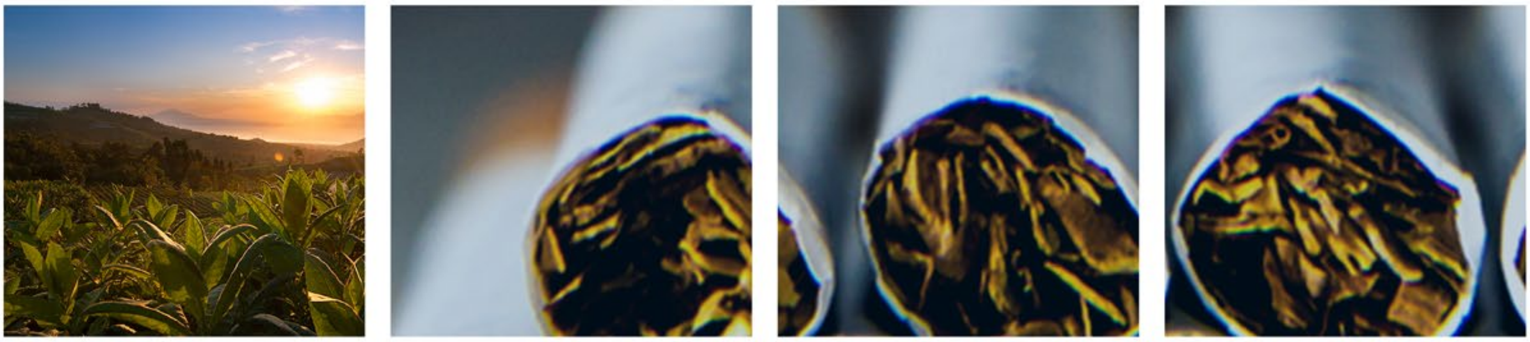
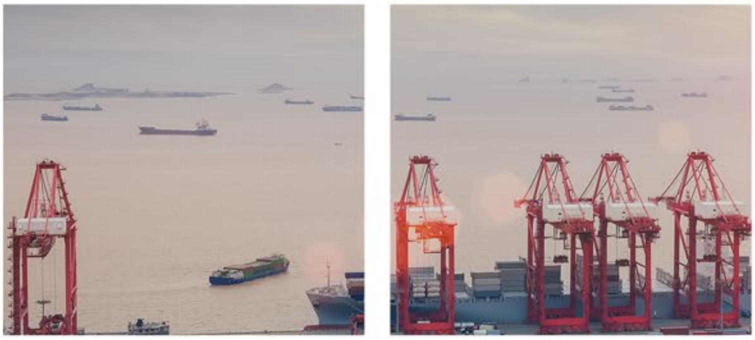


CAUSES & CONTROL OF ILLICIT TOBACCO



ALVAREZ & MARSAL

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Appendices

1. Purpose of This Booklet

The debate about the adverse health effects of tobacco is over and the health impacts are well understood. However, the debate about the relationship between high and increasing taxes on tobacco, illicit trade, organised crime and enforcement has many protagonists and is not over. This is an important issue given the broad and adverse impacts of illicit activity, ranging from lost tax revenue, to undermining health objectives, to the funding of organised crime and terrorist activities. Intergovernmental organisations such as the World Customs Organization (WCO), the World Health Organization (WHO), the Organisation for Economic Co-operation and Development (OECD) and the Financial Action Task Force (FATF) and international organisations such as Europol and INTERPOL are rightly focused on this issue. It is critically important that global alignment is established around the causes of the problem and around the solutions.

We aim to present here an objective view of the causes of illicit trade, based on the available evidence where it exists and drawing on the informed positions taken by governments, regulators, anti-tobacco activists and the tobacco industry.

Our hope is that by gaining a better understanding of and clearly identifying and explaining the root causes of illicit trade, the focus of governments, regulators, enforcement and other influential stakeholders will shift from the long-running debate about the causes of illicit trade toward tackling the problem in a unified way. This should enable all stakeholders to more effectively address both illicit demand stimuli and supply development and could result in more focused, cost-efficient and preventative measures being adopted. Only through such a shift toward more effective action can illicit trade growth be controlled and, where possible, reversed to the benefit of governments, legitimate businesses, consumers and society as a whole, particularly given the link between the trade in illicit tobacco and the funding of terrorist activities.

Lawrence Hutter
Managing Director
Alvarez & Marsal

W.A.Barker

Wayne Barker
Director
Alvarez & Marsal

2. Executive Summary

Relationship Between Tobacco Tax Policy and Illicit Trade
Accusations of Tobacco Industry Involvement in Illegal Trade

Relationship Between Tobacco Tax Policy and Illicit Trade

Based on analysis of a representative sample of 28 countries, including the world's major cigarette markets (excluding China), and on analysis of all U.S. states where data are available, affordability, measured as the proportion of disposable income required to purchase cigarettes, emerges as a principal driver of illicit trade in tobacco. Both the multicountry analysis and the pan-U.S. state analysis revealed a strong correlation between affordability and the size of illicit trade as a proportion of total consumption. By analogy, an analysis conducted on alcoholic beverages, arguably the closest product category to tobacco, also shows a strong relationship between illicit alcohol consumption and alcohol affordability.

Tobacco affordability itself is determined by a combination of retail pricing and disposable income. Alvarez & Marsal's (A&M)'s analysis shows that while disposable income changes have played a real role, particularly during the economic crisis, the principal driver of affordability declines has been retail price increases, with increases in taxation being the main driver of the extent and pace of retail price increases. We conclude therefore that tobacco tax increases have been a key driver of growth in the illicit tobacco trade. Furthermore, analysis of the dynamics of tax and price increases indicate that (a) countries that experience sudden affordability declines, usually caused by substantial tax-induced retail price increases, and/or (b) countries that are in close geographical proximity and have easy access to lower-priced alternative product from other countries, are more susceptible to growth in illicit trade. This is evidenced by many countries, for example, Latvia, which has relatively high illicit consumption despite having relatively good affordability, but which borders lower-priced Russia and Belarus; Brazil which is impacted by easy access to illicit supply from Paraguay; and more recently by the impact of the November 2015 excise duty increase in Malaysia.

The analysis also demonstrates the importance of enforcement in controlling illicit trade. We have created a composite index comprising the degree of regulatory enforcement and the effectiveness of the criminal justice system country by country. The analysis shows that in countries where enforcement is strong, the scale of illicit trade can be controlled even where taxation is at higher levels. Conversely, where enforcement is weak, the scale of illicit trade can be high even in lower tax countries. Moreover, an examination of countries with broadly similar levels of affordability shows that the scale of illicit trade is greater in countries with weaker enforcement and smaller in countries with stronger enforcement.

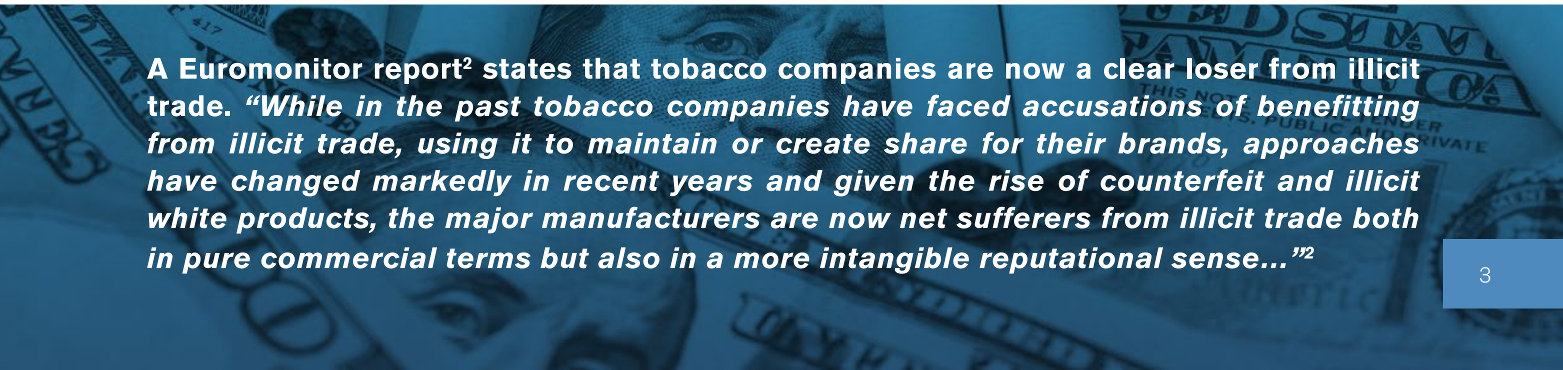
Accusations of Tobacco Industry Involvement in Illegal Trade

Accusations of the major tobacco companies benefitting from illicit trade go back 15–20 years or more, when the trade was comprised of mainly genuine contraband product. The operating environment has changed significantly for many industries, including tobacco, over the past two decades, with tougher regulation and greater attention paid by industries themselves to their business reputations and the sustainability of their business models. The composition of illicit trade has also changed dramatically in recent years away from genuine contraband product and toward counterfeit and the growing trade in so called "illicit whites." The major tobacco companies are now clear net losers from illicit trade, which cannibalises or erodes volumes and profits from their legally sold products.

