

## ***Chapter 5.***

### **A brief overview of illicit trade in tobacco products**

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*The illicit trade in tobacco is perhaps the most widespread and most documented sector in the shadow economy. It has been estimated that 570 billion illicit cigarettes were consumed worldwide in 2011. Illicit tobacco is therefore an important source of revenue for criminal networks, and it deprives government services of excise tax revenues at the same time. This chapter describes the different types of illicit tobacco products, explains some of the methods for measuring the markets and suggests measures that could be taken to impede this criminal activity.*

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The opinions expressed and arguments employed in this chapter are those of the author(s) and do not necessarily reflect the official views of the OECD or of the governments of its member countries.

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## Introduction

The global illicit trade in tobacco products presents a range of economic and social harms that should concern policy makers, ranging from adverse impacts on public health to tax evasion and the financing of terrorist groups. In Europe alone, its annual turnover has been estimated to be between EUR 7.8 billion to EUR 10.5 billion, which is higher than the nominal GDP of nearly one-quarter of the world's sovereign nations. If only 20% of these estimated revenues accrued to criminal networks as profits, the sum would still exceed the nominal GDP of some 15% of the sovereign nations in the world. These figures provide some scale to compare the economic resources of criminal networks to the many small, but sovereign, states that may be susceptible to abuse as transit points for illicit trade.

The drivers and trends of illicit trade in tobacco products are highlighted in this paper, to provide a backdrop for considering policy options to reduce it. Its attractiveness as a criminal enterprise is due not only to the potential for profits, but the leniency with which criminal sanctions are applied, by comparison with trafficking in drugs, arms or persons. Entering or expanding an illicit tobacco market therefore has strategic value for criminal enterprises, since it strengthens the financial base for extending illegal activity into additional markets at relatively low risk.

Illicit trade in tobacco products is a chain of illegal activities that may include unlicensed production, smuggling, fraudulent marketing and tax evasion. Often, illicit trade requires money laundering, corruption and various frauds and related crimes, to move the illicit goods and money through various transit and financial systems. Each link in this chain of illegality causes direct or indirect harm: the sale of illicit tobacco products deprives governments of revenue in excise and value added or general sales taxes. It also deprives legitimate manufacturers, suppliers and distributors of revenues, often provides financial support to corrupt officials, undermines investment in innovation and reduces formal employment. In addition, it raises concerns for public health world-wide and security in fragile states, as its proceeds are often reinvested to finance further criminal or terrorist organisations (Shelley, 2009).

Illicit trade in tobacco products also leads to impacts that are harder to quantify, such as loss of public trust in the integrity of key government and business sectors. Poor product performance and the unregulated manufacturing processes behind counterfeits greatly reduce the integrity of well-established brands, eroding public trust in legitimate manufacturers, who are mistakenly blamed by duped consumers. Likewise, the profits that accrue to the dominant market actors enable them financially to expand into complementary criminal operations (including extortion, bribery and weapons trafficking) and can even challenge states for supremacy, through their funding of terrorism and insurgencies.

This chapter will introduce the terminology, measurement and data collection methodologies, key issues and drivers, connections to serious organised crime and terrorism, existing legal frameworks and suggestions for countering the illicit trade. It gives an overview of a complex criminal market that can have serious impacts on security, governance, societies and economies.

## Tobacco – the legal market

The value of the global tobacco market is estimated at USD 744.2 billion in 2014, with cigarettes accounting for 91% of all tobacco products. The volume of cigarettes has declined by 0.4%, but value has increased by 6.1% over 2013. The average price increased by 6.6% to USD 2.63 per pack of 20 cigarettes. Prices around the world differ significantly from region to region, with Middle East/Africa having the lowest prices per pack (below USD 2 per pack) and Australasia the highest (USD 13). The price differentials generate smuggling from low-cost regions/countries to high-cost regions/countries (Euromonitor, 2014, Euromonitor, 2015). The global tobacco market is dominated by four companies that, combined, account for approximately 64% of the legal tobacco market (MarketLine, 2014).

In general, a “tobacco product” is any product that is made from tobacco and intended for human consumption.<sup>1</sup> Most tobacco consumption is in the form of cigarettes (more than 80%) (FAO, 2003).<sup>2</sup> Tobacco, one of the three main components of a cigarette, is a flowering plant grown in more than 120 countries and is the most widely cultivated non-food crop.<sup>3</sup> Each type of tobacco is generally defined by the curing method applied to it. Flue-cured tobacco is used mainly in the manufacture of cigarettes; the most common and popular type is Virginia, which is grown in Argentina, Brazil, China, India, Tanzania and the United States, among other countries. Air-cured tobacco can be light or dark. Dark air-cured tobaccos are mainly used in the production of chewing tobacco and snuff. Fire-cured tobacco is used mostly for pipe tobacco mixtures, snuff and chewing tobacco. Oriental tobaccos, or “Out of sun-cured tobaccos” originate in Bulgaria, Greece, the Former Yugoslav Republic of Macedonia and Turkey (International Tobacco Growers Association, n.d.; Phillip Morris International, 2015). Since tobacco is grown world wide and the curing methods vary, monitoring its cultivation as a means of controlling the supply chain is not feasible; the product can be grown outside the legal market’s supervision and regulation with ease.<sup>4</sup>

Tobacco tends to be a legal product. In most circumstances, the product is cultivated, processed, manufactured into a “tobacco product,” and distributed through legal channels. In many jurisdictions, tobacco is highly regulated from seed to final retail sale. The product can be, and often is, taxed; the taxation level and point of taxation varies between jurisdictions. The companies tend to know their farmers, processors and suppliers (including suppliers for filters, cigarette papers and packaging) to ensure the desired quality and characteristics of their specific products. The manufacturer can only control the product to a certain point. At some point in the distribution channel, the cigarettes and other tobacco products (OTP) are disseminated through systems of transit companies, wholesalers and retailers. Just over half of legal tobacco products are sold to the consumer through independent retailers, grocery stores/supermarkets, convenience stores and gas/petrol stations, with the rest sold through other legal outlets (MarketLine, 2014).

The World Health Organization (WHO) estimates that one in every ten cigarettes smoked is illicit, suggesting that a majority of the cigarette market, and even the larger tobacco market, is legal (WHO, 2015a). The fact that tobacco tends to be a legal, regulated and taxed product is one of the first characteristics of the illicit market in tobacco products, which tends to distinguish itself from other forms of illicit trade. The legality, taxation and regulation of a majority of the market set parameters for the illicit market.

## The illicit tobacco market

Illicit actors have exploited the commodity for their own financial gains and created a lucrative black market in tobacco products. The profit potential has enticed a variety of illicit actors, from small-scale bootleggers to transnational organised crime and terrorist organizations.

The illicit trade in tobacco products includes various types of illicit tobacco products. Typically, the products fall under five broad categories: 1) contraband, 2) counterfeit, 3) “cheap whites” or “illicit whites,” and 4) loose and/or raw tobacco. Mirroring the legal market, a significant percentage of illicit tobacco is in the form of cigarettes. Illicit tobacco products also take the form of cigars, cigarillos, shisha (tobacco for smoking in a hookah), raw or loose tobacco and smokeless tobacco (e.g. chewing tobacco and snuff).

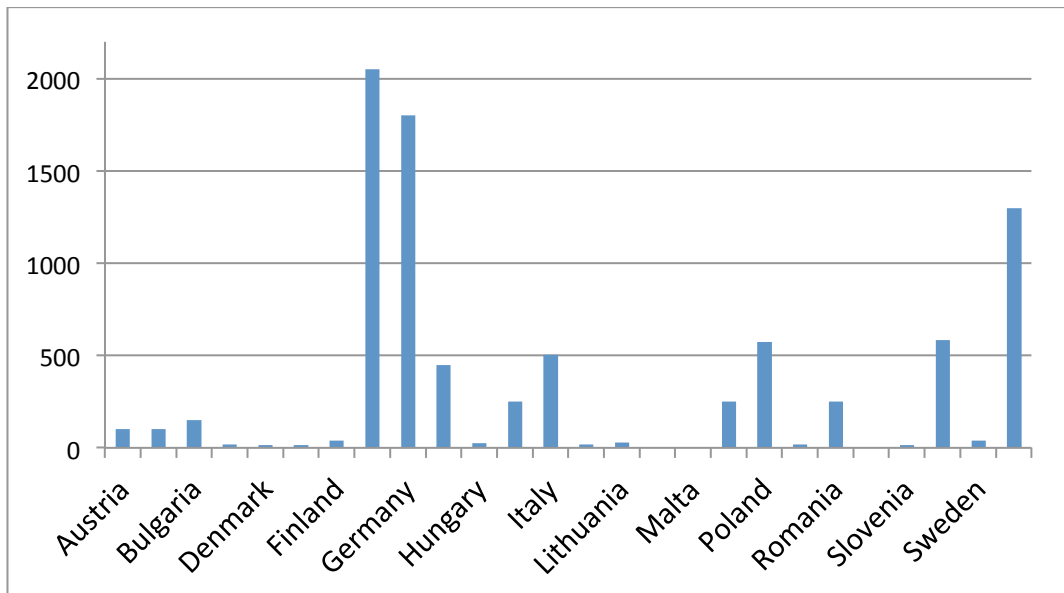
**Contraband** tobacco products are produced legally, but have been diverted after manufacture into an illegal market. A tobacco product, usually cigarettes, becomes contraband when the appropriate taxes, duties and fees are not paid. The diversion of supply from manufacturer to licensed retailer can occur via bootlegging (including Internet sales) or large-scale smuggling operations. Legal definitions of contraband vary by government. For the United States, at the federal level, “contraband cigarettes” refers to more than 10 000 cigarettes that do not bear required state or local tax stamps (Title 18, United States Code, Section 2342) (ATF, 2015).

