of official information, receiving a corrupting benefit and influencing a Commonwealth public official. Prior to the arrest, the officer was a member of the DAFF Border Compliance Division and worked at Sydney International Airport.

15 other people were arrested and charged/sentenced for offences including, conspiracy to import a commercial quantity of border controlled precursors, bribery of a Commonwealth official and dealing in the proceeds of crime. At the relevant time, one of these people was a baggage handler at Sydney International Airport.

The Chief Executive Officer of Customs and Border Protection, Michael Pezzullo, said, *“The arrests would be disappointing to the vast majority of diligent, hardworking and honest officers who are committed to their work of protecting the border and the Australian community. I know that the vast majority of officers want those who have done the wrong thing to be dealt with decisively and justly. Many officers have told me that they do not want to be associated with anyone who does not meet the high standards the community and the Government expects of us. There is no place within the Service for officers who breach the trust of their colleagues or the community. I have a clear message for such officers – even if you think you can get away with serious misconduct or criminal activity, you are on notice. We will not tolerate such behavior and you will be caught.”*^{CS-11}

He emphasized that reform of Customs and Border Protection was crucial to hardening the Service against the potential for serious misconduct or corruption. Mr. Pezzullo announced he would strengthen Customs and Border Protection’s focus on integrity, security and risk management through a major reorganization of key functions in this area. He also formally commissioned a capability review of the Service’s professional standards function.

to identify contraband or for consumers to distinguish between counterfeit and genuine products when making a purchase; and

- Helping those retailers who choose to deal in illicit products to mix them with genuine tobacco products.

Where retail (and wholesale) sales of tobacco products are subject to a registration requirement, suspension or revocation of registration plus a fine can prove a low-cost and effective sanction. Local publicity when such action is taken serves as a deterrent to others. The Scottish Government introduced a new offence of “selling tobacco while unregistered” which came into force in October 2011. By that date, all legitimate tobacco retailers had to be registered with the Scottish government and an unregistered seller now faces a maximum penalty of £20,000 and/or up to six months in prison.

The supply chain of key components used to manufacture cigarettes, if properly controlled, provides a targeted and powerful mechanism for restricting and ultimately eliminating the production of counterfeit and “illicit white” cigarettes. In particular, improving oversight of the supply chain of one such key component – acetate tow – could effectively limit access to the most widely used raw material for manufacturing filters while avoiding any interference with legitimate demand. This approach

offers the advantage of a limited pool of suppliers, an almost exclusive worldwide use of acetate tow for making cigarette filters, and a relatively limited availability of substitution materials.

6.5 Crime Proofing (Tobacco Control) Legislation (CPL) and Regulations against Illicit Trade

Professor Ernesto Savona, a renowned criminologist based at the Catholic University of Milan, and his Transcrime team have pioneered a new approach to considering draft legislation and regulations. Crime proofing is designed to assess different policy options or different legislative bills/drafts and compare their impact on the crime risks.⁷³ The CPL is a form of risk management applied to crime. Its core idea is that legislation may inadvertently produce new opportunities for crime. The CPL can be used to assess legislation in force or legislative proposals. The crime proofing scientific approach has two phases:

- Assessment of the risk that a legislative measure may produce unintended criminal implications/consequences; and
- Action to close the loopholes in the legislation, thereby “proofing” it against crime.

The process has four aims:

- Identify unintended criminal implications/consequence of existing or forthcoming legislation, if present;
- Determine whether there is crime risk, and if so, of what crime and of what magnitude;
- Analyze pros and cons in terms of crime arising from each policy option; and
- Suggest textual changes to the legislation likely to reduce the risk (either by reducing opportunities for crime or by introducing security measures that may mitigate the risk).

The Transcrime team has developed a step-based checklist for officials to use when exploring whether a regulatory strategy contains any crime risk and, if so, to separate such risk into its components.

6.6 A Functioning Judiciary

A large part of the ultimate success of any anti-illicit trade strategy depends on the judiciary and its capability to quickly deal with cases submitted by the enforcement bodies.

The interventions of enforcement authorities need to be based on adequate laws passed by national legislatures and supported by appropriate penalties which have to be made available to and used by courts to disrupt the activities of the criminals.

6.7 Enforcement

An effective targeted enforcement strategy is the cornerstone of any comprehensive anti-illicit trade strategy. Without it, all the other elements will be of little use. It is often the first step in the process as it is seen as the quickest solution to the problem. However, to be effective, it does require considerable investment in skilled resources and tools. An example from the 2011 UK Tobacco Strategy⁷⁴ is that there has been “£917 million additional investment to tackle organized crime, tax evasion and avoidance through the Government’s Spending Review.” The number of officials working on tackling the illicit tobacco trade has risen by 1,200 since 2000 in the UK.

6.7.1 Invest in Appropriate and Effective Resources

At country level, the main enforcement bodies are usually customs, border guards or specialized police units. Current intelligence and information provided to enforcement officials about smuggling and domestic illicit production methods/players and distribution chains are essential. Simple practical guidance will also be helpful, and this must be kept up-to-date to reflect trends, developments and players in the illicit trade. Information about coding

practices and the latest counterfeit techniques or even the internal and external measurement of containers (see Annex 1) can help customs officials detect false compartments if no scanners are available. Fully trained human resources are the key tool in the fight against illicit trade. They need to know the legal requirements for successful prosecutions and be able to use IT tools and analyze data sources. Leadership, management, appropriate remuneration and ethics training can help to counter a culture of corruption.