Our research suggests that the interests of governments, regulators, law enforcement and the major tobacco companies are now aligned regarding illicit trade. This is evidenced by the major tobacco companies proactively sharing information with national and international law enforcement, implementing self-enforcing commitments and establishing memoranda of understanding (MoUs) with national governments. The tobacco companies have made significant investments in the development and implementation of anti-illicit trade (AIT) measures and compliance programs. These include programs to protect their supply chains, such as “know your customer” and "know your supplier," goods-in-transit security programs, robust anti-money laundering policies and the monitoring of market shipment volumes.

The WHO is focused on the issue of tobacco and health and Article 5.3 of its Framework Convention on Tobacco Control (FCTC)[1] states that "*In setting and implementing their public health policies with respect to tobacco control, Parties shall act to protect these policies from commercial and other vested interests of the tobacco industry in accordance with national law.*" Our research suggests that the FCTC should not inhibit appropriate collaboration around controlling illicit trade where the interests of policymakers and the major tobacco companies are aligned.

There are a number of cases in which such collaboration and coordination have succeeded in halting and rolling back illicit trade. However, such measures can only be successful if tobacco taxation policies and enforcement strategies go hand in hand based on a clear understanding of the impact on the affordability of legally sold tobacco products and the potential consequences for the incentivization of illicit trade.



A Euromonitor report[2] states that tobacco companies are now a clear loser from illicit trade. *“While in the past tobacco companies have faced accusations of benefitting from illicit trade, using it to maintain or create share for their brands, approaches have changed markedly in recent years and given the rise of counterfeit and illicit white products, the major manufacturers are now net sufferers from illicit trade both in pure commercial terms but also in a more intangible reputational sense…”*[2]

3. Background

According to Euromonitor, "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."[3] Euromonitor[4] estimates that global illicit penetration (excluding China) reached 11 percent in 2015, and previously estimated the global value of illicit cigarettes at $39 billion in 2013.[2]

The OECD, the United Nations (U.N.) Security Council investigative body and national enforcement agencies around the world report that the illicit trade in tobacco has become a major security challenge and is being increasingly used to fund terrorism.[5]

The previous dominance of the illicit trade by genuine brands and counterfeit products manufactured mainly in China has declined in recent years with illicit whites taking an increasingly large share of consumption.[2] For example, between 2009–2015, the contraband proportion of total illicit trade in the EU fell from an estimated 87 percent to 56 percent, while counterfeit and illicit whites grew from 13 percent to 44 percent over the same time period.[6]

Outside of Europe, in countries where major tobacco companies have exited the market (e.g., British American Tobacco (BAT) in Thailand) or that have been impacted by significant legislative changes (e.g., the Philippines), illicit volume has grown as a result.[2] In the U.S., illicit trade still primarily takes the form of cross-state border resale of genuine product ("smurfing"), which has been increasing.[2]

"Shipments of cigarettes destined for conflict areas such as Syria and Afghanistan were identified during the Operation. There is a high possibility that the substantial profits generated when smuggling cigarettes could be used to finance the purchase of weapons, for example, in these critical areas." *WCO, December 2015*

"Hezbollah, the Taliban, and al-Qaeda are involved in smuggling cigarettes; so are the Real Irish Republican Army (Real IRA) and the Kurdistan Workers' Party (PKK). Terrorist financing through cigarette smuggling is 'huge.'" *Transnational crime expert and advisor to the World Economic Forum on illicit trade. Centre for Public Integrity, February 2014*

Illicit trade also results in easier and earlier access to tobacco for young people. When surveyed, three out of 10 16–24-year-olds in the U.K., for example, admit they sometimes buy cigarettes from illegal sources, a higher proportion than that for older age groups.[8] Survey evidence also suggests that lower socio-economic groups have a significantly higher smoking propensity and susceptibility to illicit product than higher socio-economic groups.[9]

The debate about the relationship between high and increasing taxes on tobacco, illicit trade and organised crime crystallises around two core issues: (a) the relationships between tobacco tax policy, enforcement and illicit trade; and (b) allegations of involvement of the tobacco industry itself in illegal trade.

A&M has conducted an independent analysis of the root causes of illicit trade and has assessed whether motivation exists for involvement of the tobacco companies in illicit trade. We have also considered statements made by the WHO and anti-tobacco organisations as hypotheses to be tested in order to provide evidence from which an objective view can be determined.

"The links between participation in crime and terrorism are evident in the profiles of the European-born terrorists of 2014 and 2015. A terrorist involved in the attack on Charlie Hebdo had traded in counterfeit trainers and cigarettes." *The Guardian, November 2015*

"The PKK is known for drug trafficking and smuggling for its income. It has been stated many times by security sources that PKK controls a big part of drug traffic and smuggled tobacco products in Turkey. The PKK is recognized as a terrorist organization by Turkey, the U.S., and the EU." *Daily Sabah, September 2015*

4. Relationship Between Tobacco Tax Policy and Illicit Trade

The allegations around the relationship between tobacco tax policy and illicit trade is characterised by statements such as:

"... the experience from many countries shows that there is no direct correlation between high tobacco taxes and smuggling." WHO, 2015[10]

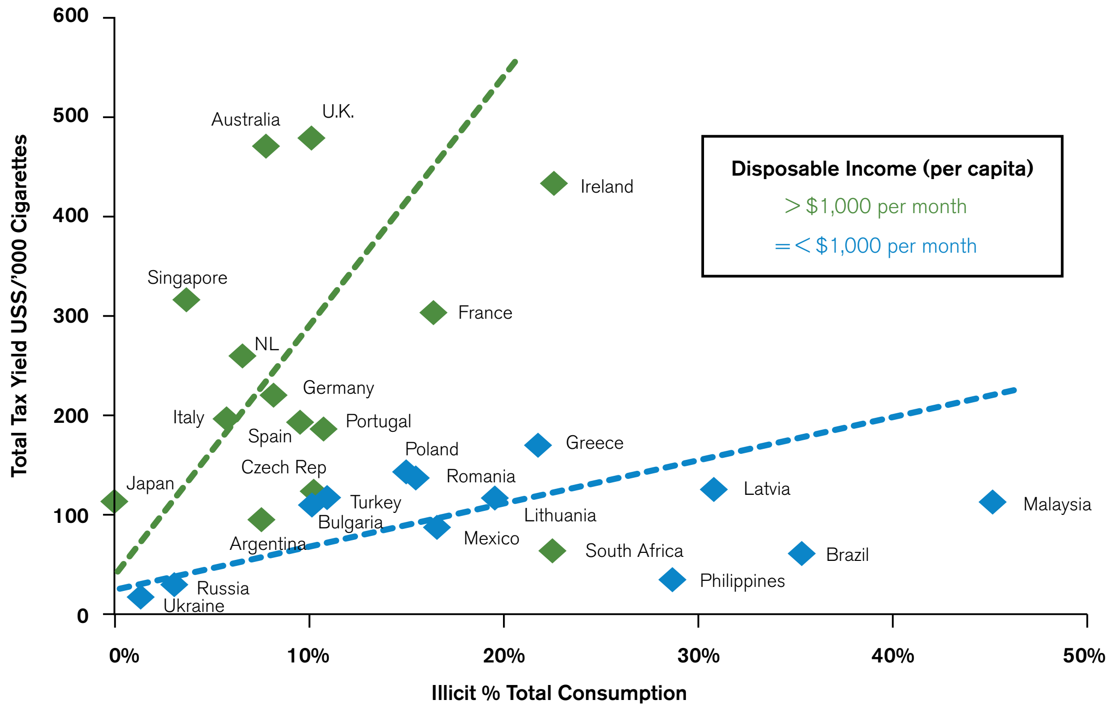
"Tobacco taxes are not the primary reason for cigarette smuggling and cigarette tax avoidance." WHO, World No Tobacco Day (WNTD), 2015[11]

Global Multicountry Analysis

First, we examined the correlation between the tax yield in U.S. dollars per thousand cigarettes and the percentage of total consumption that is illicit for a representative set of countries from across the globe that account for 53 percent and 69 percent of global cigarette volume and retail value, respectively, excluding China. At first glance, the results show no apparent overall correlation. However, once differences in disposable income levels are taken into account and countries are grouped accordingly, a relationship between tax yield and illicit consumption emerges. This suggests that taxation may be a factor that influences the level of illicit trade (Figure 1).