- **Counterfeit** tobacco products are illegally produced and bear false manufacturing labels, unauthorised trademarks or trade names. The manufacturing sophistication and the product quality can vary. The quality of the packaging has increased with various technologies, and the product can be difficult to distinguish. Not only do counterfeit tobacco products infringe upon intellectual property rights, they do not always meet standards set out by health regulations, and appropriate taxes are not usually paid. Moreover, counterfeit products tend to have higher levels of certain carcinogens and may contain sand, plastic, faeces, asbestos, mould and other harmful ingredients (von Lampe, 2006). Cigarettes tend to be the most counterfeited tobacco product. China has criminalised the production of counterfeit cigarettes, but illegal factories located in China tend to be the largest supplier of counterfeit cigarettes (Shen, Antonopoulos and von Lampe, 2010).
- **“Cheap whites” or “illicit whites” (sometimes referred to as “off-brand”)** are cigarettes legally produced in one jurisdiction for the sole purpose of being exported and illegally sold in a jurisdiction where they have no legitimate market. These cigarettes may not meet the health and manufacturing regulations of the destination country, nor are the appropriate duties paid in the destination country. In the country of production, appropriate taxes may be paid and the cigarettes may be lawfully exported (INTERPOL, 2014a). According to INTERPOL, well-known sources of illicit white production are located in Belarus, Viet Nam, Indonesia, Philippines, India, Cambodia, Paraguay, Ukraine, Russia, Montenegro, United Arab Emirates (UAE), Kenya and a number of free-trade zones (INTERPOL, 2014a).
- **Loose tobacco** is a term applied to tobacco that is often used for cigarettes. Loose tobacco may be used to illegally manufacture cigarettes or other tobacco products, such as “roll-your-own” tobacco, without payment of tax. Illicit loose tobacco can be misbranded or adulterated and may not meet regulatory standards. In Australia,

it is often sold in plastic bags so that users may roll their own cigarettes, at half the price of legal cigarettes (Bittoun, 2004). Raw tobacco, or unmanufactured tobacco, “is any part of the tobacco plant (leaf, stem, etc.) that has been harvested from the ground but does not yet meet the definition of ‘other smoking tobacco’ or ‘hand-rolling tobacco’” (HMRC, 2014a).

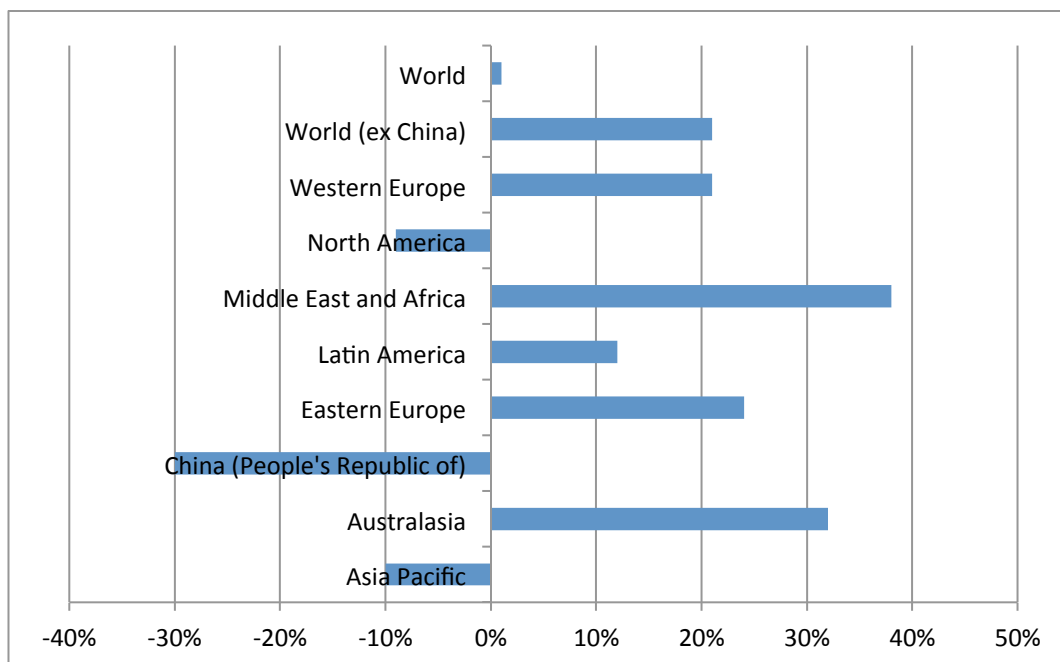
Governments, academics and private companies have used various methodologies to estimate the magnitude of the black market for tobacco products at local, national and regional levels. Two common estimates involve the percentage of the market that is illicit (e.g. illicit penetration rates) or the estimated tax losses caused by the illicit trade in tobacco products (e.g. tax-gap analysis). According to the WHO, one in every ten cigarettes and many other tobacco products consumed in the world are illegal (WHO, 2015a).<sup>5</sup> A recent analysis conducted by Transcrime estimated the European Union’s illicit market for tobacco products to yield between EUR 7.8 billion and EUR 10.5 billion annually (Transcrime, 2015). Figure 5.1, generated by using Transcrime’s data, illustrates the estimated proceeds of the illicit trade in tobacco products for 28 European Union countries. Euromonitor estimated the 2014 illicit market to be approximately 500.8 billion sticks (Euromonitor, 2015).<sup>6</sup> As displayed in Figure 5.2, Euromonitor also tracks regional illicit tobacco markets over time. As illustrated, many of the regional markets are seeing an increase in illicit cigarette trade. The Middle East and Africa region showed the largest growth in volume of illicit cigarettes over the five-year period. Euromonitor attributes this growth to political situations and conditions in the region. The North America, China and Asia Pacific regions showed decreases during the same five-year period (2009-2014) (Euromonitor, 2015).

**Figure 5.1. Estimated proceeds of the market for illicit trade in tobacco products, EU 28 (2013)**



*Note:* The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

*Source:* TRANSCRIME (2015), “European outlook on the illicit trade in tobacco products”, Trento: Transcrime – Università degli Studi di Trento, p. 12.

**Figure 5.2. World illicit trade in cigarettes by volume growth, 2009-2014**

*Note:* Where it says “ex China” above this means that in the bar it excludes the People’s Republic of China data, as they have a big decrease in illicit tobacco product.

*Source:* Euromonitor International (2015), “Global Tobacco: Key findings, Part I – Cigarettes, the ongoing quest for value, July, “Regional trends in illicit trade: Historic”, p. 25.

The United Kingdom’s illicit cigarette market estimate for 2013-2014 is 10%, consistent with the WHO estimate; this is a significant reduction from the 2000-2001 estimate of 22%. A similar reduction was found in hand-rolling tobacco, falling from 61% to 39%. This translates into a significant reduction in tax loss for the British government. During the same measurement points, 2000-2001 and 2013-2014, the estimated tax losses decreased from GBP 3.4 billion to GBP 2.1 billion (HMRC, 2015a). While the reduction illustrates that the illicit market can be reduced through various initiatives, the GBP 2.1 billion in estimated tax losses is still significant and is on par with the lower estimates for tax losses to individual states within the United States. A recent academic estimate places the United States’ illicit market between 8.5% and 21%, causing approximately USD 3 billion to USD 7 billion in tax losses to individual states. It should be noted that a majority of the illicit cigarette market in the United States’ market is contraband cigarettes moved between states; because federal taxes on contraband cigarettes are usually paid, federal tax loss is not included in the above-mentioned estimates (Reuter and Majmundar, 2015).

The United Kingdom has seen a shift in consumption of tobacco products both downwards as regards legal products and from cigarettes to hand rolling tobacco. Concerns about an increasing risk of evasion of duty through raw tobacco being freely and legally imported and then processed into illicit smoking products, led to the Government of the United Kingdom issuing a consultation paper in October 2014. The public consultation covered proposals to introduce additional controls on raw tobacco.

The industry and health groups welcomed the proposals, confirming the Government's view that a registration scheme is the correct way forward. (HMRC, 2015b).

Illicit markets vary from country to country and over time, suggesting that various factors influence the illicit market. Those factors could include the availability of legal products, taxation, disposable income, law enforcement efforts and good governance. The WHO states that the factors that influence levels of illicit trade “include the ease and cost of operating in a country, tobacco industry participation, how well-organized the crime networks are, the tax administration system’s efficiency and honesty and the likelihood of being caught and punished” (WHO, 2015a). The potential profits, and the low risks associated with being caught and convicted of a crime, entice criminals to engage in a variety of illegal schemes and methods of moving tobacco products into jurisdictions in violation of national legislation.

Criminals smuggle cigarettes by any means available: personal vehicles, luggage, postal services, boats, cargo trains, donkeys and shipping containers (Melzer, 2010). Law enforcement must be vigilant to monitor traditional vulnerabilities and methods as well as detect new trends in smuggling. The illegal tobacco products can be shipped by themselves or with cover loads, such as furniture, food, fertilizer or clothing (WCO, 2014a). The World Customs Organization (WCO) noted that smugglers have used modified cars, trucks and train cars to move cigarettes across borders. A Mercedes-Benz was modified so that it could smuggle 318 cartons of cigarettes into Singapore. In Latvia, officials have uncovered modified trucks (lorries) with false walls and floors to conceal illicit cigarettes. In Zimbabwe, officials found more than 15 million cigarettes hidden within four train cars that gave the appearance of full loads of timber (WCO, 2014b). In *Illicit Trade Report 2013*, the WCO states that “an emerging trend that is worth pointing out is the appearance of ‘mail’ as a new concealment method for large quantities” (WCO, 2014b).

Smugglers have used various types of vessels to smuggle cigarettes. In 2012, French and Spanish Customs, during a joint operation, intercepted a yacht containing more than 12 tons of illicit cigarettes (Douanes et Droits Indirects, n.d.). In 2013, Garda Síochána, the National Police Service of Ireland, seized nearly 1 million individual “plain-packaging” packs of cigarettes. The illicit cigarettes were manufactured in Viet Nam and destined for the Irish market. The shipment was uncovered when al-Qaeda operatives launched two rockets at the vessel as it sailed along Egypt’s Suez Canal, causing a fire in the shipping container. The shipment was declared as “furniture,” but contained illegal cigarettes. Authorities conducted a controlled delivery and arrested the importers (Cusack, 2013a, 2013b). The WCO noted that the use of aptly named cigarette boats to shuttle illicit cigarettes across the Adriatic Sea from Montenegro to Italy has been revived. They report that the Italian *Guardia di Finanza* conducted an investigation that discovered the “existence of a criminal association comprised of Montenegrin and Italian citizens engaged in international cigarette smuggling, using powerful boats leaving from the Montenegrin island of Sveti Nikola to land on the Adriatic coast” (WCO, 2014b).

### Box 5.1. 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 affected 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 (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 subject to any excise duty.

The leaves have been sold in specialised 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, Slovak Republic, Turkey and many others).