Effective enforcement also requires investment in technology solutions that address:

- The analysis of production, import and export traffic and trends, together with real-time risk assessment of movements of goods, real-time response operations and feedback/analysis of intervention results; and
- Supply chain security in terms of tracking and tracing products through the supply chain, authentication of products seized and verification of tax declared in comparison with production.

Other tools that have proved effective are sniffer dogs and scanning machines at transit points for international trade. Intelligence from all available sources and analysis of seizures can help identify changes of methods used by illicit traders.

6.7.2 Tackle Corruption Effectively

Because of the strong correlation between smuggling and corruption, enforcement bodies should display zero-tolerance of corruption both internally and in the private sector businesses licensed to operate as customs or excise operators. The WCO published a model Code of Conduct for customs officials,⁷⁵ and many customs and revenue authorities have now published their own Code of Ethics.⁷⁶

Singapore has a history of taking a firm stance against corruption since the creation of The Corrupt Practices Investigation Bureau (CPIB) in 1952, and is recognized as a world leader in good governance and effective administration.⁷⁷ Lithuanian Customs has taken a similar firm stance to remove corruption from its ranks with the arrest of 21 Customs Officers in December 2012 facing allegations of bribery and abuse of their powers.⁷⁸

6.7.3 Invest in Quality Data and a Robust Information Technology Infrastructure

To estimate the size of illicit trade and measure the success of strategies to counter it requires robust data. The development of effective international mutual assistance data, as well as the IT infrastructure, needs to be accurate, robust and easily accessible 24/7. Data on seizures both at borders and inland, and whether by customs or

by another enforcement authority, also needs to be robust, collated and analyzed to identify the latest trends in smuggling.

6.7.4 Examples of National and Regional Enforcement Strategies

The catalyst for the adoption of a committed enforcement strategy is government awareness of the growing illicit tobacco products trade and its undesirable effects. Several countries and international agencies have developed national enforcement strategies to tackle it. In addition to

the UK, Romania and Hungary, examples include OLAF, the Chinese Tobacco Monopoly (STMA) and, recently, Lithuania.

As Dr. Janos Nagy points out in the World Customs Journal, the UK, Hungary and Romania have been successful in reducing the size of illicit trade in tobacco products using a comprehensive enforcement strategy.⁷⁹ Canada is another example where this approach is being used.

The UK, in its “Tackling Tobacco Smuggling Together” strategies, has taken this a step further

Case Study: Lithuania – Legislation and Enforcement Applicable to Illicit Trade in Cigarettes

LEGISLATION

- 14 amendments to the Lithuanian Criminal and Administrative Codes were introduced between December 2010 and April 2011, applying more stringent sanctions related to illicit trade and corruption.
- Sentences for smuggling increased up to 10 years of imprisonment. Fines on natural persons increased five times to €56.000 (€188.000 for legal entity).
- Introduction of a new regulation on illicit enrichment, with provision for imprisonment of up to four years.
- Extended assets forfeiture (from family members and/or close relatives), if the perpetrator does not justify the legitimate origin of the funds used to purchase the assets. The burden of proof is shifted to the perpetrator.
- The Lithuanian Prime Minister established a top level Government Commission on the economic and financial control and coordination of cooperation among law enforcement agencies, with the Customs Department of the Finance Ministry being the leading institution designated to fight illicit trade.
- An action plan to strengthen measures against smuggling and illegal distribution of excised goods has been adopted by the Lithuanian Government under the supervision of the Parliamentary Budget and Finance Committee on (tax collection/budget performance serve as main criteria).
- Memorandum of Understanding (2011) between the Lithuanian Police Department, Customs and Border Guards on the fight against illicit trade, setting up seven permanent working groups responsible for coordination of actions in the regions adjacent to non-EU countries.

- Introduction of formal, quarterly meetings between the authorities and representatives of the industry.
- Allocation of additional staff and reward scheme (with an overall budget of €850.000) to promote exceptional achievements among law enforcement officers.
- On-going cooperation with the industry through: (i) regular exchange of information between the industry and key institutions; (ii) presentation of data resulting from empty discarded pack surveys to national and regional management of law enforcement agencies; (iii) joint public communication campaign against contraband cigarette trade; and (iv) open dialogue with the industry to evaluate impact of illicit trade on legitimate business.

ENFORCEMENT

- Fighting corruption through: (i) rotation of Customs and Border Guards officers (over 300 officers change their position); (ii) establishment of quick response teams of Customs and Border Guards officers responsible for re-inspection of goods; (iii) constant supervision over public officials by Special Investigation Service, a law enforcement institution reporting directly to the President of Lithuania.
- Establishment of a Joint Investigation Team, comprising of officers from the Customs Criminal Service, the Border Guards Operational Unit, the Financial Crime Investigation Service, the Criminal Police Bureau and the National Security Department to focus on identified organized crime groups.

RESULTS SO FAR

- Corruption – Seven criminal cases against Customs and Border Guards officers.
- Organized crime – two international criminal group engaged in the smuggling of tobacco products operating in Lithuania were dismantled in 2011.

Case Study: The UK's Public Awareness Program

Approximately one-fifth of the UK's smoking population admit to purchasing illicit tobacco. Around two-thirds of illicit tobacco buyers claim that cheaper illicit tobacco makes it possible for them to smoke when they

otherwise could not afford to.^{CS-12} There is also the concern that unscrupulous dealers may target vulnerable groups, such as minors,^{CS-13} and tempt them into consuming other illicit products.

Surprisingly, the findings from regional illicit tobacco surveys show that over 70% of illicit tobacco is purchased from a known source such as a friend, colleague or family member.