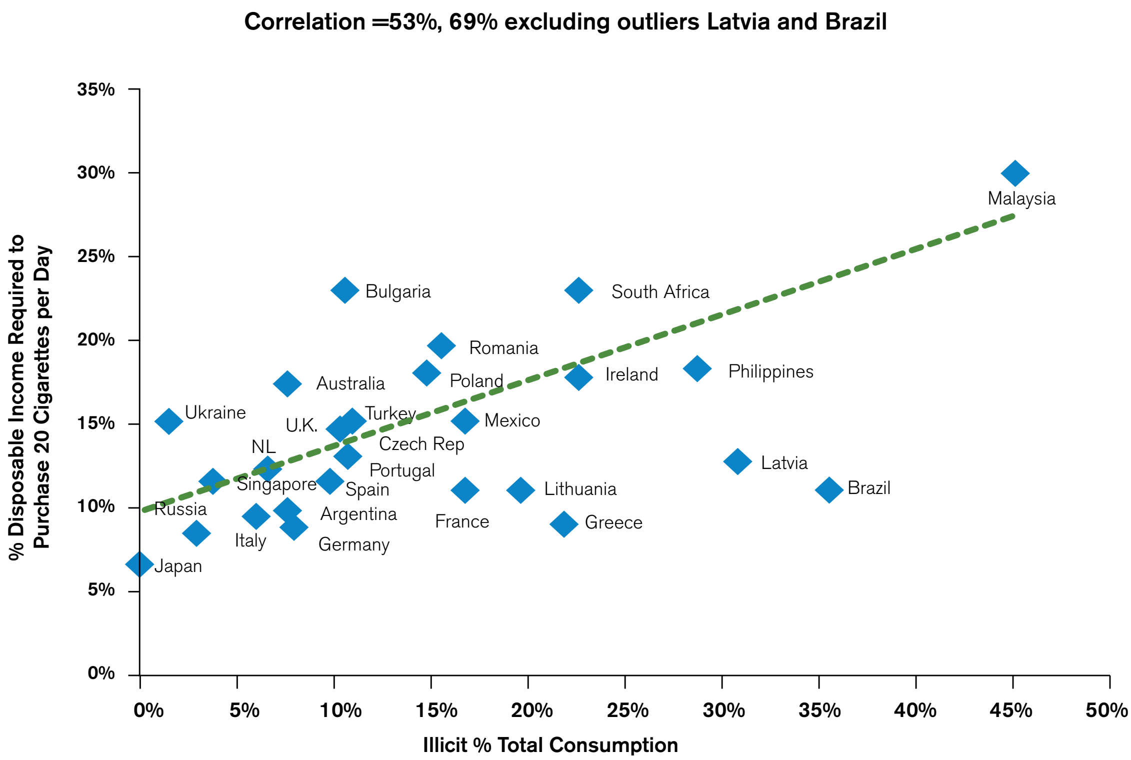
Given these observations, for each of these countries we calculated an affordability measure represented by the percentage of average disposable income required to buy a pack of 20 weighted average priced or "most popular" legal cigarettes per day and then examined the relationship between this measure and the illicit proportion of total consumption. The analysis shows a good positive correlation (53 percent), but this rises to 69 percent if the outliers Brazil and Latvia are excluded (Figure 2). These two countries have particularly high levels of illicit trade relative to affordability due to heightened supply side factors, with Brazil impacted by illicit imports from Paraguayan suppliers and the Baltics being close to lower-priced Russia and Belarus. This analysis

Figure 1: Total Tax Yield vs. Illicit Trade (2015)



Source: A&M Analysis, EU Tax Tables, Industry, Euromonitor, Business Insider U.K.

Figure 2: Affordability vs. Illicit Trade (2015)

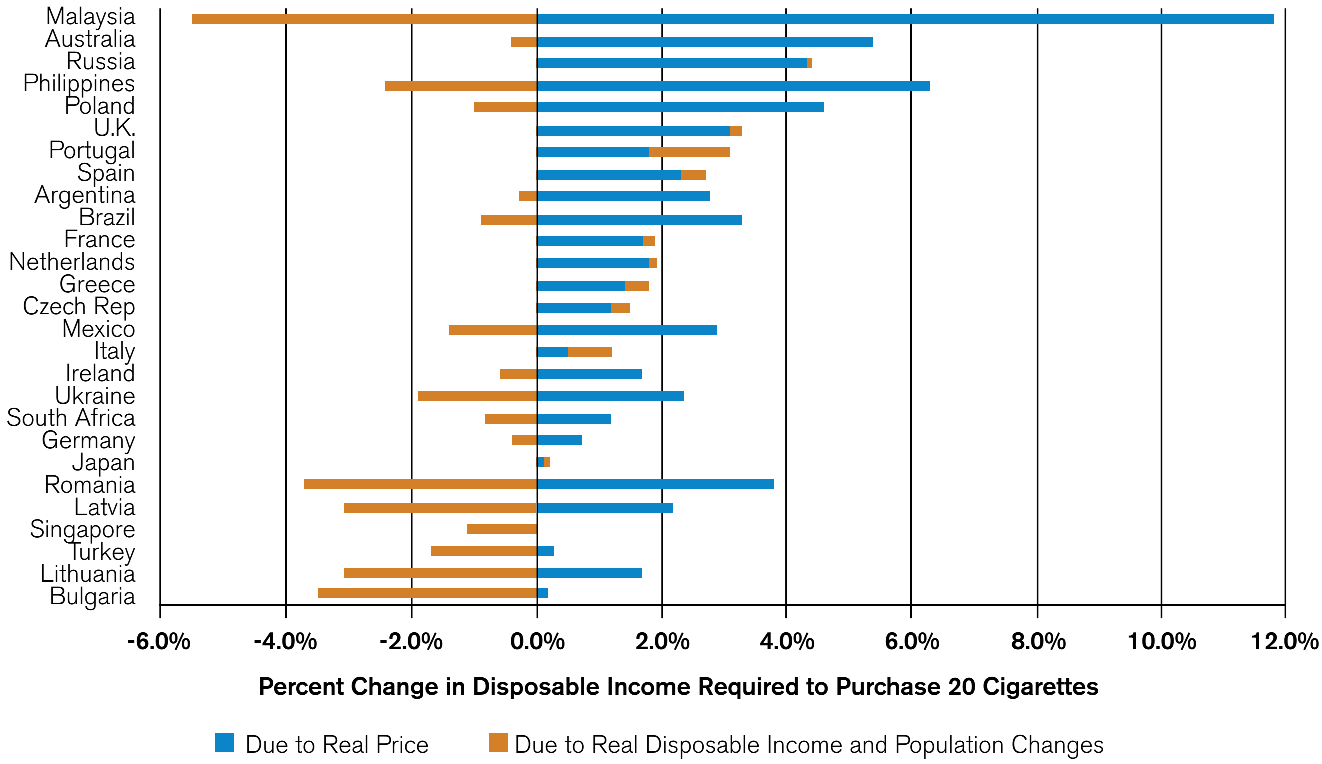


Source: A&M Analysis, EU Tax Tables, Industry, Euromonitor, EIU

suggests strongly that the tipping point at which a smoker switches to illicit product is significantly influenced by the affordability of legal product and where wide price differentials and proximity to supply exist, as evidenced by the outliers of Brazil and Latvia.

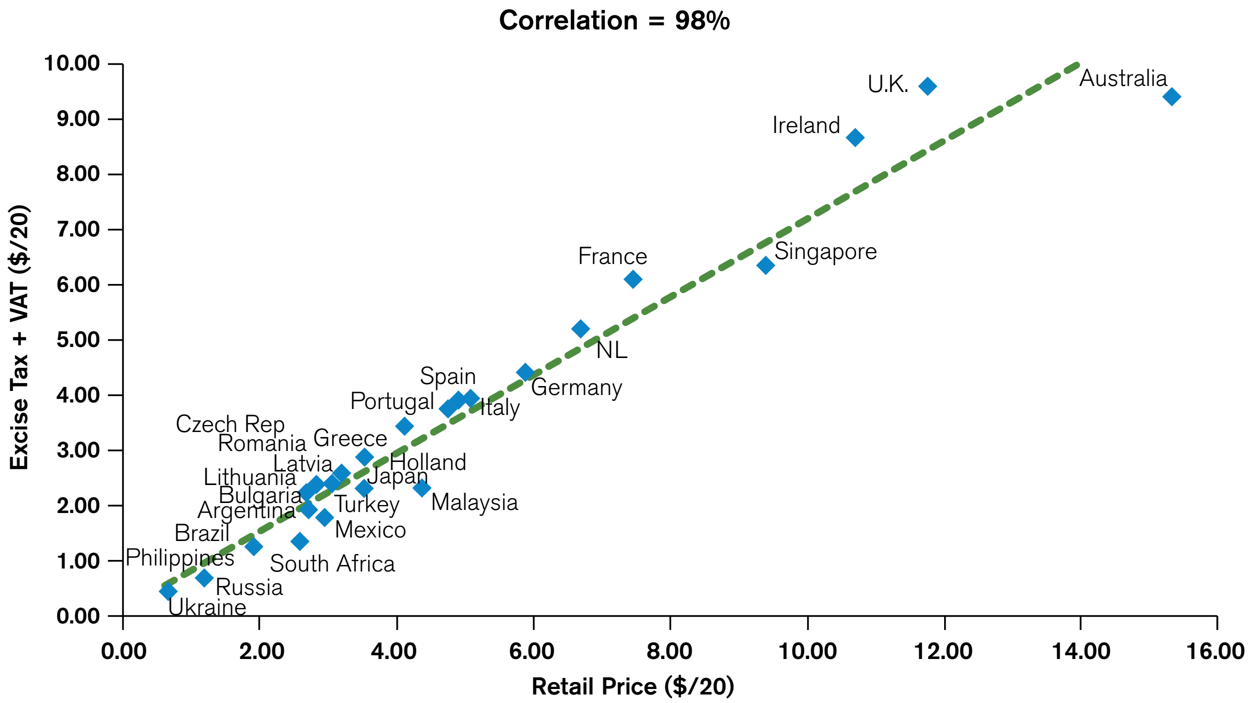
The percentage of disposable income required to buy cigarettes itself depends on both the retail price and disposable income. A&M has decomposed the separate impacts of changes in these two elements on changes in cigarette affordability over the period 2010–2015 (Figure 3). This analysis shows that reductions in cigarette affordability have been primarily driven by retail price increases. Further A&M analysis shows a 98 percent correlation between the level of taxation and the level of retail prices (Figure 4). The overall conclusion is that illicit trade primarily arises due to affordability pressure, which has mainly been driven by retail pricing and which in turn is determined by taxation.

