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WHO Framework Convention on Tobacco Control
Key issues for the INB-4
A briefing for the Government of Malaysia

Tackling the illicit trade in tobacco

Section I.1-7 of the working texts deals with the illicit trade in tobacco products.

The illicit trade in tobacco products

There are at least four forms of illegal trade in tobacco products:

1. *Transit smuggling* – the avoidance of all duties by diverting products from the legal distribution chain (in which duty is ‘suspended’) to the black market, thereby avoiding all duties –allowing large margins to the smuggler. This usually involves large consignments and is also known as freight smuggling’ or ‘container smuggling’ and involves organised crime.
2. *Bootlegging* – purchasing tobacco products in a low tax jurisdiction and selling them illegally in a higher tax jurisdiction. The trade is driven by differences in tax rates, and tends to be small scale and opportunistic in comparison to transit smuggling.
3. *Illicit manufacturing* – a legitimate factory may be producing products that directly enter the black market, working hidden shifts or production runs.
4. *Counterfeiting* – making illegal copies of legitimate products, (often using second hand machinery sold by legitimate manufacturers) and selling these on the black market. China and Russia dominate the world in the production of counterfeit.

Of these, transit smuggling dominates the illicit market. Counterfeiting is steadily increasing, and may eventually dominate

Why is illicit trade a health problem?

Roughly one third of internationally traded cigarettes (350 billion per year) are eventually sold illegally with the avoidance of duty. This reduces the price, increases demand, undermines national tobacco tax policies and – as a result harms health by increasing tobacco use. Tobacco smuggling is also linked to organised crime, money laundering, and racketeering – which are all regulated by violence.

Who benefits?

Organised crime and petty criminals clearly benefit. The tobacco companies benefit because average tobacco prices are reduced and hence demand increased and cheap smuggled cigarettes may keep people smoking who otherwise would quit. High levels of smuggling can also result in governments reducing tobacco taxes in an effort to deal with the problem. This keeps prices lower and demand higher in the *legal* market – again the tobacco companies benefit. Smokers ‘benefit’ by paying less, but may die as a result. The World Bank has identified price as a key health and economic policy in tobacco control, and smuggling undermines the effectiveness of this policy.

Tobacco smuggling as a commercial activity

Hundreds of internal documents show that tobacco companies have used smuggling as a distribution channel to launch new brands, to enter new markets and fight price wars with their competitors. British American Tobacco admitted on 5 December 2001 that it would lose profits if it took active steps to reduce smuggling by its wholesalers¹ - an admission that smuggling is profitable, and that it can take action to reduce it.

Is smuggling caused by high taxes?

Without tobacco taxes there would be little smuggling (except to penetrate closed markets). However, the *difference* in duty levels between neighbouring states is only a *minor* driver of illicit trade based on bootlegging. In Europe until recently the highest levels of smuggling were found in countries with some of the lowest taxes (Spain and Italy). This pattern is reflected around the world - where corruption, petty crime and weak enforcement are better predictors of the rate of smuggling.

Tax harmonisation as a solution

The idea of using tax harmonisation to tackle illicit trade is flawed. Even if all tobacco products in the world had exactly the same price and duty equal to the current world average, there would still be considerable incentive to smuggle – by avoiding all the duty. The success of the FCTC will depend on how it improves law enforcement and its impact on the business practices of tobacco companies.

Controlling the illicit trade

The key challenge is to secure the distribution system for tobacco products by allowing the authorities to establish where products are diverted to the black market. This would require a system of tracking and/or tracing so that contraband can be identified and investigated. Participants in the wholesale distribution system would be licensed and could be held liable for tax losses if they were found to be supplying the black market.

Tracking and tracing of tobacco products

Tracking and tracing are fundamental to securing the distribution system. It is important to define exactly what these terms mean (as they are sometimes used to mean different things). Tracing simply to identify the manufacturing plant and batch will be ineffective in tackling illicit trade as they do not help to identify where the product is diverted to the black market (see I.3). It is important to be able to track and trace *through the entire distribution chain*. The following definitions are suggested:

“Tracking” shall mean the systematic monitoring of the movement of tobacco products from manufacture to the point where all relevant duties and taxes have been paid for the purpose of assisting the competent authorities or parties in detecting, investigating and analysing illicit manufacturing and illicit trafficking.

“Tracing” shall refer to the ability of competent authorities to recreate the route taken by a tobacco product from manufacturing through the distribution chain to the point where all relevant duties and taxes have been paid using markings carried on the packaging and records of product movements accessible to the authorities for the purpose of investigating illicit trade in tobacco products.

Of these, tracing is the more practical and substantially cheaper because it does not require real time monitoring of all tobacco product movements, legal or illicit. Tracing would be used retrospectively to investigate seized contraband and identify where it had been diverted to the black market.

Licensing

The FCTC working text contains provisions for licensing tobacco traders at I.13. The most important entities to licence are those handling tobacco on which duty has not been paid: manufacturers, bonded warehouses, wholesalers, exporters, importers, rather than retailers. There are probably about 10,000 traders in the duty-suspended distribution trade world-wide, but tens of millions of retailers, many in informal street trading economies. One option therefore is to require licensing only for large-scale traders, handling tobacco on which full duties have not been paid.

Pack markings

The pack should carry a unique covert marking that can be scanned to identify the product – this is essential to enable tracability. To reduce the number of wholesalers involved, the manufacturer could be required to identify the end market with a marking on the pack –saying sales allowed only in [country, region etc] as specified in I.3.b of the FCTC working text.

Cost

A system in which tobacco products would be marked and scanned at each major wholesale trader with records kept on a computer database that could be interrogated by the authorities has been designed and costed at under two US cents per pack². The ‘technology transfer’ provisions of the FCTC (D3, Q2) could be used to disseminate the scanners, computer equipment etc world-wide.

¹ British American Tobacco, *Confirmation of earnings estimates*, 5 December 2001

² SICPA Product Security Division, *Project Hawkeye System for tracing contraband tobacco*, November 2001