CS-14

The UK has also invested in research into the key anti-illicit tobacco trade messages that resonate most with the smoking public in order to mount a strong publicity campaign to inform the public of the implications of consuming illicit tobacco products. The three key messages tested were:

- Illicit tobacco encouraging or making it easier for children to smoke;
- Illicit tobacco bringing crime into the local community; and
- Illicit tobacco putting local traders out of business.^{CS-15}

THE TESTING REVEALED THAT THE MESSAGE AROUND ILLEGAL TOBACCO ENCOURAGING OR MAKING IT EASIER FOR CHILDREN TO SMOKE WAS THE MOST SUCCESSFUL.

The media, both nationally and locally, and social networking sites have been used to inform smokers



Poster in local pharmacy in Dorset, England, photographed by author April 2013.

and parents of young teenagers of the implications of the illicit tobacco products trade. It is also an excellent tool in ensuring that successful prosecutions receive maximum publicity.

Another approach adopted recently by HM Revenue and Customs to influence public opinion was the publication of "mug shots" of the most wanted criminals and the naming and shaming of those who had agreed to a civil settlement rather than undergo criminal prosecution for involvement in smuggling and other revenue offences.



Photograph taken from the "keep it out" website published by the North of England Tackling Illicit Tobacco For Better Health programme.

with a comprehensive cross-government approach involving the national Department of Health and local authorities. Both approaches require, first and foremost, a strong political will to address the multifaceted aspects of the problem. This should ensure adequate financial resources are made available, targets are set, and regular progress reports to evaluate success (or not) are presented. This investment in funding such a strategy has proved to be good value. It has been estimated that the decline in illicit market share in the country since 2000/1 has resulted in additional revenue to the Exchequer (VAT plus excise tax) of approximately £1 billion per year. At an annual cost of under £100 million, this is a gross return on investment of 10 to 1.⁸⁰ It is telling that, when the UK Border Force diverted officials from making customs interventions to working on immigration controls during the summer of 2012, the seizure targets for illicit cigarettes were not met and the KPMG Project Star results for 2012 showed a significant increase in illicit tobacco products consumption in the UK. This emphasizes the importance of always maintaining sufficient resources to deter and detect tobacco smuggling.⁸¹

In addition, the UK has strengthened legislation and penalties in a number of areas and pioneered a truly cross-government illicit tobacco trade strategy that tackles demand as well as supply.

Enforcement effort should not be restricted to national customs or to police authorities. Some countries include local authorities and those responsible for checking the quality of food products at the retail level in their enforcement efforts. In the Tobacco Control Survey of England in 2010–11, 81 councils reported the number of visits where illicit products had been seized as 702. This means that illicit tobacco products were seized in 19% of all visits. This is a significant increase on the number of visits where tobacco was seized in 2009/10 (81 councils reported 702 visits where illicit product had been seized). Councils had taken different actions in respect to these seizures, ranging from simple cautions to prosecutions.⁸²

A comprehensive enforcement strategy is crucial in tackling illicit trade. However, as a standalone element, it cannot take the place of the complementary elements outlined in the rest of this chapter.

6.8 Educate the Public

Government agencies and the industry need to educate consumers and the wider public about the impact of illicit trade, the involvement of criminal and terrorist organizations and the consequences of continued purchasing of illicit cigarettes.

Case Study: Operation HOPE

Operation HOPE^{CS-16} is an investigation that started in 2009 based upon a formal request from Germany to OLAF. The case concerned suspect shipments of tobacco from Brazil via Lithuania, Poland and Ukraine to Armenia. In reality, the tobacco never reached its destination but was diverted for use in illegal cigarette production. In this case, a large illegal factory was raided in Poland in February 2011 and six containers of tobacco were seized in Lithuania.

With the tobacco seized during that raid, the criminals could have produced 120 million cigarettes representing potential losses to the EU taxpayer of €24 million. The factory was shut down during the test phase, but it is estimated that, had it begun producing and distributing cigarettes, it would have resulted in financial losses to the EU and Member States of €6 million per week.

Examination of paperwork relating to previous shipments indicates that this criminal organization has evaded duties of over €55 million on illegal “imports” of tobacco. The main organizers have been arrested in Germany and Lithuania.

6.9 International Cooperation

Because of its global nature and involvement of highly sophisticated international criminal networks with substantial resources, active international cooperation is essential to tackle the illicit trade in tobacco products and bring about successful investigation, arrest and prosecution of offenders. Some international and regional organizations such as Interpol, WCO and OLAF now have liaison resources sited in strategic locations across the world. Several countries have Fiscal Crime Liaison Officers (FCLOs) or Customs Attachés stationed overseas to coordinate enforcement work with other tax authorities. These officials collaborate with the host tax authorities to exploit opportunities to share intelligence and coordinate enforcement action against production and transport of illicit goods destined for their domestic markets. In the UK, this has resulted in seizures of approximately 2 billion illicit cigarettes between 2009–2011 (comprising over half of the UK's total illicit cigarette seizures). In 2012, this worldwide FCLO network covered over 60 countries. Five new FCLO posts were created to respond to threats from new source countries for the illicit tobacco trade and to strengthen cooperation with countries through which these goods transit on their way to their intended destination. France, Germany and the USA also have Liaison Officers or Customs Attachés working in a similar way.

This operation demonstrates the outstanding results that can be achieved through international cooperation.