Figure 3: Affordability Pressure (2010–2015)



Sources: A&M analysis, EU Tax Tables, Industry, EIU

Figure 4: Taxation vs. Retail Price (2015)



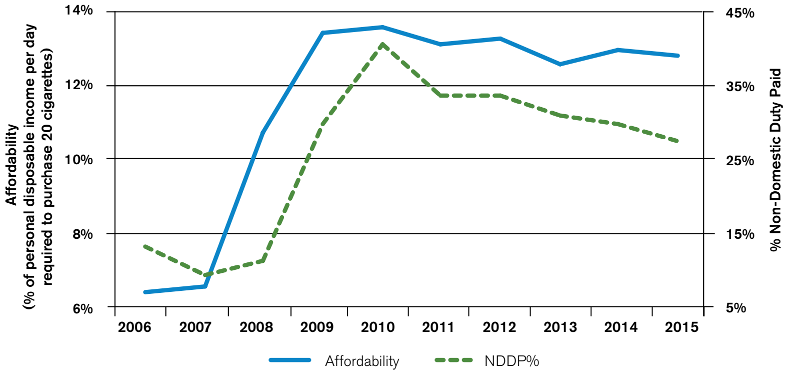
Sources: A&M analysis, EU Tax Tables, Industry

We also examined the historical development of affordability and non-domestic duty paid (NDDP) across a sample of countries.

Eastern European EU Accession countries experienced rapid reductions in cigarette affordability during the late 2000s, due to the need to comply with a legislated EU minimum excise tax rate of €64 per thousand cigarettes, and consequently experienced rapid growth in illicit trade.

Figure 5: Latvia

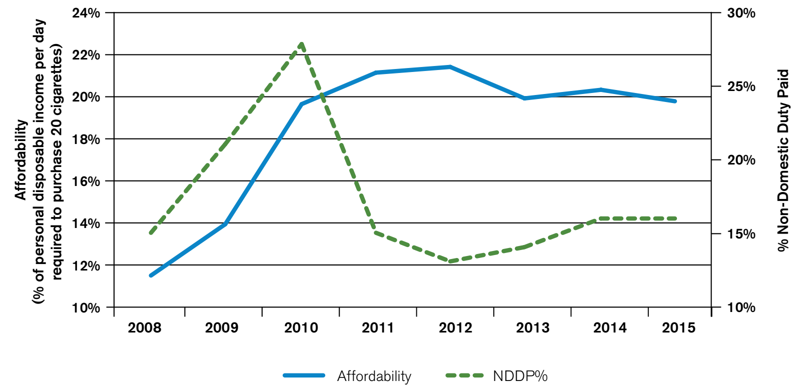
Rapid reduction in affordability due to tax-driven price increases occurred in parallel with NDDP growing from 13 percent to 41 percent of total consumption between 2008–2010. Although affordability appears to still be reasonable, cross-border smuggling of cheap cigarettes from neighbouring Russia and Belarus compounded the problem. Between 2010–2015, affordability stabilised and NDDP levelled out, albeit remaining at the highest level in the EU.



Source: EIU, KPMG Project Star/Sun, EC Excise Duty Tables

Figure 6: Romania

Rapid reduction in affordability due to tax-driven price increases over two years occurred in parallel with NDDP approaching 30 percent by 2010. Since then, more moderate tax increases coupled with stronger anti-illicit enforcement succeeded in reducing NDDP.

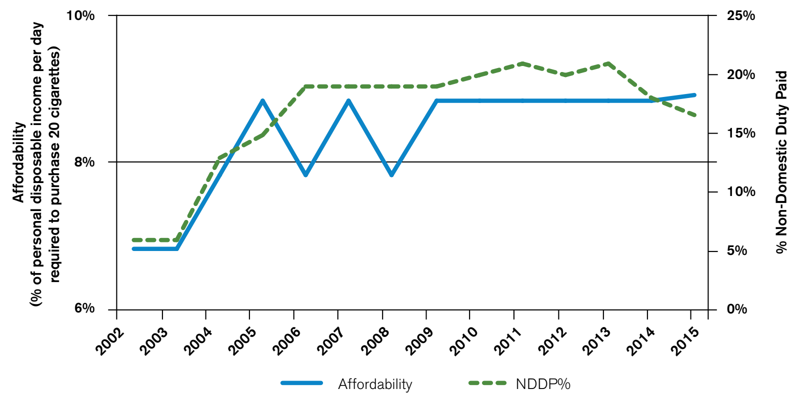


Source: EIU, Novel Research, EC Excise Duty Tables

Western European countries have experienced less drastic changes in cigarette affordability, but the same relationship with illicit trade is evident.

Figure 7: Germany

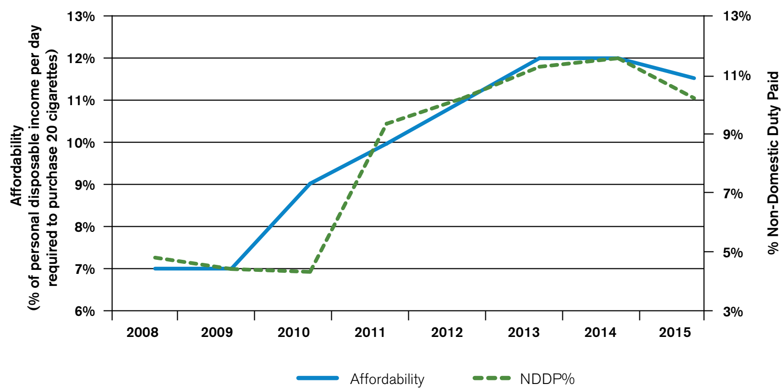
Germany has been impacted by inflows primarily from its eastern neighboring countries encouraged by high tax-driven price increases between 2002–2005 fuelling NDDP growth from 7 percent to 20 percent of total consumption. When Germany revised its tax policy and adopted more gradual tax increases planned over five years, the percentage of NDDP stabilized and more recently has fallen.



Source: EIU, DZV, EC Excise Duty Tables

Figure 8: Spain

Large tax increases between 2010–2012 drove up cigarette retail prices. This, coupled with negative income development and unemployment rate increases due to the economic crisis, reduced affordability. NDDP increased between 2010–2014. In 2015, affordability improved and NDDP declined.

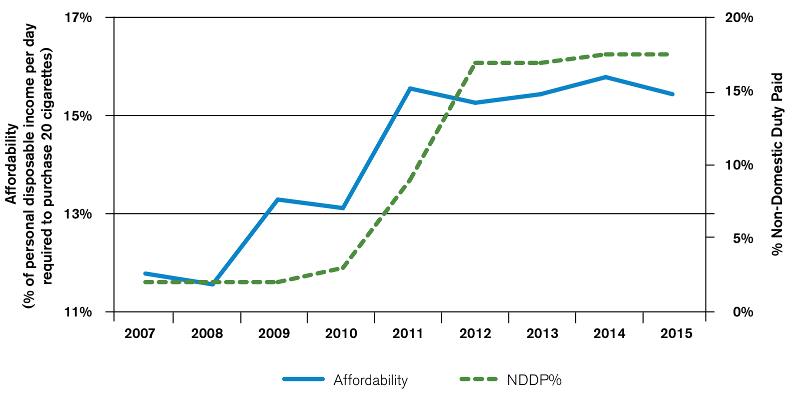


Source: EIU, KPMG Project Star/Sun, EC Excise Duty Tables

Outside of Europe the same historical relationship between affordability and illicit trade is also evident.