*Source:* Allen, E. (2013), *The Illicit Trade in Tobacco Products and How to Tackle* (Second Edition), International Tax and Investment Center (ITIC), p. 16.

## Measurement and data collection methodologies

The illicit market in tobacco is difficult to measure. In some ways, this is a unique illicit market, in that the product tends to be legal and most of the tobacco market is a legal, regulated market. Unlike *Erythroxylum coca*, the plant required for cocaine, growing tobacco tends to be a legal activity that spans the globe. Unlike the production of methamphetamines or Ecstasy, the production of cigarettes also tends to be legal and is fairly simple. The market becomes illegal when taxation, intellectual property, importation and health policies and regulations are violated.

When the tobacco product enters the black market, the clandestine nature eludes the watchful eyes of governments, and accurate statistics are not possible. Merriman, Yurekli and Chaloupka, when they attempted to measure the market in 2000, concluded that “smuggling is inherently difficult to study with econometric methodology. Because of its illegal nature, the dependent variable, cigarette smuggling, generally has to be inferred rather than be directly observed. Inferences about smuggling require some confidence about what variables influence the demand for cigarettes in the absence of smuggling and whether illegal behaviour, like smuggling, may be influenced by economic incentives” (Merriman et al., 2000).<sup>7</sup>

When discussing the measurement of the illicit market, the unit of measurement becomes the primary question and one that is not standardised. The three general categories for the unit of measurement are *i)* billion sticks, *ii)* the percentage of the market that is illegal (e.g. illicit penetration rates) and *iii)* the tax gap or tax loss. Different



types of analyses will utilise different units of measurement. Operationalising the unit of measurement is complicated, and no one method of data collection provides an accurate and reliable estimate of the illicit market. For example, while an “in billion sticks” measurement is appropriate for certain analyses, it excludes all other forms of tobacco. Researchers and analysts like to use this variable because the number of cigarettes sold in a pack or bag can vary greatly, and cigarettes are the most popular form of illicit tobacco products.<sup>8</sup> The percentage of the illicit market can be restricted to cigarettes or include other forms of tobacco. Likewise, using a tax gap or a tax loss estimate does not directly measure the profits made by transnational organised crime groups or small-time smugglers; it can provide a ceiling for the potential profits, but it does not measure their actual revenues. A tax-gap analysis can provide a range for potential or estimated tax losses for a government, with caveats on the analysis usually noted.

To date, governments, academics, industry and advocates have not been able to design a measurement and data collection strategy that would consistently measure the illicit tobacco market with accuracy, validity and reliability. Recently, several prominent academics with extensive knowledge of illicit tobacco markets and its complexities concluded that:

*“It is difficult to measure the size of the illicit tobacco market precisely. Multiple methods have been used to estimate its size, including trade gap analysis; differences in self-reported consumption and tax-paid sales; econometric modelling; population surveys; empty pack collections; pack observation, return and swap studies; and expert opinion. These methods are not easily comparable: they differ in sample sizes, time periods covered and scientific rigor, and they yield different estimates and have different sources of error. Another limitation is the difficulty of separating tax avoidance from evasion, a distinction that is important for law enforcement and policy purposes” (Reuter and Majmundar, 2015).*

Nevertheless, various attempts to measure or estimate the size of the illicit tobacco market have been conducted. Scholars attempt to measure the worldwide market using three different methods and econometric models, mostly involving import and export records, as well as population estimates and other independent variables. Researchers caution that their methods and data can be problematic, such as not including smuggled cigarettes that do not cross international borders or only capturing bootlegging and not wholesale smuggling (Merriman et al., 2000).

A recent methodological guide on the subject has been published by Tobacconomics, a research group housed at the University of Illinois at Chicago. The guide builds upon prior literature, provides a comprehensive overview and analysis of the various methodologies, and systematically evaluates recent literature concerning cigarette tax avoidance and evasion. The researcher identified 11 methodologies for estimating the illicit trade in association with taxation, which are: survey of tobacco users (self-report studies), examination of cigarette packs directly from the consumer, discarded empty pack surveys, examination of cigarette packs from retailers, gap analysis of the difference between legal sales and reported consumption, econometric modelling, analysis of taxes paid and estimated consumption, analysis of the gap between the estimated taxes and actual taxes collected, informant interviews, tobacco trade analysis and analysing data concerning illicit tobacco seizures (Ross, 2015). Each of these methodologies has its own limitations. For many of the methods analysed, the author stresses the need for an

appropriate sampling frame. The guide concludes with the recommendation of using a multi-method approach to increase the validity of the results. The correct multi-method approach will minimise inherent limitations of the various methods, while allowing for the triangulation of the results.

A committee of academics, under the umbrella of the National Academies, a private, non-profit, research organisation, also examined the illicit market in tobacco products; although they were not limited to only measuring tax avoidance and evasion. They concluded that there are seven common research methodologies to measure the size of the illicit market in tobacco products, which could be placed within three typologies: residual methods, direct measurement and expert opinion. According to this committee, “For tobacco, three basic residual approaches have been used: one based on the trade gap, one that compares tax-paid sales and self-reported consumption measures, and one that uses econometric modelling” (Reuter and Majmundar, 2015). The direct measure method involves data collection strategies such as population surveys (including self-report surveys and interviews with consumers), empty pack surveys, pack swaps, etc. Expert opinions can add value to determining the market size, but have their own set of biases, such as the expert’s own perspectives and interests, as well as weighing information from the various data sources differently. The committee considered experts to be “customs and law enforcement officials, industry representatives, researchers, tobacco control professionals and other informed parties” (Reuter and Majmundar, 2015).

The Empty Pack Survey (EPS) method has been used by academics and industry to determine the level of illicit tobacco in a given market. Academic studies tend to focus on a city or state, with New York City and Chicago being popular venues in the United States for such analysis.<sup>9</sup> The EPS methodology can be applied at the national level but tends to be expensive, increases sampling concerns and tends to require the assistance of a government or large corporation. The tobacco industry, through KPMG and the Project Sun and Project Star reports, have utilised the EPS methodology in over 100 countries as part of their methodology for country-level estimates; sampling plans are verified for statistical relevance, quota are proportional to population, results are verified for statistical significance and sampling in places of mass confluence is avoided. Appendix I has a more complete discussion of KPMG’s methodology, which utilises EPS to produce the Project Sun and Project Star reports.

Like all data collection methods, EPS has its strengths and weakness. Strengths of this method can include its reliance on physical evidence and that the pack has the possibility of indicating whether or not it is a counterfeit product. A weakness concerns sampling basis and small sample sizes (Reuter and Majmundar, 2015; Calderoni, 2014). For example, there may be statistically significant differences between a sample population that discards their cigarette packs in public and one that discards them in private, as well as the types of venues and neighbourhoods that are sampled. That said, the EPS data collection method does try to address some of the weakness of customer and self-report studies, which are biased by the tendency for humans to not disclose criminal or deviant behaviour. In illicit tobacco studies, the respondents might not be aware that they had purchased or consumed illegal products.

For domestic markets, in addition to the empty pack surveys and other methods mentioned above, some jurisdictions calculate “tax gaps” to estimate tax losses related to the illicit trade in tobacco products. Her Majesty’s Revenue and Customs (HMRC) in the United Kingdom calculates tax gaps for a range of tax regimes including excise duties

and Value Added Tax. This extends to the estimation of tax losses attributed to tobacco and alcohol fraud. It uses a “top-down” methodology. HMRC analysts estimate the total consumption within the United Kingdom, and then subtract the estimated legitimate consumption. Total consumption is estimated by using data from surveys, an “uplift factor” to account for underreporting, and United Kingdom duty paid and legal cross-border/duty free shopping data. They provide a range for the tax gap, to allow for common methodological issues, such as sampling error and under/over reporting. The revenue losses are determined by using the illicit market calculations and adding them to the financial data (price data, duty and VAT data) (HMRC, 2014b).

While conducting cross-country analyses concerning the size of the market, researchers and analysts tend to use readily available data sources, such as prior versions of the Tobacco Atlas from the American Cancer Society, Euromonitor’s estimates and the KPMG data from the Project Star and Project Sun reports. Oxford Economics publishes a report similar to KPMG’s reports for Asia. These sources tend to use a variety of data collection methodologies to generate their estimates. Table 5.1 illustrates the Tobacco Atlas, KPMG’s Project Star Report and Euromonitor estimates for the illicit cigarette market, by OECD country, in 2012. Unfortunately, Tobacco Atlas V did not include estimates for the illicit cigarette market by country. The data for 2012 is the most current year for which all three sources produced an estimate.

The methodology, such as Euromonitor’s data and estimates, can be proprietary.<sup>10</sup> The American Cancer Society provides its data sources in an appendix and can vary by country, making it difficult for cross-country analyses.<sup>11</sup> KPMG uses a mixture of data collections to estimate the size of illicit markets within a given country, including *i)* empty pack surveys, *ii)* pack swap surveys, *iii)* consumer surveys, *iv)* mystery shopping, *v)* rolling paper analysis and *vi)* seizure data. Some of its data collection methods include empty pack surveys (EPS), market research, legal domestic consumption, consumer research and various other methods. In addition, KPMG used a “yellow bag survey” conducted by IPSOS in Germany and collected 10 000 packs per month from a sample of waste disposal centres, combining it with an additional street collection to complete the assessment (KPMG, 2013).<sup>12</sup> The academic literature has been debating the use and validity of industry-sponsored data. Some researchers have critiqued its use; they have called on industry to be more transparent with their methodologies and stress that the data should be used with caution. Others conclude that, in some countries and analysis, industry-sponsored data is the only data that lends insight into the non-domestic consumption of illicit tobacco on a regular and annual basis (Gilmore et al., 2013; Reuter and Majmundar, 2015; Calderoni, 2014).

