

The FCTC and tobacco smuggling
NGO Briefing for the International Conference on Illicit
Trade in Tobacco
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The following briefing paper from the Framework Convention Alliance^[1] outlines some of the key provisions for an effective smuggling regime that should be considered at the International Conference on Illicit Tobacco Trade (ICITT).

The Problem

Around one quarter of internationally traded cigarettes enter the black market. From a world total of exports of 846 billion in 2000, some 227 billion cigarettes did not reappear as imports. Total lost revenue by governments due to cigarette smuggling around the world is estimated at US\$25-30 billion annually. Large-scale organized tobacco smuggling, which should be the main focus of an international treaty like the FCTC, involves the diversion of large consignments into the black market while the product is in transit. By diverting cigarettes while they are in the wholesale distribution chain (where they are carried untaxed), large-scale smugglers generally avoid all taxes. Smuggling is widely misunderstood to arise from exploitation of tax differentials between countries or states, but this is a relatively small part of the problem and less profitable to the smugglers. In fact even if all countries had exactly the same price and tax structure, smuggling would continue on a similar scale.

Winners and losers in smuggling – the problem of perverse incentives

The root of the problem is that losses arising from smuggling fall on national finance ministries, not on tobacco manufacturers or wholesalers that control the distribution system. On the other hand, tobacco manufacturers and wholesalers gain from smuggling in several ways: they make their profit when the product is first sold; smuggling creates a supply of cheap cigarettes and lowers average prices, boosting demand; and smuggling enables tobacco company lobbyists to press for lower rates of tobacco tax in the legal market, again with the aim of boosting demand. Furthermore, each tobacco company has commercial incentives to beat its competitors in the black market – when looking at sales, the companies consider the whole market performance. This quote from a British American Tobacco internal document released through litigation in the United States shows that BAT's aim was to actively manage the black market in its products to achieve optimum 'system-wide' performance:^[2]

1.1.1 Market trends:

1.1.1.4 (iii) Continued pressures on domestic market performance and profitability rising from border business and in some markets, from excise/ tax evasion. In 1993, it is estimated that nearly 6% of the total world cigarette sales of 5.4 trillion were DNP sales. Eastern Europe and the Asia-Pacific region (c85bln each) accounted for the majority of this volume. Though Western Europe (c50bln) was also significant. In relation to total market sales, DNP volumes are largest in Eastern Europe (c13%) and Africa/ M. East (c12%), but are also significant in Latin America (c9%) and Western Europe (c7%). *A key issue for BAT is to ensure that the Group's system-wide objectives and performance are given the necessary priority through the active and effective management of such business.*" (Emphasis added)

These ‘perverse incentives’ mean that a freight container of cigarettes worth up to US\$2 million at legal retail prices can somehow be ‘lost’ to the black market in transit. Most of the US\$2 million is ultimately due to finance ministries in the countries in which the product will eventually be sold, but tobacco companies and wholesalers still take their share even if the product enters the black market. We believe that smuggling simply would not occur if the tobacco companies and wholesalers had any incentive to protect the full US\$2 million retail value of the consignment. Instead they have the opposite incentive.

Involvement of tobacco companies in preventing smuggling: A further implication of the perverse incentives operating in the wholesale tobacco market is that governments should be extremely wary of the claims and involvement of tobacco companies in tackling smuggling. Until they can demonstrate otherwise, tobacco companies should be seen as part of the problem rather than part of the solution.

Key elements of a global anti-smuggling regime

We advocate two main strategic approaches to tobacco smuggling:

1. **Eliminate perverse incentives to smuggle.** Change the wholesale tobacco trade so that manufacturers and wholesalers have incentives to prevent smuggling, rather than to promote it. This means ensuring that traders and manufacturers, not just national finance ministries, lose money if they are careless or calculating in selling on to black market traders.
2. **Secure the distribution chain.** Make it much more difficult, expensive, and risky for criminal organizations to be engaged in cigarette smuggling and for tobacco manufacturers and wholesalers to be involved in its management.

These two strategies reinforce each other. For example a tracking and tracing regime will be much more effective if the wholesale trade needs it in order to avoid fines or liability. The sections below suggest measures to implement these two strategies.