Figure 9: Mexico

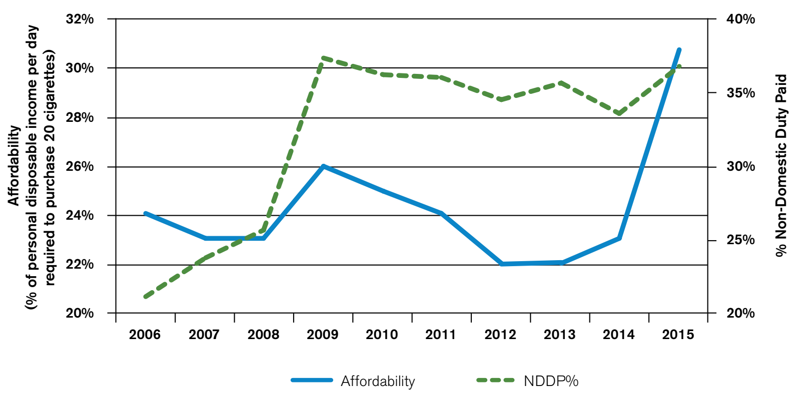
In Mexico, a 34 percent excise tax increase in November 2010 resulted in a 27 percent retail price increase, compared to an inflation rate of 3 percent. The increased affordability pressures caused a sharp increase in illicit trade.



Source: EIU, Industry Estimates

Figure 10: Malaysia

Malaysia is one of the most pressured countries in terms of cigarette affordability and has high levels of illicit consumption. Most recently, a 35 percent excise tax hike in November 2015 caused the NDDP estimate for 2016 to surge to above 50 percent.

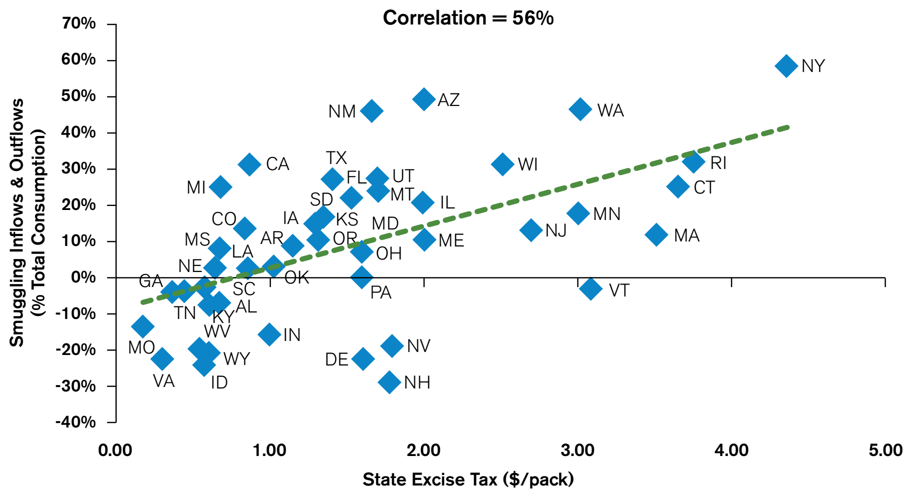


Source: EIU, Empty Pack Surveys

U.S. Analysis by State

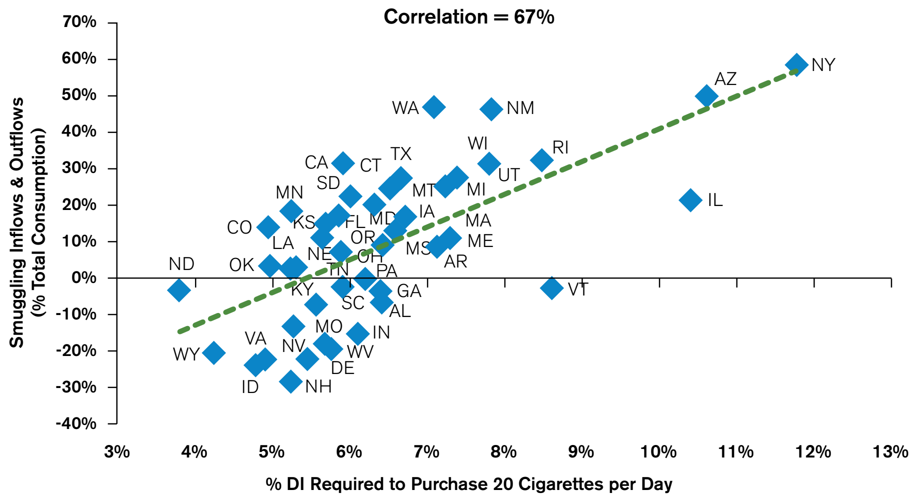
Due to the very wide differences between states in taxation, retail pricing, disposable income, and smuggling inflows and outflows, analysis has to be carried out at the state level to be meaningful. A&M has therefore conducted a detailed analysis of the 47 states for which consistent data is available. The analysis shows that within the U.S. there is a reasonably good correlation between the degree of state cigarette smuggling and state excise tax rates (56 percent) (Figure 11). A&M has also undertaken an affordability analysis across the states and has found an even stronger correlation between cigarette smuggling and affordability (67 percent) (Figure 12).

Figure 11: U.S.: Smuggling and State Excise Tax



Sources: Americans for Tax Reform (Global Tobacco Networking Forum)[8]

Figure 12: U.S.: Smuggling and Affordability



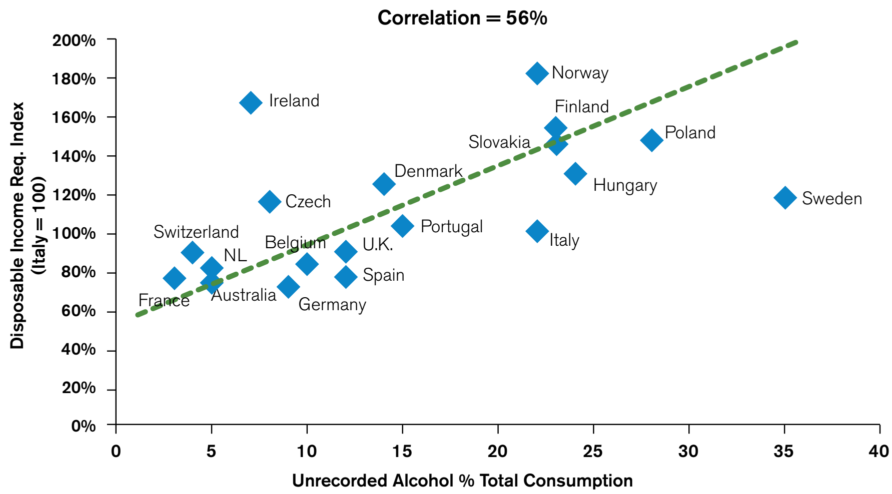
Sources: A&M Analysis, Americans for Tax Reform, Bureau of Economic Analysis, U.S. Dept. of Commerce, The AWL

By way of analogy, the same relationship between affordability and illicit trade across countries is also seen in the alcohol sector, the closest excisable product to tobacco (Figure 13). There is substantial evidence that low affordability driven by alcohol duties is correlated with the level of unrecorded alcohol consumption.[12] The highest rates of unofficial alcohol consumption in Europe are in the low-income Eastern European countries and in the highly taxed Scandinavian countries.

In summary, changes in affordability have been the major driver of growth in the illicit tobacco trade, and affordability changes have been primarily driven by retail price changes, which in turn have mainly been caused by tobacco tax increases.

The analysis demonstrates that there is a clear link between tobacco tax increases, which reduce affordability, and growth in the illicit trade, absent concomitant strengthening of enforcement.

Figure 13: Unrecorded Alcohol % Total Consumption



Source: A&M Analysis, Institute of Economic Affairs

Governments acknowledge a link between illicit tobacco and high taxation

The Taylor report to the U.K. Chancellor of the Exchequer (1999)[13] stated that *"The principal cause of the smuggling, of course, is the high level of duty in the U.K., which not only has the world's most expensive cigarettes apart from Norway but is raising their price rapidly."*

"The U.K. has some of the highest tobacco taxes in the world with huge profits to be made (from smuggling)… U.K.'s tobacco duty escalator will see the real price of tobacco products continue to increase – ongoing incentive to smuggle remains very high." **HMRC (2013)[14]**

"Every country with high tobacco taxes has an illegal tobacco problem. Ireland, which has exceptionally high tobacco taxes and tobacco prices, has a significant problem." **Assistant Secretary, Revenue Commissioners, Oireachtas Health Committee Hearing (2014)[15]**