6.10 Involvement of Stakeholders

The successful combating of illicit trade in tobacco products requires law enforcement authorities and all those involved in legitimate import, export, production, storage and movement of tobacco products, whatever their size, to work together to address the problem constructively in a spirit of mutual trust and cooperation, and provide authorities with information and assistance on specified key elements. In this way formal agreements can be put in place between the authorities and stakeholders to:

- Assess and measure levels and sources of the illicit trade in tobacco products and exchange of data;
- Implement a proactive approach to address the problem;
- Monitor the movement of (suspected) illicit tobacco products and other materials used in the manufacture of tobacco products;
- Analyze and destroy seized goods;
- Support the anti-illicit trade efforts of the region and/or countries concerned;
- Track and trace tobacco products;
- Implement a “know-your-customer” policy;
- Implement anti-money laundering provisions and transparent payment procedures; and
- Ensure that markets are supplied commensurate with local and legitimate cross border demand.

6.11 Protecting Revenue when Moving to a Regional Customs Union

All over the world, regional customs unions are being put in place with the expectation that these will facilitate trade and economic development for the countries involved. The removal of tariffs and non-tariff barriers (such as border delays and related unofficial payments, the liberalization of trade in services, facilitation of trade, investment, and movement of business and of people underpinned by the implementation of joint infrastructure programs) are some of the many anticipated benefits. There should also be specific customs benefits through improved trade information, better coordination of national and international border agencies, reduced border costs through shared responsibilities, and reduced opportunities for corruption.

However, if the constituent countries in a proposed customs union all apply different tax rates and structures to excisable goods and there are different levels of Gross Domestic Product (GDP) and, thus, affordability across the region, it is essential to put in place measures to protect excise revenue before removing customs barriers within that region. Suggested excise guidelines for national and regional application can be found in Annex 2.

7. The Protocol to Eliminate Illicit Trade in Tobacco Products (ITP)

7.1 Background

The WHO Framework Convention on Tobacco Control (FCTC) was adopted by the World Health Assembly in May 2003 and entered into force on 27 February 2005. Article 15.1 of the WHO FCTC states:

"The Parties recognize that the elimination of all forms of illicit trade in tobacco products, including smuggling, illicit manufacturing and counterfeiting, and the development and implementation of related national law, in addition to sub-regional, regional and global agreements, are essential components of tobacco control."

FCTC Article 15 contains seven clauses which are currently legally binding in over 170 government Parties. In July 2007, the Conference of the Parties (COP), which is the governing body of the FCTC, decided to establish an Intergovernmental Negotiating Body (INB) open to all Parties of the FCTC to negotiate a Protocol to eliminate the illicit trade in tobacco products. The purpose of the ITP is to create more detailed binding obligations for Parties aimed at curbing the illicit trade in tobacco products by building upon and complementing the existing legal obligations outlined in FCTC Article 15.

The ITP was adopted in November 2012 and is open for signature, ratification and/or accession by the Parties. It will enter into force as international law once 40 Parties have ratified it. As a multi-lateral treaty, it will be binding on Parties only once it is enabled into national law.

The three main elements of the ITP: supply chain security, offences and enforcement, and international cooperation are detailed in the following sections.

7.2. Supply Chain Security

The ITP is designed to reduce illicit trade in tobacco products by securing the legitimate supply chain. This requires participants in the supply chain to take measures to prevent diversion of tobacco products and machinery into illicit trade channels. These measures are intended to promote responsible business conduct that must apply equally to all participants regardless of size.

If the global tobacco supply chain can be secured for all genuine branded products, then enforcement authorities will be able to devote a greater proportion of their resources to detecting and investigating illicit products.

7.2.1 Tracking and Tracing

Since the first edition of this booklet, technology has evolved and there are a wide variety of new track and trace systems on the market designed to



secure the supply chain for different commodities. Some of the new systems use advanced unique digital coding technology printed directly onto packaging. They are easily readable and can also serve as authentication tools.

Article 8 of the ITP aims to establish a tracking and tracing regime to help combat the diversion of genuine product as an integral part of efforts to fight illicit trade. Tracking is the ability to monitor the forward movement of finished goods through the supply chain. Tracing is the ability to recreate that movement up to a certain point in the supply chain to help determine where the product was diverted into illegal channels.

The ability to exchange and manage data consistently on a global basis is vital. This point is highlighted in the WHO FCTC Expert Report on Tracking and Tracing.⁸³ The report has an assessment of the current systems and approaches available to meeting the tracking and tracing requirements of the ITP. The report stressed that:

- The need for aggregation of packaging is fundamental (linking packs to cartons and cartons to master cases);
- It is vital that implementation starts from the top down (master case to carton and from carton to pack);⁸⁴ and

- It is not feasible to have only pack level tracking and tracing without addressing also the intermediate levels.

7.2.2 Implementation of the Track and Trace Requirements

There are many products being marketed that purport to meet the requirements of the ITP Track and Trace provisions. There are many different approaches being considered by different countries. In deciding how to implement the track and trace requirements, Governments will need to consider the advantages and disadvantages of different systems and the different approaches that each permit in the context of their national situation. It will be of key importance to enforcement authorities worldwide to ensure that the data provided by a track and trace system can be read quickly and easily. The data also needs to be accurate, secure and easy to share with other enforcement authorities. To ensure that governments planning to implement the track and trace provisions can assess the suitability of the systems available, internationally agreed standards could be useful. Such standards would avoid a situation where countries adopt track and trace systems that result in incompatible data systems covering domestic manufacture and export, transit, and import across a supply chain that stretches over several countries and continents.

Such standards should include the format for information recording, reporting, security and access by government officials. They should also enable data to be exchanged easily between enforcement authorities and provide for simple, user-friendly assurance of identification markings by

enforcement officials and consumers. Consistency of standards for track and trace systems should facilitate enforcement and ensure that the systems used by manufacturers (large and small) meet the provisions of the ITP.