1. Eliminate perverse incentives that encourage smuggling

The FCTC should contain measures that remove the incentive to orchestrate smuggling and create incentives to prevent diversion into the black market. Such measure could include:

Liability regime: Parties should establish a liability regime in which manufacturers or exporters are held liable for tax losses arising from smuggling of their products. This would create a ‘top-down’ pressure to establish a secure distribution chain and create a ‘duty of care’ in which each participant in the distribution chain would be responsible for ensuring that onward sale was strictly to legitimate traders. The liability and compensation protocol of the Basel Convention on Transboundary Movement of Hazardous Waste serves as a useful model – both in principle and at a technical level. A simple starting point for a strict liability mechanism would be to levy a tax or fine on each tobacco company or its representatives in proportion to the amount of contraband seized by customs. The authorities could apply an uplift sufficiently large to recover all the estimated tax losses.

Redeemable bond or export tax for tobacco products in transit: Each time a large consignment is exported, the exporter should purchase a bond redeemable when the product is sold legally. The bonds would be effectively a down payment of tobacco tax in the country of final destination. Notification from the recipient country that tax had been paid would release the bond back to the manufacturer. A scheme similar to this was used in Canada and has proved successful. Where exports were to low-tax 'havens' in the first instance, the export bond would be repayable if the product was re-exported. If 'tax-havens' remain outside the system, then parties within the system could block imports from those countries or only permit exports for consumption in that country. The proposals below on the operation of a secure distribution system give some practical tools with which this could be achieved – for example final destination labelling and prior notification.

Licensing of large-scale participants in the tobacco trade: The goal in the FCTC should be to require the licensing of *large-scale* participants in the tobacco trade -- manufacturers, wholesalers and import-export businesses -- as these are where the most effective interventions against large-scale smuggling can be made. This is a manageable proposition since there are only about 10,000 worldwide. The loss of a licence would be an effective deterrent and customs organizations could operate a warning notification scheme that would identify suspect traders, put them on notice and ultimately withdraw their licence. The focus should not be on the licensing of retailers – this would be expensive and impractical in many developing countries and would divert resources away from more effective tobacco control measures for little return.

Legal action for racketeering and money laundering: Parties should ensure that domestic law can tackle the *orchestration* of tobacco smuggling even if that smuggling happens in another country through a third party. Conspiracy or racketeering legislation is available to do this in some countries but not all. The European Commission and 10 European Union member states and the State Governors of Colombia have taken legal action against major tobacco companies, alleging that they have operated a global smuggling enterprise, and engaged in fraud and money laundering. These cases and the risk of more of the same have the potential to reform the tobacco companies involved.

Investigative powers and disclosure: Parties should ensure that their customs and security organisations have adequate powers to investigate *orchestration* of smuggling – for example release of contractual information, export volumes by country and wholesaler, data on end-market potential and promotional activity, and the power to question tobacco executives under oath. The parties should require tobacco companies to export to only those countries where they can demonstrate a legitimate market. This approach has recently been introduced in an agreement between UK customs and a tobacco company, Gallaher.

Destruction of seized contraband: an additional perverse incentive is the destruction of contraband tobacco products that have been seized by enforcement agencies. When a seizure is made, the demand does not substantially change. But if the seized product is withdrawn from the market and destroyed, the product is effectively supplied twice with twice the profit to the manufacturer. It is important to find some

means to eliminate this perverse incentive. Contraband seizures could be sold back to the tobacco companies at retail price or attract a fine.

Cost allocation: Tobacco companies or consumers should carry the costs of all the measures necessary to secure the distribution system and to collect tax revenue as part of the price.