5. The Importance of Enforcement

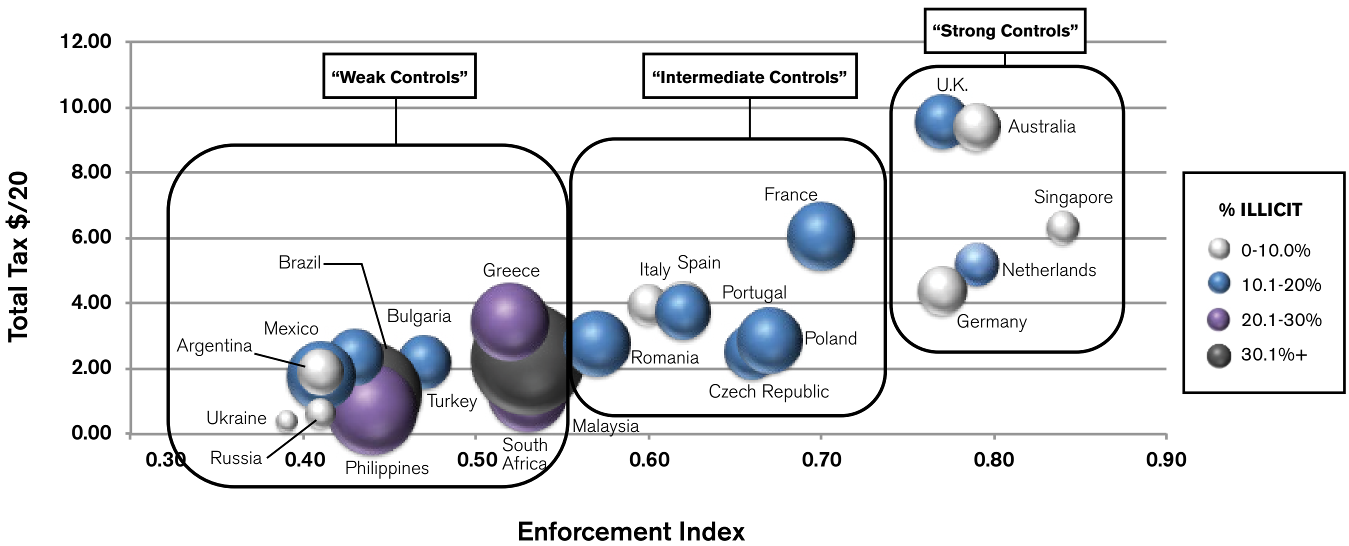
We have concluded from our analysis that the strength of enforcement versus the incentives for illicit supply is the other key factor that influences the level of illicit trade.

Global Multicountry Analysis

We have approximated the level of enforcement by creating a composite index comprising the degree of regulatory enforcement and the effectiveness of the criminal justice system, which are two separate indices compiled by the World Justice Project and used in the calculation of its Rule of Law Index.[16]

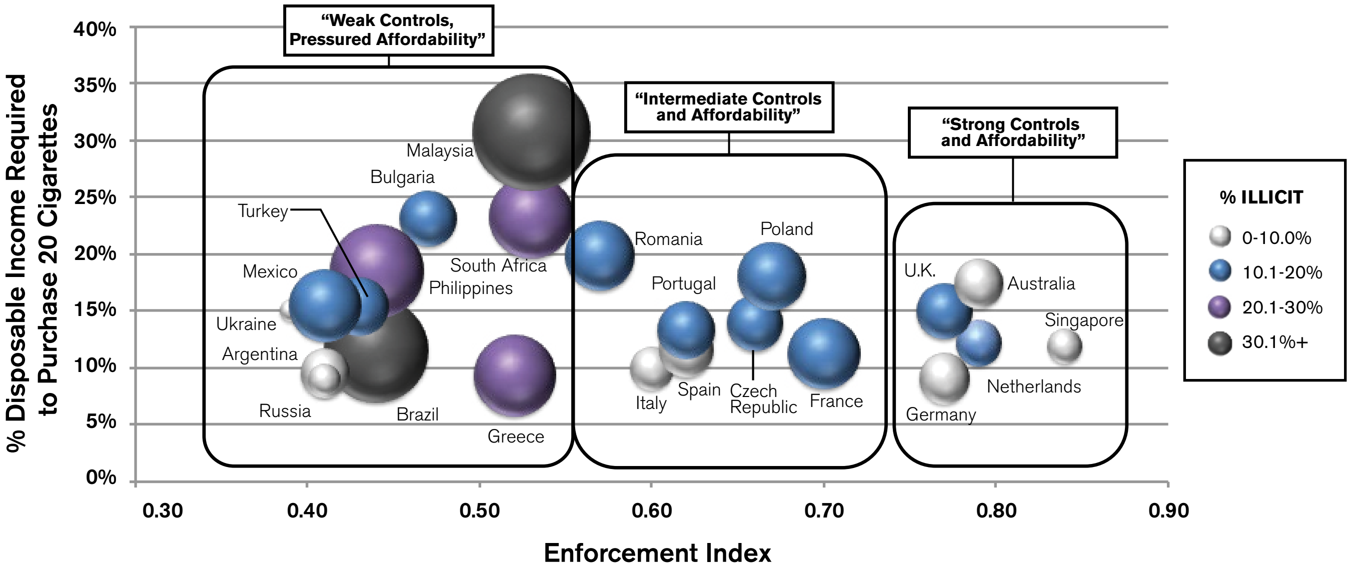
Our analysis demonstrates that: (a) enforcement tends to be highest in more developed countries, where tax rates and tax burdens also tend to be higher, (Figure 14, upper right cluster); (b) there is a clear link between the level of enforcement and the level of illicit trade as a proportion of total

Figure 14: Enforcement & Illicit Trade



Sources: World Justice Project, Euromonitor, EU Tax Tables, TDC, A&M analysis

Figure 15: Affordability vs. Enforcement



Sources: World Justice Project, Euromonitor, EU Tax Tables, TDC, EIU, A&M analysis

consumption – lower levels of enforcement tend to yield higher levels of illicit trade (Figure 14, lower left cluster); and (c) where affordability is pressured and/or enforcement is weak, higher levels of illicit trade occur (Figure 15, upper left cluster). In contrast, where affordability is less pressured and enforcement is stronger, lower levels of illicit trade result (Figure 15, lower right cluster).

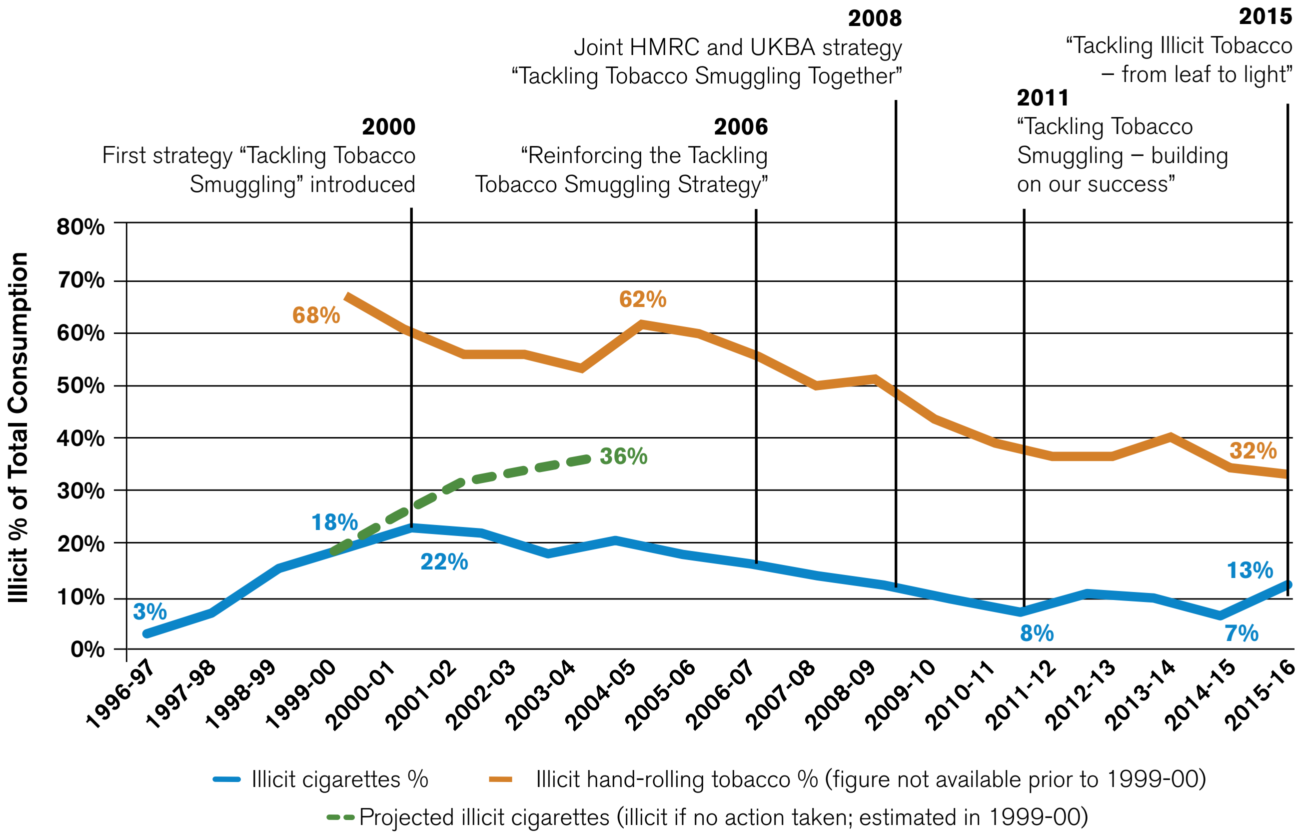
AIT Strategy and Fiscal Policy U.K. Country Example