Information collected by these tracking and tracing systems includes sensitive and confidential data so it remains critical that manufacturers can comply with the legislation covering data privacy and data protection.

Many suppliers are developing, or already marketing, track and trace systems to meet the ITP requirements and work is underway in ISO Technical Committee 247 WG3⁸⁵ to develop a standard for interoperability that can be used in track and trace systems for any commodity.

7.2.3 Customer Identification

Key participants in the supply chain must conduct due diligence with respect to customers ("first purchasers"), including:

- Verification of their legitimacy to trade in, or purchase, tobacco products;
- Determining whether volumes are commensurate with demand;
- Reporting suspicious transactions; and
- Terminating business relationships when laws have been broken.

7.2.4 Record Keeping

Key participants in the supply chain are required to maintain complete and accurate records of all

Industry Track and Trace Standards

Based on the EU Agreements with OLAF, British American Tobacco, Imperial Tobacco, Japan Tobacco International and Philip Morris International have worked together to establish industry standards which meet the requirements of international standards for tracking and tracing. The industry standards comprise:

- 'Open' coding standard – all information reported is in a standard format regardless of the manufacturer. The open standard is compliant with international coding standards;
- Reporting standard – all reports come in the same format and content regardless of the manufacturer; enabling customs officials to use the same methodology to read the codes whichever the manufacturer of the brand is; and
- Standard report source – government officials can have one point of contact for report requests.

These standards enable all manufacturers, large or small, to adopt a solution that is fit for purpose according to their unique systems, processes and resources.

relevant transactions for four years and to make records available to relevant authorities. Records are required to be shared between Parties to the ITP.

7.2.5 Licensing or Equivalent Approval Systems

When accompanied by effective enforcement and deterrent penalties, the licensing system helps ensure that only legitimate and law-abiding businesses are engaged in the manufacture, import, and export of tobacco products and manufacturing equipment.

7.2.6 Free Zones

To reduce illicit trade, these Zones need to be subject to the same provisions and under the same level of official control as elsewhere (licensing, tax warehousing, record-keeping, tracking and tracing). The intermingling of tobacco and non-tobacco products at export is prohibited in the ITP.

7.2.7 Destruction

The destruction of confiscated manufacturing equipment, tobacco, non-tobacco materials and illicit tobacco products is essential to prevent these items from finding their way back into the illicit trade or being used to produce additional illicit products.

7.3 Offences and Enforcement

This part of the ITP provides for the legislative and enforcement aspects of dealing with the illicit trade problem. It outlines guidance for governments in terms of measures to deal with unlawful conduct, including prosecutions and sanctions for criminal activity, as well as liability. It covers search of premises and seizure of evidence, confiscation of assets, seizure payments, destruction of seized products and investigative techniques.

7.4 International Cooperation

The ITP provides for all Parties to cooperate with each other and competent international organizations, as mutually agreed, in sharing a wide range of enforcement information and best practices and to cooperate, with each other and/or through competent international and regional organizations, in providing training, technical assistance and cooperation in scientific, technical and technological matters.

7.5 Issues for Consideration in Implementing the ITP

Not all provisions of the ITP are mandatory – many are optional – and each government will interpret and carry out the Protocol in its own way. Successful implementation of the ITP will rest on

the ability of governments to invest in capacity building, both for regulatory and law enforcement agencies, as well as technological equipment and international cooperation.

Implementation of the ITP might be more effective in the drive to eliminate illicit trade in tobacco products if Parties choose to implement additional measures, such as applying the ITP provisions also to key inputs – such as acetate tow – or to the major components used when producing tobacco products. For maximum effect, the ITP will need to apply to all tobacco manufacturers without exception.

Each country or region may be expected to develop an illicit trade action plan that is specific to their needs. This will normally include a gap analysis to compare and contrast the measures they already have in place to fight illicit trade with the ITP requirements and identify all changes required to current legislation for implementation of the ITP, in addition to any other desirable measures. To fight a global problem, countries will need to look beyond their borders when crafting illicit trade policies, and harmonize their overall illicit trade measures with those of neighboring countries, while ensuring that resulting ITP legislative changes align with each country or region's needs and expectations.

7.5.1 Policy and Administration Issues

There are many areas covered by the Protocol, and the wording includes many levels of obligation. Some items are mandatory but others are optional (e.g. to license transporters). Decisions need to be made on each of these options, as well as the detailed responsibilities of the authorities and stakeholders, new processes, resource requirements, training, costs and timescales.

Completion of this analysis will inform policy decisions, determine funding requirements, and enable detailed action plans to be put in place for successful implementation of the Protocol.

Some customs unions or free trade areas may want to develop a regional approach to many of the issues to avoid inconsistent implementation (i.e. when one or more countries in a customs union choose to license only the mandatory subjects, whereas others choose to make full use of the licensing options).

7.5.2 Enforcement Considerations

If the Track and Trace provisions are implemented effectively across the world, it should become easier for enforcement authorities to detect both the point where any traced products are diverted to the illicit market and the criminals who trade in them.

Enforcement authorities will need to ensure that all track and trace products meet the full requirements for the ITP Track and Trace provisions. It could be helpful to have a set of agreed standards to provide guidance to officials who have to make decisions on whether or not a product meets those full requirements. Other enforcement considerations are:

- What are the key technology and security standards required for a product to be used for Track and Trace?
- How do these mesh with technology and security standards for worldwide transportation of the products, such as by container?
- Which components of Track and Trace will enforcement authorities need to use for risk analysis, exchange of information under mutual assistance arrangements, training, and public awareness?
- What proportion of interventions in comparison to declared imports of tobacco products will be needed to provide satisfactory assurance that codes are not being counterfeited?
- What resources will be required to make the appropriate interventions?
- How will information resulting from interventions be fed into risk and resourcing systems and processes both nationally and internationally?