2. Secure the distribution system

The FCTC should introduce a series of measures that make detection and prosecution much more likely. Such measures should include:

Develop a secure system with prior notification: Given the large losses involved in tobacco smuggling and high value of many consignments, a much more robust distribution system would be justified. Examples of secure distribution do exist. In March 2001, the United Nations Firearms Protocol^[3] was completed. The Firearms Protocol sets out comprehensive procedures for the import, export and transit of firearms, their parts and components, and ammunition. It is a reciprocal system requiring countries to provide authorizations to one another before permitting shipments of firearms to leave, arrive or transit across their territory and enables law enforcement to track the legal movement of shipments to prevent theft and diversion. A similar approach could be developed for tobacco – *if there was the will to take smuggling seriously.*

End Destination Labeling: A first step to ensure that tobacco products arrive legally at their end-market destination is to oblige the tobacco manufacturers to specify on the label of tobacco products their final destination. So for example, a packet of Marlboros manufactured in the Philippines and destined for export to Thailand would carry the message “Sales only allowed in Thailand” – this inevitably shortens the distribution chain and would make it difficult to explain why, for instance, such cigarettes were routed to Australia or Brazil. Note that it is certainly practical to know the destination at the time of manufacturing. In Europe, for example, packs have to be printed with health warnings in the national language, and this is achieved even for small markets such as Sweden and Denmark. It may be inconvenient for tobacco companies, but it is certainly possible. The aim should be to require the tobacco companies to identify the final market *at the time of manufacture*. Parties should also make it an offence to tamper with markings.

Pack Markings: Manufacturers should be required to place unique overt and covert markings on cigarette packs that would allow law enforcement authorities to identify details about the product (manufacturing plant, batch, date and onward sale to wholesalers) – either directly from the mark, or by reference to a database and records kept about the movement of the pack. Such markings should be made unique to each pack, machine readable and used to enable a tracking and tracing regime.

Tracking & Tracing: Tracking and tracing are essential for the control of distribution and enforcement action against smugglers. In both cases, unique pack markings would be scanned on arrival and departure from each licensed wholesale trader – scanning the markings on a pallet would capture the markings on cases, cartons and

packs within. We do not envisage that cost will be a problem – the ‘Hawkeye’ system, for example, has been developed to do this for under US\$0.02 per pack, and that cost could easily be carried by manufacturers in the retail price.

Tracking is the systematic monitoring of the movement of tobacco products from the place of manufacture to the place where all relevant duties and taxes have been paid.

Tracing refers to the ability of competent authorities retrospectively to recreate the route taken by a tobacco product from the manufacturing plant through the distribution chain to the point where a product was diverted into the black market.

It is important to recognize that the marking itself does not have to contain all the data about the product and its movement. The marking has to be unique and used to identify the product as it is traded – the trades would be recorded in a database.

Challenges with tracking and tracing, and suggested solutions: The main problem with a global tracking and tracing regime is that a determined smuggler can route through ‘safe havens’ including non-parties or those outside the boundaries of the secured system. Despite this, there are several arguments and approaches that favor implementation of tracking and tracing regime in the FCTC:

- ***A limited system has value and will develop.*** Even if incomplete, implementation of tracking and tracing will narrow the options for illegal routing, increase the cost to parties wishing to smuggle, and make orchestrated fraud more obvious if backed by record keeping and licensing. As the FCTC develops, the technology and participation will increase and the secure part of the system will grow. The FCTC should express the aim of developing a system in which the products can be tracked and traced and then set about developing it. Few policy solutions have ever been perfect at the outset.
- ***Place an obligation on manufacturers to use it.*** There is also scope to require the major trading multinationals to implement a tracking and tracing regime within their own distribution chains (many do this already to control their gray market and parallel imports). Legislatively this would be similar to anti-corruption legislation pioneered by the United States, in which US domiciled companies are committing an offence in US law if they use bribes overseas. In this case, the obligation would be take measures designed to prevent fraud. If European Union, Japan, and North America agreed to impose these obligations on manufacturers, it would cover a large majority of international trade.
- ***Banning sales of cigarettes to ‘safe havens’.*** Any new regime would need to address the problem of safe havens in undermining enforcement efforts against smugglers – and such safe havens would also undermine a tracking and tracing regime. Wholesale tobacco smuggling is greatly facilitated by states with poor transparency and/or corruption and such states can be the Achilles heel in a multilateral effort to tackle tobacco smuggling. The Montreal Protocol on the protection of the ozone layer banned sales of ozone depleting substances like

CFC from parties to non-parties, and there are precedents for restricting sales to states if there is a strong suspicion that the sale will lead to illegal acts. The parties should identify rogue safe havens and agree to impose trade restrictions on them.