In the U.K., an excise duty annual "escalator" of 5 percent[17] above inflation coincided with an increase in cigarette smuggling from 3 percent of total consumption in 1996–1997 to 18 percent in 1999–2000, with a projection to reach 36 percent by 2003–2004 if no action was taken.[18] In response, in 2000–2001 the U.K. government halted the escalator in favour of excise increases in line with inflation and concurrently implemented several anti-illicit trade strategies. These strategies included the introduction of fiscal marks, the heightening of interception, seizures and asset confiscations, increased penalties including criminal prosecutions with up to a seven-year sentence, financial wrongdoing penalties of up to 70 percent of the duty due, civil actions including winding up orders and bankruptcy, prohibitions on sales for up to six months and withdrawal of hauliers' licences, as well as improved public awareness. These strategies were supported by an investment of £209 million over three years into Her Majesty's Revenue and Customs (HMRC) staffing and technology.[19]

Although cigarette smuggling stabilized, it did not return to its previous lower levels and the composition of illicit trade also changed toward counterfeit and illicit white product. The U.K. government responded by updating and reinforcing its strategy in 2006, 2008, 2011 and 2015. Over this period it strengthened cooperation with tobacco manufacturers, collaborated with overseas partners and international organizations, expanded HMRC to be able to focus in addition on hand-rolling tobacco, increased the network of Foreign Liaison Officers, and also introduced new technology and detection capabilities.[18,19]

As a result, illicit cigarettes were reduced from 22 percent of total cigarette consumption in 2000–2001 to 13 percent by 2007–2008 and to approximately 8 percent by 2011–2012, while illicit hand-rolling tobacco reduced from 68 percent of total hand-rolling consumption in 1999–2000 to 32 percent in 2015–2016 (Figure 16).

Figure 16: Impact of "Tackling Tobacco Smuggling" Strategy on Illicit Trade



Conclusion on Relationship between Tax Policy and Illicit Trade

High tobacco taxes in the absence of adequate enforcement and effective penalties are the key primary driver of tax evasion and smuggling. We observe a clear link between high tobacco taxes, cigarette affordability and illicit trade. Higher tobacco taxes cause higher retail prices, which in turn incentivise demand for more affordable alternatives to legal product and encourage supply development by providing a greater profit opportunity to smugglers. We conclude that the illicit tobacco trade can only be controlled if governments ensure that the level of enforcement applied is commensurate with the level of tobacco taxes and the affordability of tobacco products for consumers who choose to smoke.


FILTER CIGARETTES
Курение – причина развития сердечно-сосудистых и раковых заболеваний

6. Allegations of Tobacco Industry Involvement in Illegal Trade

A variety of allegations have been made about the way in which the tobacco companies treat the illegal trade, for example:

"The tobacco industry covertly and overtly supports the illegal trade..." WHO[10]

"Parties need to be aware that the tobacco industry's efforts to address the illicit trade, and to establish partnerships with governments in implementing the Protocol, are in breach of both the WHO FCTC and with the Protocol… It is noteworthy that the texts of these two international instruments (the WHO FCTC and the Protocol) acknowledge that the interests of the tobacco industry and the interests of tobacco control are irreconcilable and that partnerships between government and tobacco industry should be avoided. In fact, to ensure that tobacco industry interference was contained and public health interests prevailed, the Parties approved the Guidelines to Implement Article 5.3, on protecting tobacco control policies from interference by the tobacco industry." FCTC Secretariat[20]

"Growing evidence indicates that the TTCs (Transnational Tobacco Companies) remain involved in the illicit trade or are at best failing to secure their supply chains as required by the agreements." Joossens et al[21]

A Euromonitor report[2] states that tobacco companies are now a clear loser from illicit trade. *"While in the past tobacco companies have faced accusations of benefitting from illicit trade, using it to maintain or create share for their brands, approaches have changed markedly in recent years and, given the rise of counterfeit and illicit white products, the major manufacturers are now net sufferers from illicit trade both in pure commercial terms but also in a more intangible reputational sense… As a result, manufacturers have begun to look at the "retrieval" of volumes from the illicit trade as a business expansion opportunity in its own right."*

The composition of illicit trade has shifted in recent years away from contraband and toward counterfeit and illicit whites. For example, in the EU, while contraband volume has been declining, illicit white and counterfeit volume has been increasing. As a result, the contraband proportion of total illicit trade in the EU fell from an estimated 87 percent to 56 percent between 2009–2015.[6]

The major tobacco companies have no economic interest in either counterfeit or illicit whites, which erode their volumes and profits from their legally sold products. Furthermore, France, U.K., Germany and Italy, for example, are the destinations for more than 60 percent of EU contraband volume.[6] As these four countries are significant sources of profit for the major tobacco companies, these contraband flows of genuine product, which are intended for lower-cost countries outside the EU, cannibalise their legal brand volumes and undermine their overall profitability, given the price difference between source and higher-taxed destination countries.

A&M therefore concurs with the Euromonitor statement that the major manufacturers are now net sufferers from illicit trade.

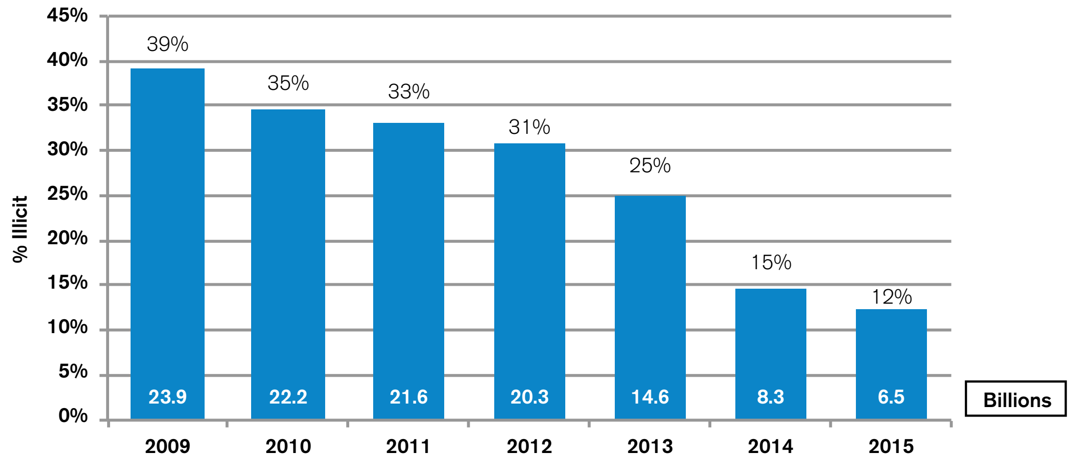
Allegations by tobacco control groups and non-governmental organizations (NGOs) of tobacco companies benefitting from illicit trade reference issues dating back 15–20 years or more. The basis for these allegations therefore predates the rapid change in the composition of illicit trade toward illicit whites and counterfeit as well as the significant compliance reforms, investments into supply chain controls and anti-illicit trade programs undertaken by major tobacco companies since then.

Cooperative Agreements

Agreements between the four major tobacco companies and the EU's European Anti-Fraud Office (OLAF) appear to have succeeded in reducing EU sourced illicit product by some 75 percent over the period of 2009–2015 (Figure 17).

These agreements require the companies to: (a) make annual payments to fund anti-illicit measures, with additional fines payable if genuine contraband product is seized in sufficient quantities; (b) ensure tobacco quantities supplied to EU markets are commensurate with legitimate local demand; (c) adopt measures to ensure sales are made to legitimate customers only; and (d) develop and implement track and trace systems to monitor product flow through the supply chain.

Figure 17: EU Sourced Illicit Product as Proportion of Total EU Illicit Product



Source: KPMG Project Star/Sun, A&M Analysis

The Vice President of the EU Commission, in referring to the expiry of the 12-year OLAF agreement with Philip Morris International (PMI) in July 2016, stated that "*This agreement has served its purpose, reducing PMI contraband on the illicit tobacco market and providing public revenues of around U.S.D 1 billion to Member States and the EU budget. In a changing legal and market environment, we will redeploy our resources and continue to fight illegal tobacco trade by focusing on cheap whites, strict law enforcement and strengthened international cooperation.*"[22]

The effectiveness of the agreements between the major tobacco companies and the EU was also highlighted by OLAF in a statement to the U.K. House of Lords Select Committee: "*... the agreements that we have with the major tobacco companies are working and are effective. We are certainly very much better off with them than we would have been without them. They are – as we have already implied – setting a model for what we would hope to see in a future regime, also through the Tobacco Products Directive and through the Framework Convention on Tobacco Control (FCTC) agreement...*"[23]

The WHO FCTC Protocol to eliminate illicit trade in tobacco products (the Protocol) incorporates many elements from the EU OLAF agreements, and in so doing establishes these as best practices to be applied at the global level. The Protocol requires in its provisions: (a) the licensing of all manufacturers, importers and exporters of tobacco products or manufacturing equipment; (b) the fining of tobacco companies for discovery of contraband product worldwide; and (c) a pack level "track and trace" regime that is controlled by the government.[1] Pursuant to Article 15 of the FCTC,

Figure 18:

AIT Programs	Description of Major Tobacco Company AIT Programs
Know Your Customer	• Policies to ensure tobacco companies will only do business with and supply product to customers who have a reputation for honesty and integrity and are not involved in the diversion of product into the illegal trade, and only supply product that meets fiscal, legal and regulatory requirements of the intended retail market
Know Your Supplier	• Policies to ensure that tobacco company suppliers are known for honesty and integrity (e.g., that a warehouse or trucking company will not illegally sell goods) and does not engage in providing materials, machinery or services to illegal trade operators
Security Programs	• Measures that specifically lower the risk of product theft during transportation, thereby reducing the likelihood of genuine stolen product entering into the legal market
Anti-Money Laundering	• Policies to mitigate the risks of tobacco products being used by money launderers as instruments in financial systems
Market and Shipment Monitoring	• Monitor market and volume developments to ensure products are only supplied in quantities commensurate with legitimate market demand and consumption in the intended market of retail sale
Detection of Genuine Product Diversion	• Product seizure investigation and track and trace capabilities, which enable the tobacco companies and law enforcement to detect where genuine products could become diverted from legitimate supply chains into unintended markets
Cooperation with Government	• Cooperative partnerships (e.g., with EU member states) and memoranda of understanding with law enforcement agencies

the Protocol was adopted in 2012 after several years of formulation and is open for ratification by the Parties to the FCTC.