Finally, as we know from experience, the behaviors of smugglers change in response to every fraud opportunity closed. How will the behaviors of smugglers and their supply chains change once Track and Trace has been implemented?

7.6 Conclusions

The Illicit Trade Protocol is the first international agreement addressing all three forms of illicit trade – smuggling, counterfeit, and tax and duty evasion. Other international agreements have covered only part of the problem, such as contravention of International Property Rights. International agreements on taxation tend to cover income tax and corporation tax crime, but not indirect or excise tax evasion.

The Protocol can assist all stakeholders by creating a platform for an international legislative framework for governments to address illicit trade.

There will be a lengthy period of transition as the Protocol is implemented by national governments. It will be important for authorities to use this time to prepare their local tobacco industries, administrations and enforcement resources for the Protocol, and to introduce it as much as possible into national legislation as quickly as they can. The Protocol cannot be completely effective until all Parties have implemented it across all participants in the supply chain. During the transition period, the Track and Trace requirements may be implemented at different times and in a different way in each country. The large criminal organizations will, undoubtedly, adapt their routes and methods to take advantage of the differences so enforcement authorities will need to factor this into their operations.

Consistent and effective implementation will be important for all the Protocol obligations. In particular, the requirement for a track and trace system should help reduce illicit trade in legally sold tobacco products provided that there are sufficient effective interventions at the borders and inland to confirm that duplicate identification markings are not being used by smugglers. This will have no impact on the smuggling of counterfeit products. Track and Trace will be useful to enforcement, but cannot be the only tool in the armoury as the other components of a comprehensive strategic approach will still be essential.

Future Perspective

Around the world, countries are adopting approaches to reducing tobacco consumption through regulatory measures (e.g. ban on cigarette vending machines, display bans, smoke free public and workplace areas). There has been very little evidence-based research published to date on the impact of these regulatory changes on overall tobacco consumption and illicit trade. A study by Dr. Patrick Basham and John Luik concludes that display bans in Canada, Iceland and Thailand have not resulted in reduced smoking and the retail sector, in particular convenience stores, have suffered and the countries concerned have seen an increase in illicit trade in tobacco products.⁸⁶

Work is progressing to develop scanning technology to enable 100% scanning which may prove a real help to customs over the coming years. Sophisticated digital Track and Trace systems are also being developed and trialled. There is also increasing awareness of the extent, nature and implications of illicit trade among politicians, senior revenue and customs officials. The success of several countries in reducing illicit trade through a comprehensive anti-illicit tobacco strategy shows what can be done with sufficient will, funding and expertise. The EU has published a regional enforcement strategy, and there are international organizations such as the WCO and Interpol who are willing to support their members with capacity building and other programs.

However, the problem of illicit trade in tobacco products is unlikely to go away. As long as there are profits to be made from illicit trade in these products and consumers continue to buy the goods, the criminal organizations will find ways to continue their trade. Dramatic tax hikes and legislation introduced with the aim of reducing consumption of tobacco products are unlikely to succeed in achieving their health objectives without continued and comprehensive enforcement strategies, and public awareness campaigns. Making tackling illicit trade a priority across the world and further developing national and international cooperation will remain essential.

End Notes

- ¹ The examples and case studies in this publication (shaded in grey) have been provided by public sector organizations, academics, consultants and industry.
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Case Study End Notes

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Glossary of Terms and Abbreviations

Approval: authorities usually require a warehouse to be approved for the storage of tax suspended goods and for specific operations on those goods. The warehouse keeper and owners of goods in a tax warehouse may also require approval.

Barcode: a way to represent information that can be read electronically. Barcodes are subject to international standards.

Cigarette Packaging: a pack usually contains 20 cigarettes; a carton usually holds 10 packs or 200 cigarettes; and a master case generally holds 50 cartons or 10,000 cigarettes.

Confiscation Order: a confiscation order is made after conviction to deprive the defendant of the benefit that he has obtained from crime.

Due Diligence: conducting a reasonable, thorough investigation before the start of, or during the course of, a business relationship for the purpose of ascertaining whether a business partner or prospective business partner is complying with, or can reasonably be expected to comply, with his or her legal obligations.

FATF: Financial Action Task Force.

FCTC: Framework Convention on Tobacco Control.

FCLO: Fiscal Crime Liaison Officer.

Fiscal Marker: a marker that indicates tax has been paid but which has no tax value.

Free Zone: a specially designated area in which goods are treated as being outside the customs territory of a country. This means that import duty and taxes are not due to be paid unless the goods are sold domestically within the country. Such Zones are also known as Free Trade Zones, Export Processing Zones or Foreign Trade Zones. Free Zones normally need to be designated by the Customs Administration which applies and monitors the application of conditions applying to operators within the Free Zone.

Guarantee: an undertaking given by the guarantor to pay a sum of money up to the level of the guarantee required by the authority. This usually includes an automatic restitution facility.

HRT: hand-rolling tobacco.

ITP: Protocol to Eliminate Illicit Trade in Tobacco Products.

Manufacturing Equipment: cigarette makers, cigarette packers, cigarette filter-making and filter-combining machines, and other machines that are used for the purpose of producing tobacco products. In this context, it includes all reconditioned equipment, spare-parts and constituent parts.