**Table 5.1. Comparison of illicit cigarette penetration, in percentages, for OECD countries in 2012**

Country	Tobacco Atlas IV	KPMG	Euromonitor	Country	Tobacco Atlas IV	KPMG	Euromonitor
Australia	3.4	No data	4.1	Japan	0.1	No data	0.0
Austria	13.6	9.7	16.9	Korea	0.4	No data	0.4
Belgium	5.0	7.5	3.7	Luxembourg	No data	2.0	No data
Canada	14.0	No data	17.6	Mexico	6.1	15.6	18.6
Chile	1.6	No data	3.3	Netherlands	9.5	11.0	10.9
Czech Republic	10.0	2.2	9.5	New Zealand	3.2	No data	1.3
Denmark	1.0	2.4	1.1	Norway	4.1	No data	4.9
Estonia	36.2	19.7	21.7	Poland	8.5	13.0	24.1
Finland	5.8	16.9	6.0	Portugal	6.3	2.8	9.0
France	12.8	15.7	15.0	Slovak Republic	15.0	0.8	19.8
Germany	8.4	11.1	7.8	Slovenia	8.1	6.7	8.7
Greece	7.0	13.4	12.8	Spain	1.0	7.5	8.2
Hungary	12.4	4.1	7.0	Sweden	15.4	11.9	10.4
Iceland	No data	No data	No data	Switzerland	5.0	No data	5.9
Ireland	33.2	19.1	29.7	Turkey	15.7	No data	15.6
Israel	2.8	No data	2.9	United Kingdom	11.0	16.4	11.7
Italy	2.4	8.5	5.8	United States	6.4	No data	7.1

*Note:* The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

### Box 5.2. Measuring tax gaps

Her Majesty's Revenue and Customs (HMRC) in the United Kingdom produces an annual estimate of the "tax gap", that is, the difference between the amount of tax that should, in theory be collected, against what is actually received. HMRC uses a range of internal and external data and different analytical techniques to produce best estimates.<sup>1</sup> The findings are further refined through estimates of the gap by type of tax and the composition of the associated behaviours (such as error, evasion, hidden economy and criminal attack).

An assessment of the UK's tax gap methodologies was carried out by the International Monetary Fund in August 2013. It concluded that "HMRC's tax gap analysis program is comprehensive in tax coverage and effectively addresses its multiple dimensions". The tax gap for 2012-13 is estimated to be GBP 34 billion, which is 6.8% of all tax liabilities. The report found that the illicit market share for cigarettes was 9% with a tax gap market share of 36% with a tax gap of £ 900 million. The estimates are produced using a top down methodology, that is, total consumption is estimated from which legitimate consumption is subtracted, the remainder being the illicit market. Since the launch of the Tackling Tobacco Smuggling strategy in 2000 HMRC estimates that revenue losses have reduced from GBP 3.4 billion to GBP 2.1 billion.

For more information on measuring tax gaps and HMRC's Methodological annex, please visit: [www.gov.uk/government/statistics/measuring-tax-gaps](http://www.gov.uk/government/statistics/measuring-tax-gaps).

*Sources:* HMRC (2014b), Measuring tax gaps 2014 edition. An Official Statistics release 16 October 2014. HMRC (2015a), Tackling illicit tobacco: From leaf to light. The HMRC and Border Force strategy to tackle tobacco smuggling.

As displayed in the table from the Committee on the Illicit Tobacco Market: Collection and Analysis of the International Experience's *Understanding the U.S. Illicit Tobacco Market: Characteristics, Policy Context and Lessons from International*, each methodology has its own strengths and weaknesses, including challenges that concern data collection, reliability and validity. Collecting the data needed to estimate a value for the measurement can be done in several ways. Often, these data sources are combined and weighted to estimate a value for a given market. For domestic analysis, researchers and analysts may use government data, such as tax gaps, as well as the above listed methodologies. It is important to note that all data and data collection methods will have their own strengths and weaknesses.

Accurate tracking and measurement is fundamental to designing appropriate policies that attempt to combat the illicit trade in tobacco products. In addition to the challenges listed above, the clandestine and criminal nature of the trade does not allow itself to be easily measured. Criminals and terrorists who traffic in illicit tobacco do not report their transactions to authorities, use methods to conceal their shipments and activities, do not declare profits on their tax returns, launder their proceeds and so on. As a result, many studies derive their estimates of illicit trade in tobacco from reported seizures, econometric proxies, consumer/market surveys and a variety of other methods that do not yield an accurate estimate. While agreement on a single method remains elusive, there are various methods of measuring the illicit trade in tobacco that, when taken jointly, provide a rough measure of the global scale and prevalence of the illicit trade in tobacco products.

### Drivers and facilitators of the illicit trade in tobacco products

Factors that influence the illicit trade in tobacco products can be determined by econometric modelling and/or qualitative assessments. These analyses can be conducted at the micro or macro levels. When analysing the situation via econometric modelling, researchers tend to first measure size of the illicit market and then build the models with variables that are hypothesised to impact the illicit market (factors that facilitate or hinder the illicit trade). The variables in the model will be dependent on the specific analysis and theoretical framework; common variables can include purchasing price, proximity to borders, Internet penetration, taxation levels, smoking prevalence rates, sales per capita, GDP per capita or estimated disposable income, unemployment rates, corruption, presence of organised crime networks, perceived legitimacy of the tax, rule of law/good governance indexes, prosecution rates, punishments and variables measuring law enforcement actions/effectiveness (including border security and seizure rates). The illicit trade in tobacco cannot be attributed to one or two factors; it is the combination of factors, or variables, that interact with each other to allow or hinder the illicit trade. These factors vary over time and jurisdiction, allowing for trend and cross-country/state analyses.

The legitimacy of the taxation, as viewed by the consumer and society, can influence the demand and purchase of illicit tobacco. Research conducted in Edinburgh, Scotland, focused on the attitudes of smokers concerning illicit tobacco products. Some respondents indicated that the smugglers were providing a service, that smuggling was a “reasonable response” to the price, taxation levels on tobacco products were excessive, the taxation encouraged smuggling, and “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” (Wiltshire et al., 2001). Additional research conducted in the United

Kingdom revealed that 60%-69% of illicit tobacco buyers claim that cheaper illicit tobacco makes it possible for them to smoke when they otherwise could not afford to purchase legal cigarettes. Although the same survey indicated that only 15%-28% of the respondents were comfortable with illicit tobacco products and 18%-20% of the respondents stated they buy illicit tobacco products (All Party Parliamentary Group on Smoking and Health, 2013). Another study, conducted in Nottingham, United Kingdom, showed similar results for the support of smugglers and the purchase of illicit tobacco products, with the notable exceptions of counterfeit products and smugglers selling to children; respondents did not care for the counterfeit products and selling to children was not supported. Overall, respondents felt the smugglers assisted the local economy and taxation rates were unfair (Stead et al., 2013). Similar views can be found in New York and New York City. When New York increased taxation rates for cigarettes in 2002, smokers in Harlem started to openly buy their cigarettes from the “\$5 Man” to avoid the price increase. Smugglers received the same admiration from respondents as they did in the Edinburgh study: “a justifiable and appreciated response” (Shelley et al. 2007).

Often cross-border shopping, tourism and other forms of the illicit trade, perpetrated by consumers or smaller-scale smugglers, are attributed to the final price per pack and the proximity of cheaper cigarettes. As mentioned above, the perceived legitimacy of the tax can be associated with this type of illicit trade. For small-scale smuggling within the United States, one study found that while most smokers purchased their product within their state, some consumers were willing to travel up to 3 miles (approximately 4.8 kilometres) to save USD 1 per pack, and heavy smokers were more likely to travel to a low-tax jurisdiction to buy their cigarettes. They also concluded that a state’s cigarette sales are impacted by other state’s taxation levels (Chiou and Muehlegger, 2008). Another study concerning the United States found that “13% and 25% of consumers purchase cigarettes in a lower-price state or Native American Reservation” (Lovenheim, 2008).<sup>13</sup>

Research on small-scale smuggling within 23 European countries, published in 2000, indicated that “the greater the incentives for illegal importation, the lower were recorded sales. Similarly, the greater the incentives for illegal exportation, the higher were recorded sales. We estimated that, in a typical European country, bootlegged cigarettes accounted for about 3% of domestic consumption” (Merriman et al., 2000). It should be noted that the researchers used “frequency of travel between countries” instead of proximity for their cross-border shopping analysis. For cross-border shopping, the jurisdiction where the product is purchased and sold may not be adjacent to each other. In the United States, cigarettes are frequently purchased in Virginia with the intent of selling them in New York. In the United Kingdom, cross-border shoppers and small-scale smugglers will travel to several countries in continental Europe, purchase tobacco products with lower taxes and then return to the United Kingdom.

Corruption is often discussed as a facilitator for various forms of illicit trade, including the illicit trade in tobacco products. Several studies in the early 2000s examined corruption in regards to cigarette smuggling. They found corruption to be a significant factor, as well as the presence of organised crime, public acceptance, informal distribution networks and widespread street selling (cigarettes and other goods) helped large-scale smuggling organisations (Merriman et al., 2000). In later research, the analysis indicated that the state’s ability to govern, in many sections of society, affects cigarette smuggling. A state’s ability to govern effectively and score low on the Fund for

Peace’s “failed state index” (now called the Fragile States Index) is related to a reduction in the percentage of the cigarette market that is illegal (Melzer, 2010).

Corruption, border security, law enforcement effectiveness, and other variables related to the ability to effectively govern, all affect large-scale smuggling operations. Various forms of illicit tobacco being moved in large-scale smuggling operations tend to be moved in 40-foot shipping containers, with false bills of lading and can be linked to other crimes, such as trade-based money laundering schemes. The ability of governments to detect the illegal product is linked to its ability to govern and secure its borders.

Academic research that leans more toward qualitative assessments has also examined key variables for both small- and large-scale smuggling operations. The literature, usually found within criminology, tends to categorise the factors that facilitate cigarette smuggling into five broad categories: *i*) price differentials between duty-free and the legal retail prices; *ii*) price differentials in retail prices or taxation rates between jurisdictions; *iii*) the existence of corruption among border and customs officials, *iv*) the long-term involvement of organised crime groups in the cigarette trade and other illicit markets; and *v*) the oversupplying of tobacco products to key markets, or the production of a tobacco product that exceeds the consumption rates for the brand’s legal market (Beare, 2002; Joossens and Raw, 2008; van Duyne, 2003; von Lampe, 2005, 2006).<sup>14</sup>

### Free trade zones

Free trade zones (FTZs) have been linked to the illicit trade in tobacco products, possibly as a facilitator or as an important trade and economic zone that is being exploited by criminals. As the magnitude of smuggling has changed around the globe, attention has turned to the role of FTZs, which, paradoxically, were created to facilitate legitimate business and economic growth, but have turned out to be vulnerable to illicit activity and transnational crime. The FTZ offers a preferential environment for manufacturing, wholesale, warehousing, import and export facilities, and goods introduced into a zone can undergo a range of economic operations, including assembly, processing, repackaging and transshipment. This environment can be exploited by criminals and organised crime.