Beyond the EU, the major tobacco companies have also voluntarily implemented similar control measures to the EU agreements. For example, Japan Tobacco International (JTI) has agreed to 47 AIT MoUs with government agencies in 35 countries around the world, which call for a close working relationship between the public and private sectors to combat the illegal trade.[24] JTI has trained more than 7,000 police and customs officers to help them recognize fake from genuine cigarettes.

Other major tobacco companies have adopted similar measures. For example, Imperial Brands has agreed to 24 MoUs with government agencies around the world, which define their cooperative agreements with law enforcement agencies.[25]

The legitimate tobacco companies view the prevention of illicit trade as a major business priority and have made significant investments in the development and implementation of AIT measures and compliance programs. They have all established sizeable dedicated teams to run their programs. For example, JTI's AIT group is a global team of more than 50 people, including former law enforcement officials, customs agents, lawyers and intelligence officers. They have each established codes of conduct that ensure that the requirements stipulated in agreements and MoUs with government entities around the world are met (Figure 18).[26]

However, there is strong pressure against governments collaborating with the industry in the fight against illicit trade on the basis of Article 5.3 of the FCTC, which states that "*In setting and implementing their public health policies with respect to tobacco control, Parties shall act to protect these policies from commercial and other vested interests of the tobacco industry in accordance with national law.*" Such pressure seems counterproductive as the objectives of the protocol and the major tobacco companies are aligned. Furthermore, the tobacco companies possess knowledge and expertise that can be successfully brought to bear in the fight against illicit trade.[27]

Examples of AIT Successes

The major tobacco companies have recorded some notable successes in the fight against illicit trade. For example, in 2015 and 2016, information supplied by JTI to law enforcement authorities across the globe led to the seizure of just under two billion cigarettes, the raid of 52 counterfeit locations and the removal of over 5,000 links to illicit trade websites.[28]

Similarly, Imperial Brands uncovered organised criminals who were submitting legitimate export paperwork while diverting genuine tobacco product, which led in March 2015 to the identification of what was, at the time, the biggest illegal illicit tobacco factory in Europe, located in Poland. Officers seized 2.5 million kilograms of illegal tobacco worth €375 million, four illegal production lines, 20 million cigarettes without Polish tax stamps and more than €8 million in cash.[29]

As is demonstrable from the past, most effective solutions to tackle the illicit trade have involved collaboration and coordination between government (fiscal policy, regulation, enforcement), health community (including educational campaigns[30]) and industry (intelligence, expertise, e.g., no ID no sale).

Such collaborative efforts have, for example, succeeded in halting and rolling back illicit trade in the U.K. and Romania (Figure 19).[18,19,31,32]

It has already been demonstrated earlier in this booklet that a major cause of illicit trade is tobacco taxation, which creates pressure on affordability. This generates both the demand for cheaper illicit product from financially pressured smokers and the profit incentive for smugglers. Therefore, the goal of eradicating illicit trade will always be a challenge, and taxation must be balanced with appropriate levels of enforcement if efforts to control illicit tobacco are to be successful.

Figure 19

Fiscal Authority Collaboration	U.K.	Romania
Collaboration With Other National Enforcement	• Border Force • Regional Intelligence Units • National Crime Agency • VOSA	• Border and National Police • Financial Guard • National Customs Authority • Secret Service
Collaboration With Other Countries and International Organisations	• Bilateral MoUs With Other Countries • Collaboration With OLAF, WCO, WHO • Expertise Sharing • Fiscal Crime Liaison Officer Network	• Increased Customs Cooperation With Moldova, Ukraine and Serbia • Cooperation With OLAF, WCO, EUBAM, SELEC
Collaboration With the Tobacco Industry	• MoU With Tobacco Companies, Set Boundaries of Cooperation Within FCTC Article 5.3 • Anti-illicit Trade Joint Working Group	• Increasing and Frequent Institutional Dialogue With Main Tobacco Companies

EUBAM: European Union Border Assistance Mission to Moldova and Ukraine
SELEC: Southeast European Law Enforcement Center

Conclusion on Allegations of Involvement of Tobacco Companies in Illegal Trade

In spite of the industry reforms implemented over recent years, the tobacco manufacturers are still viewed as being part of the problem rather than part of the solution.

However, it is evident from the changing mix of the illicit trade and from the major tobacco companies' extensive AIT programs and cooperative successes that the interests of governments, regulators, law enforcement and the major tobacco companies are increasingly aligned against the illicit trade.

The claims made by the FCTC Secretariat that the interests of the major legitimate tobacco companies and the interests of tobacco control are irreconcilable in the area of illicit trade seem not to be well-founded, and their interpretation of the WHO FCTC and its Article 5.3 may hinder achievement of its objectives.

Article 5.3 of the WHO FCTC does not prohibit governments from interacting with the tobacco companies. It just requires that the parties "protect policies from commercial and other vested interests of the tobacco industry." As such, this appears to A&M to be a moot point because the vested interests of the major tobacco companies and governments are aligned on this issue.

In practice, interaction with the tobacco industry will, for example, be necessary to establish and implement effective supply chain control mechanisms. Article 8.13 of the Protocol[1] states that interaction between the competent authorities and the tobacco products sector should be limited *"to the extent strictly necessary in the implementation of [track and trace],"* which suggests that the Protocol anticipates interaction and recognises the importance of cooperation between the industry and the Parties.

7. Overall Conclusions

The evidence appears conclusive that increasing levels of tobacco taxation without appropriate strengthening of enforcement have been the principal catalyst for growth in the illicit trade. Tax increases have been the main cause of increased pressure on the affordability of cigarettes for smokers who may seek alternative more affordable and, if necessary, illegal products instead of quitting. Widely differing levels of tobacco taxes across markets generate attractive profit opportunities for smugglers. Furthermore, the available evidence suggests that the identified root causes of illicit trade are not unique to tobacco, evidenced by the existence of the same relationship between affordability and illicit trade in the alcohol industry.

The impact of tax policies on affordability needs to be clearly understood, and enforcement measures should be determined accordingly in order to mitigate the risk of illicit tobacco growth. The level of enforcement needs to be consistently applied because if it is not, the evidence from many countries suggests that illicit trade can escalate rapidly and can then be difficult to eradicate once supply routes have become established.

Despite the existing distrust of tobacco companies amongst some policy formulators, there would seem to be merit in including the major tobacco companies in the debate on illicit tobacco control, as long as interactions with them are conducted in a transparent manner. Their business objectives regarding illicit trade are now aligned with those of policymakers and, given their specific sector expertise, they should be able to provide important information and views on the practicalities and enforceability of the FCTC Protocol provisions.

Given the global nature of the illicit trade in tobacco, the involvement of organised crime[33,34,35] and its role in funding terrorism,[5] successfully combating illicit trade is critically important and can only be achieved through a coordinated effort involving all key stakeholders including policymakers and law enforcement agencies, public health professionals and the legitimate tobacco companies. This effort also requires alignment behind a common recognition of the problem and a clear campaign to eliminate illicit tobacco trade, which, the evidence suggests, goes hand-in-hand with other criminal activities.

Only through such collaboration can effective and executable measures be implemented and any potential unintended consequences identified and avoided.


D

Appendices

I. Glossary of Terms

Illicit Trade
The supply, distribution and sale of products on which applicable taxes in the country of consumption are not paid

Contraband
Unlawful movement of genuine tobacco products from one tax jurisdiction to another, without the payment of applicable taxes

Counterfeit
Illegal manufacturing where product bears a trademark without the owner's consent

Illicit Whites
Products typically produced for the purposes of smuggling into countries where there is no prior legal market for them

Track and Trace
Process of determining the current and past locations (and other information) of a unique item or property

Non-Domestic Duty Paid (NDDP)
Product on which appropriate destination country taxes have not been paid

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