OCG: organized criminal group.

OLAF: European Anti-Fraud Office.

Protocol: “A protocol, in the context of treaty law and practice, has the same legal characteristics as a treaty. The term protocol is often used to describe agreements of a less formal nature than those entitled treaty or convention. Generally, a protocol amends, supplements or clarifies a multi-lateral treaty. A protocol is normally open to participation by the parties to the parent agreement. However, in recent times States have negotiated a number of protocols that do not follow this principle. The advantage of a protocol is that, while it is linked to the parent agreement, it can focus on a specific aspect of that agreement in greater detail.”⁸⁷

Security: when goods are stored or travel in tax/duty suspension, the tax due is normally covered by a guarantee or bond. Security is provided by a premises guarantee and/or a movement guarantee.

Tax/Bonded Warehouse: a warehouse authorized for the deposit of goods without payment of tax or duty.

Tracing: re-creating the route already taken by products through the supply chain.

Tracking: monitoring the route being taken by products through the supply chain.

Transit: a customs facility available to operators to enable goods to cross a country or territory without paying customs duties normally due when goods enter that country or territory.

Useful Links

1. International Economic Organizations

- 1.1. Organisation for Economic Co-operation and Development (OECD) – www.oecd.org
- 1.2. World Bank – www.worldbank.org
- 1.3. International Monetary Fund (IMF) – www.imf.org
- 1.4. World Intellectual Property Organization (WIPO) – www.wipo.int
- 1.5. World Trade Organization (WTO) – www.wto.org

2. Customs/Enforcement-Driven Organizations

- 2.1 World Customs Organization (WCO) – www.wcoomd.org
- 2.2 European Anti-Fraud Office (OLAF) – http://ec.europa.eu/anti_fraud/
- 2.3 Interpol – www.interpol.int
- 2.4 Europol – www.europol.europa.eu
- 2.5 Her Majesty's Revenue and Customs (HMRC) – www.hmrc.gov.uk
- 2.6 Bureau of Alcohol, Tobacco, Firearms and Explosives (ATF) – www.atf.gov

3. International Health Organizations

- 3.1 World Health Organization (WHO) – www.who.int

4. Academic and Investigative Journalism Organizations

- 4.1 Terrorism, Transnational Crime and Corruption Center (TraCCC) – <http://policy-traccc.gmu.edu/>
- 4.2 Transcrime – <http://www.transcrime.unitn.it/tc/664.php>
- 4.3 World Customs Journal – <http://www.worldcustomsjournal.org/>
- 4.4 Center for Public Integrity (CPI) – <http://www.publicintegrity.org/health/public-health/tobacco>
- 4.5 International Consortium of Investigative Journalists (ICIJ) – <http://www.icij.org/>

5. Business Organizations

- 5.1 Business Action to Stop Counterfeiting and Piracy (BASCAP) – www.bascap.com
- 5.2 International Trademark Association (INTA) – <http://www.inta.org/Pages/Home.aspx>
- 5.3 Tax Stamp Forum – <http://www.taxstampforum.com/>

6. Non-Governmental Organizations (NGOs)

- 6.1 Framework Convention Alliance (FCA) – www.fctc.org
- 6.2 International Tax and Investment Center (ITIC) – www.ITICnet.org
- 6.3 World Economic Forum (WEF) – www.weforum.org

Additional ITIC Reading Material

Global “Best Practice” in Tobacco Tax Policy: Insight from Tax Practitioners around the World, International Tax and Investment Center and Oxford Economics, August 2013.

The Impacts of Imposing a Global Excise Target for Cigarettes: Experience from the EU Accession Countries, International Tax and Investment Center and Oxford Economics, September 2012.

The Linkage between Tax Burden and Illicit Trade of Excisable Products: The Example of Tobacco, Adrian

Cooper and Daniel Witt, “World Customs Journal,” September 2012.

An Analysis of Tobacco Taxation and Affordability Issues in Russia, International Tax and Investment Center and Oxford Economics, May 2012.

Review of the WHO Technical Manual on Tobacco Tax Administration: One Size Does Not Fit All, International Tax and Investment Center and Oxford Economics, December 2011.

Annex 1

Container Sizes (para. 6.7.1 refers)

Source: David Child

Dry Freight 20-Foot Container



Inside Length	5.900 M
Inside Width	2.350 M
Inside Height	2.393 M
Tare Weight	2,230 Kgs
Max Cargo	21,770 Kgs

Dry Freight 40-Foot Container



Inside Length	12.036 M
Inside Width	2.350 M
Inside Height	2.392 M
Tare Weight	3,700 Kgs
Max Cargo	26,780 Kgs

Dry Freight 40-Foot Container (High)



Inside Length	12.036 M
Inside Width	2.350 M
Inside Height	2.697 M
Tare Weight	3,970 Kgs
Max Cargo	26,510 Kgs

Refrigerated 20-Foot Container



Inside Length	5.425 M
Inside Width	2.275 M
Inside Height	2.260 M
Tare Weight	3,200 Kgs
Max Cargo	20,800 Kgs

Refrigerated 40-Foot Container



Inside Length	11.493 M
Inside Width	2.270 M
Inside Height	2.197 M
Tare Weight	4,900 Kgs
Max Cargo	25,580 Kgs

Refrigerated 40-Foot Container Hicube



Inside Length	11.557 M
Inside Width	2.294 M
Inside Height	2.500 M
Tare Weight	4,500 Kgs
Max Cargo	25,980 Kgs

Annex 2

A Regional and National Strategic Approach to Tackling Illicit Trade in Excise Goods

Source: Elizabeth Allen

AIM

- To have an overarching strategic approach encompassing all aspects of excise tax policy, administration and enforcement working with all public sector and legitimate stakeholders, nationally and internationally.