- ***Make it in the tobacco industry's interest to control smuggling.*** The strategic key to successful implementation of tracking and tracing will be a to eliminate the perverse incentives that align the interests of tobacco manufacturers and wholesalers with organized crime. For this reason, we propose the measures – such as a liability regime – described above.

Banning Duty Free Sales: Smuggling is aided by the existence of tax free zones and tax-free sales – large quantities may be sold legally from duty free outlets to smugglers, but the responsibility to pay tax or to sell only modest amounts rests with the smuggler not the duty free outlet. Traders have explained that duty free can be used as a excuse to cover larger scale illegal activity^[4] The end of all duty free tobacco would mean that tobacco traders cannot use the duty free sales argument to justify the increasing amount of disappearing cigarettes worldwide. The European Union has banned duty free sales between its member states even though they have different currencies and tax regimes.

Co-operation and mutual assistance: The US White Paper and World Customs Organisation protocol proposal (presented at INB-3) make a number of proposals for co-operation and mutual assistance between customs organisations and others involved in law enforcement. The main elements of the WCO draft protocol released at INB-3 in November 2001 include: joint surveillance, enforcement and sting operations, hot pursuit, information exchange, recovery of Customs claims, expert witnesses, confidentiality, and procedures for making requests, costs sharing and other aspects of co-operation and assistance.

Technology transfer: The technology needed for markings, tracking and tracing could be transferred to developing countries under the technology transfer provisions of the FCTC. The necessary funds should be generated by recovered excise taxes, but the Financial Mechanism could also be used in the first instance to meet start-up costs. Though the technology for tracking and tracing can be sophisticated, it is hardly unprecedented and certainly not beyond the reach of wholesale traders operating in developing countries, assuming adequate support and technology transfer.

How the system would change the international wholesale tobacco business

These proposals would fundamentally change the wholesale trade in tobacco to make the protection of government tax revenue and public health policy the main priority. The main features would be:

- Exporters would need to know where they were exporting to at the time of manufacture and label accordingly – this would reduce the scope for fraud by shortening the wholesale distribution chain to no more than two or three wholesalers.

- Exports and imports would be conducted with knowledge of the authorities in the importing, exporting and transit countries.
- Tobacco companies would have a strong incentive – legal action, bonds, fines and/or liability - to protect future government revenue by preventing smuggling of their products while in transit.
- It would be easier to identify the ‘rogue’ traders diverting to the black market and exclude them from a system of licensed responsible traders.
- Governments would have an incentive to participate in such a secure system (for tax revenue) and to apply import and export controls to those outside the system or those that offer ‘havens’ for smuggling.
- The costs would be met from tobacco product prices, but would be a small fraction of the price (note that the US Master Settlement generates around US\$10 billion per year recovered from a US\$0.40 price increase – and the expected secure system costs would be far less than that, for example the ‘Hawkeye’ marking and tracing system is estimated to cost under US\$0.02 per pack).

Conclusion

Governments lose billions of dollars through tobacco smuggling. However, the ambition of the measures so far discussed in the FCTC falls far short of what is needed to tackle the problem and what can be justified by the sums of money that governments are losing. A twin strategy of measures designed to reverse the manufacturers’ and wholesalers’ incentives to smuggle and measures to secure the distribution system would be effective and cost-effective in tackling tobacco smuggling, protecting and increasing tax revenues, and, above all, in protecting health by allowing the price mechanism to discourage tobacco use.

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[1] The Framework Convention Alliance is a coalition of more than 170 groups from more than 70 countries working for a strong Framework Convention on Tobacco Control. Specific text recommendations and further information on the causes of smuggling, can be found at <http://fctc.org/factsheets/8.pdf> and www.ash.org.uk/html/smuggling.php

[2] BATCo Global Five-year Plan 1994-1998 – Bates no. 500018206. DNP means ‘duty not paid’ – a euphemism for cigarettes smuggled and sold illegally – other documents confirm this definition)

[3] United Nations Protocol Against the Illicit Manufacturing of and Trafficking in Firearms, their Parts and Components, and Ammunition.

[4] See for instance Förster N, Husic S, “Investigators probe Montenegro’s role at centre of illegal cigarette trade,” *Financial Times*, 10 August 2001.