FTZs have proliferated in recent years. The 2010 Financial Action Task Force (FATF) report *Money- Laundering Vulnerabilities of Free Trade Zones* stated that there were “approximately 3 000 FTZ in 135 countries around the world, with a total turnover of billions of US dollars” (FATF, 2010a).

FATF acknowledged that FTZs are central to the integrated global economy. They stimulate economic growth and play a central role in business for many countries and leading manufacturers. However, the 2010 report also carries the warning that standards, oversight and regulations governing FTZs have not kept up with the pace of these developments, and that as a result, illicit actors have been able to take advantage of inadequate oversight and the lack of transparency in zones to launder the proceeds of crime, finance terrorism, facilitate the proliferation of weapons of mass destruction (WMD) and smuggle contraband. Although the conditions for establishing FTZs may be regulated by the local customs or relevant management authority, the extent of customs controls or interventions is often insufficient or absent.

In October 2014, the WCO announced the results of its first global operation against the illicit trade in tobacco. The operation, codenamed *Gryphon*, confirmed that FTZs play

an important role in the smuggling of cigarettes. “Consignments arriving in these zones are subsequently repacked into other containers, enabling the illicit cigarettes to be lost or disappear. They then leave the zone as low-value goods (e.g. textiles) either mis-declared or concealed in other shipments” (WCO, 2014a).

The issue of illicit whites, or cheap whites, has caught the attention of policy makers, researchers, international organisations and industry. The KPMG Project Sun analysis reported that illicit whites are an increasing component of counterfeit and contraband in the EU, with an exponential growth in the category from virtually zero in 2006 to 37% in 2014 (KPMG, 2015). FATF also drew attention to FTZs in its Illicit Tobacco Trade Report, June 2012. It highlights the financial incentive to source product in a lower-priced market and transport, distribute and sell in a higher-priced market. The report examines the illicit whites phenomenon, describing the product thus:

*“Cheap whites are factory-made cigarettes produced with the approval of a licensing authority in that jurisdiction. These are sometimes known as illicit whites, but this is an incorrect term, as they are produced legally” (FATF, 2010b).*

Meanwhile, the concentration of cigarette manufacturers operating in the FTZs in the United Arab Emirates (UAE) continues to grow. The 2013 European Union (EU) strategy “Stepping up the fight against cigarette smuggling and other forms of illicit trade in tobacco products” claims “whilst in the past, the UAE appeared mainly as a point of transshipment, current information clearly points to its new role as an important production location for other brands, particularly in its free zones” (Communication from the European Commission to the Council and the European Parliament, 2013).

The characteristics relied upon in the promotion of Jebel Ali factories include their ability to produce their own brands, as well as contract manufacturing, the utilisation of technologically advanced machinery, round-the-clock operations with high yield and logistical proximity of plant, port and time to market. The growing prosperity of the Jebel Ali Free Zone is illustrated by a 7% growth in trade in the first six months of 2014. Cigarettes were the number one non-oil export, valued at AE 2.2 billion, or 19% of the total exports from the free zones in the same period (Bouyamourn, 2015). Unlike in the UAE, where 51% of a business must be owned by UAE nationals, companies located in the FTZ may have 100% foreign ownership.

In Central America, Insight Crime reported claims that an FTZ in the Corozal district of Belize has become a hub for the illicit cigarette trade in the region, highlighting how lax customs controls create criminal opportunities, with regional distribution of cigarettes from India, China, Switzerland, Paraguay and Panama (Cawley, 2013).

In common with Jebel Ali, the Colón Free Trade Zone (CFTZ) occupies a strategic trading position, geographically situated at the Atlantic gateway to the Panama Canal, with access to both the Atlantic and the Pacific. The CFTZ is the world’s second-largest and handles more than USD 16 billion in imports and re-exports each year.

The U.S. Department of State International Narcotics Control Strategy Report 2015 posits that the Colón FTZ continues to be vulnerable to illicit financial activities and abuse by criminal groups, due primarily to weak customs enforcement and limited oversight of trade and financial transactions (U.S. Department of State, 2015). Bulk cash is easily introduced into the country by declaring that it is for use in the CFTZ, but there is no official verification process to confirm its end use for lawful business in the free



zone. Furthermore, the lack of integration of the CFTZ's electronic cargo tracking system with Panamanian Customs hinders timely analysis.

### Supply chain management

To counteract some of the facilitators and vulnerabilities listed above is to attempt to control the supply chains related to tobacco products. When discussing supply chains, the conversation can include everything from tobacco in the field to specialised filters and papers for cigarette production, to the packaging of the cigarettes and monitoring the completed product until it reaches the end consumer.

Accordingly, several countries use the regulation of supply chains as an approach to reduce illicit trade in tobacco. The European Union, through the European Commission's European Anti-Fraud Office (OLAF) and its OLAF Cigarettes Task Group, has entered into legally binding agreements with four significant major tobacco manufacturers. The agreement delineates the steps the four manufacturers must follow to ensure that their products do not enter the black market.<sup>15</sup> Stating the obvious, illicit manufacturers and manufacturers producing cigarettes for the illicit market in Europe are not bound by these agreements. There are specific actions that are required by these agreements, such as requirements to track and trace the movement of tobacco products and executing stringent due diligence with vendors of tobacco products. These measures are also promoted by international treaties, such as the WHO Framework Convention on Tobacco Control (FCTC) and its Protocol to Eliminate the Illicit Trade in Tobacco Products, and by regional regulations (the European Union's Tobacco Products Directive), national laws and actions of governments with UN agencies. Research has shown that while the overall level of illicit tobacco has decreased in Europe, illicit whites' percentage of the illicit market has increased, and accounts for 33% of all illicit tobacco sales (KPMG, 2014). Since 2006, the market share of illicit whites has steadily increased in Europe, with an average of 27.9% in 2013 (Transcrime, 2015).

One of the most effective means to control diversion of tobacco products into illegal channels is tracking and tracing the product from manufacture to end retailer. This activity is present in many industries, from logistics to pharmaceuticals. It provides law enforcement information so they may authenticate the origin and verify the flow of products. According to the European Commission, the tobacco industry's tracking and tracing systems "have allowed OLAF and the Member States rapidly to recreate the route taken by genuine smuggled cigarettes from the factory into the hands of the smugglers" (European Commission, 2006).

The core of "track and trace" is providing unit packs with unique identifiers. These have to contain a set of dynamically changing data and must be able to be applied on the packs in high-speed manufacturing environments (up to 20 000 units a minute). The data in the unique identifiers is readable by various types of industry-grade scanners, and is expected to be exchangeable between different data management systems in a standardised manner. Under their agreements with the European Union, tobacco manufacturers developed a suite of technology solutions to address this challenge, which has been operating across national borders for more than 10 years.

Another effective means to curb the diversion of genuine cigarettes from the legitimate supply chain is the establishment of know-your-customer policies and practices along the supply chain. The FCTC and its protocol provides a solid framework to

establish due diligence regulations that have a proven potential to decrease the black market of cigarettes. As mentioned earlier, stringent due diligence is required from tobacco manufacturers under their agreements with the European Union.

On top of “track and trace” and due diligence policies, the FCTC and its protocol also calls for the establishment of licensing, “the manufacturing, import and export of tobacco products and manufacturing equipment, and establishing a global tracking and tracing regime to assist in the investigation of illicit trade” (WHO, 2015b). Some governments have already started to utilise these regulatory options to control certain areas of illicit trade. The Ukrainian Parliament adopted a set of anti-illicit tobacco regulations in August 2014, one of them being a licensing requirement for manufacturing equipment. This provision has significantly contributed to better controls of unregistered manufacturers that were predominantly producing for the illegal market. Another example of the effective use of licensing is the amendment of the Excise Law by the Polish Parliament. This law, adopted in August 2015, was designed to establish better controls of tobacco traders’ operations. Reportedly, lawmakers have high hopes that the newly introduced licensing regulation will contribute to curbing criminal activities related to trading in raw tobacco, which has become a major issue in Poland in recent years.

The focus of attention in supply-chain management solutions tends to be on finished products, such as cigarettes. Recently, attention has moved to the precursor ingredients for cigarettes. The control of the production and supply of key components in cigarettes presents a structured approach to the reduction of illicit trade. Small-scale production of illegal cigarettes may use “rolling machines”, but to produce cigarettes in large quantities, illegal manufactures need specialised machinery similar to those used by legal manufactures. The major manufacturers take measures to ensure their manufacturing equipment is not used for the illicit production of cigarettes (Reuter and Majmundar, 2015).<sup>16</sup>

The three components – tobacco, filter and paper – required to produce a cigarettes are more difficult to monitor than manufacturing equipment. As stated above, tobacco is legal to grow in more than 120 countries. According to the 2015 Tobacco Atlas, tobacco cultivation occurred on approximately 4.3 million hectares of land world wide, resulting in approximately 7.5 million tons of tobacco leaf (American Cancer Society, 2014). The raw tobacco market is highly fragmented, easily accessible and is unregulated in some countries. Given that millions of farmers grow tobacco all over the world, implementing rigorous supply-side controls in the effort to prohibit illicit manufacturing of tobacco products would be a challenge. Likewise, attempting to control paper and its use in illicit cigarette production would be difficult. While cigarette paper is a unique type of paper that only a few manufacturers produce, the product can be easily substituted in the production of illegal cigarettes (Reuter and Majmundar, 2015).<sup>17</sup> Controls on the supply of cigarette components have therefore focused on filters.

The most commonly used cigarette filter is made with a wood-pulp-based synthetic fibre called “cellulose acetate”. The cellulose acetate is transformed into “acetate tow” and is produced by very few companies world wide. Cellulose acetate can be used in highlighters, pens, markers, oil filters and medical devices, and it is extensively used to produce cigarette filters (Eastman Estron, n.d.).<sup>18</sup> According to the Committee on the Illicit Tobacco Market (2015), “more than 80% of world production [of acetate tow] is reportedly used in the manufacture of cigarettes” (Reuter and Majmundar, 2015).<sup>19</sup> The

use of an acetate tow filter is preferred in cigarette manufacturing, and there appears to be no consumer-preferred substitute.