Key Aspects for National and Regional Application

- **Zero tolerance of corruption** – Develop and promote strict adherence to a Code of Ethics for all Customs/Revenue officials.
- Develop a **balanced evidence-based tax policy** leading to specific duty structure for tobacco products and potential regional tax approximation.
- Collect and maintain **reliable, complete and accurate standard data** (e.g. an electronic national/regional register of all licensed excise operators, their responsible officers, their licensed premises, operations, bond or security requirements, annual production/throughput, declarations and payments record, compliance record, transporters used).
- Adopt the principle that permission to manufacture, warehouse or move excisable goods under bond is **a privilege, not a right**, to be granted only to those who are “fit and proper” persons with appropriate security, financial guarantees and internal controls.
- Know the **size and nature** of the enemy to collect accurate seizure data with methods, routes, transport used, as well as details of products and persons involved.
- Develop a **targeted enforcement strategy** with action plans and shared targets across all enforcement agencies.
- Develop a regional approach to **supply chain control requirements across the entire** production, movement and wholesale/retail distribution chain.
- Develop a regional approach to **shared specialist training for excise auditors, mutual assistance including exchange of information and shared enforcement tools** (e.g. one-stop shop customs posts).
- **Work** with all public sector and industry stakeholders, nationally and internationally.

Excise Tax Burden

- Keep the **tax structure simple** and avoid opportunities for taxpayers to make mistakes, deliberate or otherwise.
- **Consult with industry in advance** of changes in tax structure or rate in order to understand the implications for the trade sector and related employment.
- Avoid sudden tax hikes by **increasing tax gradually and after consultation with stakeholders**.
- Take into account **the overall tax burden**, affordability and rates of tax in neighboring countries.

Excise Administration

- **Clear, straightforward and appropriate modern excise administration policies and legislation** – review and revise legislation to support effective and efficient administration for government and taxpayers based on modern business practice and with regional approximation for requirements on taxpayers (e.g. bonds/securities, licensing, declaration and payment of tax, record keeping, transport, track and trace, civil penalties approach and asset forfeiture).
- **Embrace e-government** – set-up an electronic register of excise operators, provide for electronic excise accounting and payment, electronic compliance records, an intelligence database feeding a risk and resourcing tool, integration with electronic customs data for excise operators and imports/exports of excisable goods.
- **Invest** in regional **audit training** and industry awareness for excise and customs audit staff.
- **Ensure a national and professional focus on excise control** – use *professional* in-depth audits supplemented by *unannounced* excise interventions made *outside normal office hours*.
- **Ensure there are appropriate offences**,

penalties and a judiciary and media aware of the seriousness of excise fraud and smuggling.

- **Supply chain controls on products and on wholesale and retail outlets**
 - » Develop a regional approach to implementing ITP track and trace requirements for tobacco products utilizing effective and efficient tools.
 - » Develop memoranda of agreement with other public sector stakeholders – Police (shared targets and joint campaigns), regional/local authorities (licensing of wholesaler/retailers), Trade/Commerce (inspections at retail outlets and penalties for non-compliance with regulatory or tax/customs legislation), Health (standard approach to regulatory requirements and FCTC) and Transport (licensing of transporters); and
 - » Develop binding legal cooperation agreements with industry, as in the EU agreements.
- **Require** industry to train excise officials in their **business processes** and provide full details of customers/suppliers/transporters (including any changes) and their **internal management** and **external audit controls**.
- **Require** industry to display **zero tolerance of corruption**.

Excise/Customs Interface

- **Ensure effective interface** between excise and customs accounts and declarations including restrictions on storage time allowed in customs warehouses (shelf life) and on movements of goods between customs warehouses using “single window” concept wherever possible.
- Ensure there is an **appropriate excise risk-based component** within any regional transit system to highlight all movements of components used in tobacco products manufacture (e.g. acetate tow).

Mutual Assistance

- Develop a regional protocol and **practical** mechanism for mutual assistance and electronic interrogation by authorized staff 24/7.

- **Invest in and share** tools (e.g. one-stop border posts, scanners, sniffer dogs).

Enforcement

- Bring together **intelligence** on **all** high risk smuggled/counterfeited products, not just tobacco products, distribution routes, transport and persons involved.
- Ensure there is only **one national seizure database** covering all seizures, whether by excise, customs, local authority, police or any other enforcement agency, and that seizure data is **analyzed to provide up-to-date information in accordance with the ITP**, (including case reference information where appropriate, quantity, value of seizure, product description, entities involved, date and place of manufacture) and **modi operandi** (including means of transport, concealment, routing and detection). This should inform risk targeting and resource allocation.
- Invest in **risk management, intelligence** and **detection training** for enforcement staff.
- Invest in **scanners, mobile task forces and sniffer dogs** and **fund work outside normal office hours** for excise and customs auditors/inspectors as well as for enforcement officials.
- Use **independent laboratory testing facilities**.
- Use **industry sources to provide counterfeit awareness training for customs preventive officials**.
- Develop **joint and shared targets across enforcement agencies**.
- Educate the **judiciary about the implications of illicit trade and the methods used by organized criminal groups**.
- Provide **clear and effective channels** for receipt of intelligence from industry and the general public.
- **Publicize** penalties and successful prosecutions.
- **Feedback** information on all interventions to improve risk targeting and **alert colleagues to new and increasing risks**.

For more information, please visit ITIC's website: **www.ITICnet.org**



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