Producing acetate tow requires large-scale capital investments, and the product is difficult to produce. The barriers for entering into the acetate tow production industry are high, and the industry is highly concentrated. There are five primary manufacturers of acetate tow, and they supply nearly all of the product required by the tobacco industry. On these grounds, the Committee on the Illicit Tobacco Market (2015) concluded that “acetate tow could be controlled to make illegal manufacturing of cigarettes more difficult” (Reuter and Majmundar, 2015).<sup>20</sup> The committee also noted that controlling the acetate tow filter supply chain could have an impact on counterfeit cigarettes, because they must look like the real product. It added that “the tracking and tracing of acetate tow also could be facilitated by the fact that it has a unique code in the harmonised tariff schedules of Brazil, Canada, China, the European Union and the United States” (Reuter and Majmundar, 2015).<sup>21</sup>

The Global Acetate Manufacturers’ Association (GAMA) has taken measures, such as know-your-customer procedures, to curb illicit trade. In 2006, GAMA introduced its voluntary system and includes know-your-customer audits every two years. Not all manufacturers are members of GAMA, and the GAMA system is voluntary. It is speculated that acetate tow is currently being supplied to certain countries where estimated supply greatly exceeds anticipated demand. The excess is thought to be used for the production of cigarettes, which are then smuggled internationally. The international community may have responded to the need to monitor acetate tow when, in 2014, the WCO introduced a new category, “artificial filament tow” to its International Convention on the Harmonized Commodity Description and Doing System (1983), Amendments to the Nomenclature, Appended as an Annex to the Convention. A subcategory to “artificial filament tow” includes cellulose acetate, and its inclusion could assist the global efforts to detect and reduce the amount of acetate tow filters being used in illicit production. The new coding scheme will enter into force in 2017 (WCO, 2014c).

### Tackling demand for illicit tobacco products

While global efforts to reduce illegal trade in tobacco products have focused on enforcement, to stem supplies, there are a few examples, such as those from Canada and the United Kingdom, of attempts by authorities to reduce demand. The Royal Canadian Mounted Police (RCMP) included illicit tobacco in its Contraband Tobacco Enforcement Strategy Progress Report (May 2008-May 2009). Its strategy included disrupting organised crime with traditional law enforcement efforts, as well as a public awareness campaign about the illicit market in tobacco products. Priority 5 of its strategy included “Heighten awareness about the public safety and health consequences of the illicit tobacco trade” (RCMP, 2010). To that end, the RCMP’s strategy included releasing declassified versions of intelligence assessments on illicit tobacco and the bad actors associated with it, such as organised crime. Additionally, the strategy included briefing police chiefs and developing public service announcements concerning the harms associated with illicit tobacco. It is notable that the RCMP educated the population who benefits from the illicit trade in tobacco products. More important, the RCMP concluded that key government and enforcement decision-makers needed to have an awareness of the nature, harms and reach of illicit tobacco (RCMP, 2010).

Sustained efforts to reduce demand for illegal tobacco products have been made by the Health and Local Authorities in the United Kingdom on the basis that illicit tobacco undermines the effect of tobacco control strategies. The first efforts took place in the north of England and were funded by the Health Authority. The public awareness campaign focused on two key messages: “IT [illicit tobacco] made it easier for children to start smoking, and that IT brought crime into the community” (McNeill et al., 2013). A mixed-method evaluation of this public awareness campaign, including interviewing stakeholders at the time of the campaign and a year later, concluded:

*“To our knowledge, this is the first assessment, globally, of any programme developed to reduce the demand as well as the supply of IT. Indeed, the main preoccupation of IT work in the past has been on supply, but the large numbers of buyers (and small sellers) identified across the sociodemographic spectrum highlights the limited likely impact of approaches focusing purely on supply. Misperceptions about IT were also observed, which militated against an appreciation of the wider harms of tobacco smuggling arising from its links to organised crime, irrespective of the financial and health costs. The resultant Get Some Answers campaign was based on evidence collected by the Programme that the messages that would influence demand were those focussing on the harm IT causes children and the criminality that IT brought into communities. Awareness and the volume of calls concerning supply increased, although only small attitudinal shifts were observed, mostly in the preferred direction. The one channel of IT supply that reportedly increased, namely shops, could be a consequence of some of the imagery about street sellers shown in the campaign. The sale of IT through shops is of concern, but retailers in England can currently be fined for doing this” (McNeill et al., 2013).*

Studies on demand reduction tend to focus on smoking overall and are not limited to illicit products. For example, Australia’s National Tobacco Strategy 2012-2018 includes very little about tackling demand for illegal products, as the focus seems to be on reducing smoking overall by means of a number of regulations on supply, workplace smoking bans, public campaigns to stop smoking and assistance in giving up smoking. There is no mention of any specific programme to reduce demand for illicit products. The focus is on maintaining enforcement and international co-operation to stem supplies (Commonwealth of Australia, 2012). Demand reduction policies for tobacco can have an impact on the demand for illicit tobacco products. However, demand reduction strategies could be more effective if illicit tobacco was included as part of the strategy.

### **Box 5.3. Public awareness campaign in Nova Scotia**

In 2008, Crimestoppers started a public awareness campaign to combat illicit tobacco in Nova Scotia, Canada. Crimestoppers is a non-governmental organisation that allows the public to provide anonymous tips to law enforcement about illegal activities (<http://crimestoppers.ns.ca/category/illegal-tobacco/>). This public awareness campaign featured television spots and Internet clips that focused on illicit tobacco. The initial phase of the campaign aimed to educate the public that selling illicit cigarettes was subject to penalties. Later phases of this campaign emphasised the link between illicit tobacco and organised crime and the negative impact illicit tobacco can have on the local community. These spots have aired during hockey games, providing wide exposure to the public. According to data provided by Crimestoppers, the number of tobacco-related tips has nearly tripled since the start of this campaign, from 213 from 1 January 2000 to 31 December 2008 to 609 from 1 January 2009 to 31 December 2014.

## Links with organised crime and terrorist groups

In terms of circumventing law enforcement while making substantial profits, cigarettes are an ideal product for criminal groups. This is a product that has high consumer demand, is lightweight and is highly profitable, due to the relatively low cost of production and the high price at point of sale, due in most part to high levels of domestic taxation. If and when the illegal products are discovered, the risk of a lengthy prison sentence is low. Therefore, the illicit trade in tobacco products is enticing for organised crime and terrorist organisations, and has been for decades. There are numerous historic and contemporary examples of serious organised crime groups and terror organisations linked to the illicit trade in tobacco products.<sup>22</sup>

In the 1980s, illicit tobacco started to become a revenue source for certain actors in North Africa. Lacher contends that “Cigarette smuggling in particular has greatly contributed to the emergence of the practices and networks that have allowed drug trafficking to grow” (Lacher, 2012). The links of a senior commander of Al-Qaeda in the Islamic Maghreb (AQIM), Mokhtar Belmokhtar, to cigarettes smuggling is so commonly assumed that his moniker is “Mr. Marlboro”. AQIM realises enormous profits, either by charging a “tax” for the safe passage of cigarettes or by facilitating their transport (Doward, 2013). When AQIM ousted Belmokhtar for prioritising financial gains over the group’s ideological and religious objectives, he founded a new terrorist group, Katibat El-Mulathameen (“the Signed-in-Blood Battalion”), and continued engaging in the trafficking of tobacco products (INTERPOL, 2014a). However, AQIM is not the only terrorist group that raises funds through the illicit trade in tobacco. More than a decade ago, a commentary in *Police Chief* drew attention to not only the immense profits and relatively low penalties associated with cigarette smuggling, but also the link to numerous terror organisations, such as Hezbollah, the Real IRA (RIRA), Al-Qaeda, Hamas, the Kurdistan Workers’ Party (PKK) and Egyptian and Palestinian Islamic Jihad (Billingslea, 2004). In 2009, the International Consortium of Investigative Journalists reported that the Taliban, renowned for its heroin trafficking, also profits from illicit tobacco. Estimates indicate that revenue from illicit cigarette “trade accounts for as much as 20% of funding for militant groups in this region, second only to heroin production” (Willson, 2009).

More contemporary examples of illicit tobacco funding terrorism and organised crime may be found in and near Syria and Iraq. It has been estimated that cigarette smuggling has increased by 135% since the Syrian civil war began (Gingeras, 2014). Chris Rawley, vice-president of the Center for International Maritime Security (CIMSEC), documented a particular cigarette smuggling network that involves both the Assad regime and the Islamic State of Iraq and the Levant (ISIL, also known as IS, ISIS and Daesh) and could account for the increase of illicit tobacco in Turkey. Cigarettes were loaded on a ship in Bulgaria, moved across the Black Sea, through the Strait of Bosphorus and then either to Syria or to the Persian Gulf by way of the Red Sea. The illicit cigarettes were then offloaded and sold in Syria or smuggled into Turkey. They eventually entered ISIL-controlled territory; the group profited from this illicit trade by “taxing” the transportation of these cigarettes as they pass through various transshipment points. According to Rawley, “The product and profit not only support ISIL and their organised crime network, but other Al-Qaeda affiliates and foreign fighters drawn to the region. The illicit tobacco trade is an instrumental part of their funding portfolio, which also includes weapons trafficking and sale of stolen oil.” The cigarette-trafficking routes and taxation

schemes used by ISIL are similar to those used by the PKK before ISIL took over the region (Rawley, 2014).

Academic research has documented the connections between corruption, organised crime and terrorism and their involvement in a variety of illicit trade, including the illicit trade in tobacco. Academics have documented connections between cigarette smuggling in general and to specific terrorist organisations, such as AQIM, the Kosovo Liberation Army (KLA), PKK, RIRA and Hezbollah (Shelley, 2014; Shelley and Melzer, 2008). And more recently, researchers have outlined how ISIL uses illicit trade, including cigarette smuggling, to finance terrorism (Shelley, 2014).

The WHO stated “Cigarette smuggling has also been linked to armed insurgent groups in the Middle East, Africa and other parts of the world. In areas of central and eastern Africa, research has found that rebel groups accused of mass murder, torture and forced recruitment of children have used the illegal trade of tobacco products to finance their activities” (WHO, 2015a). Similarly, and according to the United Nations Office on Drugs and Crime (UNODC), cigarette smuggling in West Africa is a significant revenue source for illicit actors, with illicit cigarettes accounting for approximately 80% of the market and the value estimated at USD 774 million (UNODC, 2009). When looking at the African continent as a whole, the illicit market is approximately 15% (UNODC, 2009). The cigarettes flooding West African markets appear to originate in Europe or Asia. For Asia, the cigarettes originate in Viet Nam and China, flowing through various FTZ. The cigarettes tend to land at West African seaports and make their way into North Africa. The European cigarettes, originate in Luxembourg, Greece and Bulgaria, and transit through Jebel Ali, before arriving at West African seaports (UNODC, 2009). Illicit whites from Dubai also enter the market.<sup>23</sup> INTERPOL has also documented the link between cigarette smuggling and rebel groups in Africa (see Box 5.4.).

#### Box 5.4. Funding the rebels

In 2009, a smuggler pleaded guilty to tax evasion at a court in Eastern Cape Province, South Africa. He was originally arrested at Heathrow Airport in London, following the issue of an INTERPOL red notice for his arrest. He was extradited to South Africa, where he had several businesses to import tobacco and produce cigarettes for both export and domestic sale. The smugglers admitted that, thanks to unpaid taxes and duty, he had received a financial benefit of ZAF 60 million (USD 5.41 million). He was sentenced to pay this back at a rate of ZAF million (USD 90 000) per month.

On 12 December 2008, the United Nations Security Council published a report by its Group of Experts on the Democratic Republic of the Congo (DRC). The report accused the smuggler of channelling money from his companies to a Congolese rebel group called *Congrès National pour la Défense du Peuple* (National Congress for the Defense of the People, or CNDP). The CNDP is one of the rebel groups fighting to control the mineral-rich territory in DRC and has been implicated in human rights violations including murders, the recruitment of child soldiers, mass rape, slavery and torture.

Source: Interpol (2014b), Adapted from *Against Organized Crime: INTERPOL Trafficking and Counterfeiting Casebook 2014*, p. 32, available at: <http://www.interpol.int/News-and-media/News/2014/N2014-057>

The United States has several notable cases involving a connection between cigarette smuggling, organised crimes and terrorist involvement. Operations Smoking Dragon and Royal Charm linked counterfeit cigarettes to organised crime, counterfeit pharmaceuticals, counterfeit currency, surface-to-air missiles, money laundering and various other national security concerns (see Box 5.5 below). In Operation Smokescreen, local and federal authorities spent years meticulously gathering surveillance and evidence on a group of individuals known as the “Charlotte Cell,” who were involved in cigarette smuggling as well as a host of other crimes, including immigration and visa fraud, identity theft, money laundering, bank fraud and mail and wire fraud. The Charlotte, North Carolina, cell of Hezbollah smuggled approximately USD 7.9 million in cigarettes from North Carolina to Michigan. Authorities were able to document that the cell sent some of the proceeds to Hezbollah leaders in Lebanon. The cell also paid for dual-use equipment purchased in Canada and then shipped to Lebanon from Canada because it was illegal to do so in the United States. The cell’s members were convicted of numerous charges, including the transportation of contraband cigarettes and providing material support to a designated foreign terrorist organisation. The conviction originally carried a sentence of 155 years in prison, although the sentence was later reduced to 30 years (Shelley and Melzer, 2008; Swecker, 2012; DHS/ICE, 2011).

In 2013, an investigation by New York state and New York City, as well as federal authorities, investigated a smuggling ring that generated USD 22 million in profits. Dubbed “Operation Tobacco Road”, the investigation found that the group had transported USD 55 million worth of cigarettes from Virginia to New York, where they sold them without paying taxes to the state of New York or New York City. Authorities also uncovered counterfeit tax stamps. The conspiracy involved 16 people, 14 of whom were in the country illegally. Conspirators were charged with enterprise corruption, money laundering, related tax crimes and other crimes. Authorities also uncovered a murder-for-hire conspiracy by two of the men charged. They had planned to murder individuals they believed to be witnesses against them and helping law enforcement with the case (Brand, 2013; State of New York, 2013a, 2013b).

Not all cigarette smuggling schemes are linked to terrorist organisations. In 2012, a UK national and his accomplices attempted to disguise 13 million counterfeit cigarettes as yogurt, ice cream and pizza and smuggle them into the United Kingdom by hiding the cigarettes in lorries and driving them through the ports of Dover and Newhaven (BBC, 2012). “According to HM Revenue and Customs (HMRC), Allison admitted he had been dealing in illicit cigarettes for a number of years, and had lied to investigators to hide his criminal income. His earnings funded gambling, holidays, shares and two flats in Glasgow, Scotland, and if he had successfully smuggled the cigarettes, they would have avoided paying GBP 2.7 million (USD 4.4 million) in duty to the government” (INTERPOL 2014b).

### Box 5.5. Operations Smoking Dragon and Royal Charm (2005)

Operations Smoking Dragon and Royal Charm were multi-year operations conducted in the United States and led by the Federal Bureau of Investigation (FBI) and in co-operation with numerous American and Canadian law enforcement agencies. Smoking Dragon was primarily conducted on the West Coast, while Royal Charm was carried out on the East Coast. Smugglers shipped approximately USD 40 million worth of counterfeit cigarettes and other illegal commodities into the United States from China and the Democratic People's Republic of Korea. Smugglers also shipped Ecstasy, methamphetamines, counterfeit pharmaceuticals, millions of dollars in "Supernotes" (highly deceptive counterfeit currency), and Chinese military-grade weapons, including the QW-2 surface-to-air missiles. The operations led to the indictment of 87 individuals from the United States, Canada, China and Chinese Taipei.

The illicit trade was shipped from China directly to ports in the United States, such as the Port of Newark in New Jersey and the California ports of Los Angeles and Long Beach, and distributed throughout the United States and Canada. False bills of lading for toys, rattan furniture, wicker baskets and other goods were used as an attempt to conceal the 40-foot shipping containers' cargo of counterfeit cigarettes, goods and currency, as well as drugs and weapons. These operations were not the only cases linked to the Democratic People's Republic of Korea. From 2002 to 2005, counterfeit Marlboro cigarettes originating from the Democratic People's Republic of Korea were detected in 1 300 incidents within US jurisdiction.

During this period, US Department of Justice, US Secret Service, Internal Revenue Service (IRS) and other US law enforcement investigated a group who were engaged with the Democratic People's Republic of Korea to manufacture and distribute counterfeit Marlboro cigarettes. During the investigation, these individuals provided agents with counterfeit pharmaceuticals and Supernotes manufactured in the Democratic People's Republic of Korea and smuggled through China. This case culminated in the arrest and conviction of three individuals for criminal conspiracy, smuggling, distribution of counterfeit cigarettes, conspiracy to distribute US securities and money laundering. Over USD 1 million was forfeited as the proceeds of the defendants' illicit activities through the use of an unlicensed money remitter in Hong Kong, China and a *hawala*-type financial system in mainland China. The Hong Kong, China police participated in the financial investigation.

*Sources:*

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## Potential responses

In order to combat the illicit trade in tobacco products, governments must work together and with a variety of partners. There are various treaties and agreements that are applicable to combating illicit tobacco. The WHO FCTC and its accompanying protocol, the Protocol to Eliminate Illicit Trade in Tobacco Products, are often cited in anti-illicit trade efforts. Additional international treaties that can be used to fight illicit tobacco include the United Nations Convention on Transnational Organized Crime (UNTOC), the United Nations Convention Against Corruption (UNCAC), the International Convention for the Suppression of the Financing of Terrorism (Terrorist Financing Convention) and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement). The various treaties not only highlight the importance of international co-operation but also the vast nature of illicit tobacco and its nexus to other crimes, such as intellectual property rights violations, terrorism, corruption, money laundering and organised crime. The illicit trade in tobacco can only be fought through a synergetic and sometimes creative use of a number of international treaties.

### *Framework Convention on Tobacco Control*

The World Health Organization's (WHO) Framework Convention on Tobacco Control (FCTC) entered into force in 2005 and established a wide array of measures on smoking prevention, including Article 15 on combating illicit trade in tobacco products. As of August 2015, there were 180 parties to the FCTC. In response to the growing illegal trade in tobacco products parties to the WHO FCTC negotiated and adopted, in 2012, the Protocol to Eliminate Illicit Trade in Tobacco Products. The Protocol further builds on the provisions of Article 15 aiming to eliminate all forms of illicit trade in tobacco products, through a series of measures to be taken by countries in co-operation with one another. The Protocol defines illicit trade as “any practice or conduct prohibited by law and which relates to the production, shipment, receipt, possession, distribution, sale or purchase, including any practice or conduct intended to facilitate such activity” (WHO, 2013).

Under Article 15 of the FCTC, Parties recognised that elimination of all forms of illicit trade is an essential component of tobacco control. They further agreed to a series of measures to pursue this goal, including:

- Adopting measures to ensure that unit packs of tobacco products are marked to assist Parties in determining origin, point of diversion and final destination and to monitor, document and control the movement and legal status of tobacco products.
- Considering the development of a tracking and tracing regime.
- Monitoring and collecting data on cross-border trade in tobacco products.
- Adopting appropriate penalties and remedies against illicit trade.
- Ensuring all confiscated manufacturing equipment and illicit products are destroyed or disposed of.
- Adopting measures to monitor, document and control tobacco products held or moving under suspension of taxes or duties.

- Enabling the confiscation of proceeds derived from illicit trade.
- Providing relevant data in periodic reports to the Conference of the Parties.
- Promoting co-operation between national, regional and international agencies to combat illicit trade.
- Endeavouring to adopt further measures, including licensing, to control or regulate the production and distribution of tobacco products.

### ***Protocol to Eliminate Illicit Trade in Tobacco Products (Protocol)***

Recognising the importance of international collaboration to combat illicit trade, the Parties to the FCTC established an expert group to build upon Article 15 and develop a template for a Protocol on illicit trade. Once the work of the expert group concluded, an intergovernmental negotiating body was established to draft the Protocol, and after five negotiation sessions, a draft was adopted by the Parties to the FCTC in November 2012. As of August 2015, there were 54 signatories and 9 Parties to the Protocol, which will take effect on the 90th day following the deposit of the 40th instrument of ratification.

The Protocol is an international legal instrument that aims to prevent the diversion of tobacco products from the licit tobacco supply chain and increase penalties for and enforcement against illicit trade. Many of its provisions elaborate upon the initial set of measures agreed to in Article 15 of the FCTC. The Protocol promotes co-operation at the national, regional and international levels and reflects an inclusive approach involving all affected stakeholders and relevant processes (INTERPOL, 2014a). A whole-of-government approach will be required to effectively implement the full range of Protocol requirements. At the national level, Parties will need to designate competent authorities, such as customs and police, to lead implementation of certain provisions.<sup>24</sup>

Three sections that deal specifically with how to combat illicit trade are: Supply Chain Controls (Articles 6-13), Offences (Articles 14-19) and International Co-operation (Articles 20-31). Some examples of the areas covered in these sections are listed below. This list is not intended to be a comprehensive representation of the Protocol. For a full copy of the Protocol and to view all of its articles, please visit [www.who.int/fctc/protocol/](http://www.who.int/fctc/protocol/).

#### *Supply chain controls*

- Licensing for manufacturers, importers and exporters of tobacco products and manufacturing equipment.
- Tracking and tracing of all tobacco products to the first customer who is not affiliated with the manufacturer.
- Record-keeping by all persons in the supply chain of tobacco, tobacco products and manufacturing equipment.

#### *Offences*

- Subjecting offences to effective, proportionate and dissuasive criminal or non-criminal sanctions.
- Considering adoption of measures for seizure payments.

- Ensuring the disposal or destruction of confiscated tobacco, tobacco products and manufacturing equipment.

#### *International co-operation*

- Enforcement information sharing between Parties to combat illicit trade.
- International assistance and co-operation to build capacity and collaborate in combating illicit trade.
- Ensuring the protection of sovereignty in carrying out the obligations of the Protocol.

While the Protocol presents an important policy roadmap for countries seeking to address illicit trade, it will not resolve the problem of illicit trade alone. Controls will only be effective if matched with strong enforcement and prosecution of offenders (FATF, 2010b). One country's efforts to implement the Protocol could be undercut without international collaboration, which is essential to tackling illicit trade, given its transnational nature (INTERPOL, 2014a). Illicit trade is a global phenomenon, which calls for global solutions. One of the most important tools of law enforcement is information exchange and international co-operation.

The FCTC is not the only international treaty that governments can utilise to combat illicit tobacco. Two significant treaties are the UNTOC and UNCAC. Unlike the Protocol, UNTOC and UNCAC are in force and have been ratified by 185 and 176 states respectively, and represent indispensable legal frameworks for current global efforts.<sup>25</sup>

The value of UNTOC and UNCAC in combating illicit tobacco lies in the fact that, while these two treaties were not specifically conceived to address this phenomenon, they tackle its key facilitators, namely: the need for organised criminal groups to plan their activities and their roles in the illegal supply chain (through conspiracies, criminal associations, etc.) and the need they have to resort to corruption practices as an almost unavoidable type of crime to ensure that goods (whether fake or authentic) are manufactured and distributed. Moreover, these treaties also address other crimes often associated with or linked to the illicit trade in tobacco products.

In addition to including facilitators in their scope of application, UNTOC and UNCAC tackle the conditions that make the illicit trade in tobacco products profitable. Both treaties set forth a globally applicable legal framework for, among other things, the criminalisation of the “laundering of proceeds of crime” and the freezing and confiscation of criminal assets. This latter measure is expected to be implemented across borders upon the request of foreign countries.

To ensure that those two treaties become effective tools against the illicit trade in tobacco products, the following considerations could be made:

A number of States parties have not yet taken action to fully implement them. It will be important to act through relevant technical assistance organisations (notably UNODC, which have developed several model laws and legal assistance programs) to continue to support States' effort in this direction. The fact that country implementation is “checked” at the international level by two Conferences of Parties (COPs) facilitates efforts aimed at encouraging further efforts in this direction. As a minimum, the two COPs and their various working groups set up thereby should ensure that the attention of the international community remains focused on those two instruments in the years to come. In the context

of UNCAC, the inter-governmental peer-review mechanism established in 2009 to monitor treaty implementation is advancing and constitutes an important platform for dialogue, the exchange of recommendations and good practices;

The possibility of using UNTOC and UNCAC as concrete legal bases for international co-operation against the illicit tobacco trade is largely unknown or unexplored. Awareness-raising campaigns could be launched in this respect among criminal justice officers. INTERPOL's Office of Legal Affairs has been promoting this approach since 2013, through the organisation of training seminars, legal guides and international dialogues across regions.

### ***International Convention for the Suppression of the Financing of Terrorism (Terrorist Financing Convention)***

While the Terrorist Financing Convention is not an obvious choice when practitioners seek to identify international legal bases to be employed against illicit tobacco, it could turn out to be useful in circumstances where illicit trade practices are linked to the commission of terrorist acts.

In particular, the international co-operation measures contained in the Terrorist Financing Convention apply to situations where natural or legal persons provide or collect funds with the intention that they should be used or in the knowledge that they are to be used, in full or in part, in order to carry out [an act of terrorism as defined in the Convention itself with reference, also, to a number of existing counter-terrorism treaties]" (Art. 2).

Crucially, by including in its scope of application "assets of every kind, whether tangible or intangible, movable or immovable, however acquired [...]" (Art 1.1), the definition of "funds" appears broad enough to also include tobacco products. Thus, potentially, the Terrorist Financing Convention could constitute the backbone of international co-operation efforts where the supply of cigarettes ended up supporting terrorist activity, regardless of whether or not a terrorist act is eventually committed.

Where States manage to make the necessary connections between cigarette smuggling and the planning of terrorist acts, this convention could provide an interesting legal basis.

### ***Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS)***

The section of TRIPS devoted to criminal enforcement is less developed than the one devoted to civil and administrative enforcement. Still, it offers some relevant elements to guide policy makers in addressing counterfeit cigarettes and tobacco products with requirements and standards contained in other international treaties. For example, TRIPS sets forth a clear-cut obligation for States Parties to apply penal measures (as opposed to simply administrative sanctions) when trademark counterfeiting is committed on a commercial scale. Also, it envisages the seizure, forfeiture and destruction not only of the infringing goods, but also any materials and implements being used. Such materials and implements play a key role in the production of counterfeit tobacco products (Art. 61 TRIPS).

### *INTERPOL's Legal Handbook on Illicit Trade in Tobacco Products – a Guide for Policy-Makers*

This handbook intends to offer the first comprehensive analysis of the international legal framework against illicit tobacco. It provides guidance for policy makers and law enforcement authorities on the effective implementation of key international instruments in this area, with an emphasis on the Tobacco Protocol. It examines the phenomenon in terms of its development over the past few decades, characteristics, forms and legislative and law enforcement responses. The intention is to provide States with guidance and policy recommendations needed to design and implement anti-illicit tobacco policies and strategies from a legal and institutional perspective.

The appendices contain some practical tools, including a country assessment checklist and a table outlining national legislation across various legal areas, including intellectual property, criminal and customs legislation, as well as specific tobacco legislation regarding licensing and marking requirements and the seizure and destruction of illicit goods. The table is designed as a comparative tool for countries to understand how other jurisdictions have treated the same issue.

The full text of the Handbook is currently available in English and Spanish, and can be downloaded from INTERPOL's webpage at: <http://www.interpol.int/Crime-areas/Trafficking-in-illicit-goods-and-counterfeiting/Legal-assistance/Legal-publications>.

It is planned for the Handbook to become available in Arabic and French towards the end of 2015.

### National strategies to tackle illicit trade

Illicit trade in tobacco is a complex criminal phenomenon that undermines countries' fiscal, security/governance, health and economic/regulatory policies:

- **Fiscal:** Deprives governments of tax revenue
- **Security/governance:** Promotes criminality and corruption
- **Health:** Affects consumer health and health care provision
- **Economic/regulatory:** Undercuts the legitimate marketplace and regulatory regimes governing the legitimate industry (FATF, 2010b).

These negative impacts extend far beyond the remit of any single government ministry or agency. As a consequence, governments must ensure that all relevant agencies are aligned around the same objectives and contribute to the fight against illicit trade, in order to address the issue in a comprehensive way (Allen, 2013). In addition to relevant agencies, governments should also involve the private sector and other affected stakeholders in these efforts, to benefit from their expertise and capabilities.<sup>26</sup> Strong political will to tackle illicit trade is also an essential component in any comprehensive approach (Allen, 2013).

A number of countries worldwide have developed whole-of-government approaches to fighting illicit trade in tobacco products. These aim to address the problem in a broad and concerted way, including consultation with affected stakeholders. These national strategies, action plans and/or task forces often seek to bring together relevant agencies

and stakeholders, outline a comprehensive set of enforcement and policy measures and co-ordinate anti-illicit trade efforts between various agencies.

### ***European Union***

The European Commission (EC) announced a bloc-wide strategy and action plan to fight illicit trade in tobacco products in June 2013. The strategy aimed for a “comprehensive approach,” recognising that “the fight against the illicit trade is a cross-cutting issue that is affected by many factors and drivers and in turn involves a broad range of EU and/or national policies” (European Commission, 2013a). The EC’s strategy and action plan called for co-ordinated action by a wide range of national and EU agencies, in order to adopt and enforce measures to decrease incentives, secure the supply chain, address challenges of EU enforcement authorities, enhance co-operation with major source and transit countries and strengthen sanctions (European Commission, 2013b). The strategy also endorsed the creation of co-ordinating bodies to enhance law enforcement co-operation, noting that “the creation of designated task forces, embracing customs and finance guards, police as well as any other law enforcement agency, has proven to be successful” (European Commission, 2013a).

### ***Turkey***

Turkey adopted an Action Plan to Combat Smuggling of Tobacco and Tobacco Products (2011- 2013) in October 2011. The Action Plan aimed to co-ordinate the efforts of the Ministries of Justice, Foreign Affairs, Economy, Customs and Trade, Interior, Finance, Education, Health and Transport, as well as the Land Forces Command, Tobacco and Alcohol Market Regulatory Authority and Revenue Administration. The Action Plan listed the overarching objectives and assigned specific actions and deadlines to various agencies (European Commission, 2013b). Underscoring the high-level political commitment attached to the issue, meetings to discuss the Action Plan were chaired by Turkey’s deputy prime minister for the Economy (Donmez, 2011).

### ***United Kingdom***

The United Kingdom has had a national strategy to combat illicit trade since its first Tackling Tobacco Smuggling Strategy was introduced in 2000 by Her Majesty’s Revenue and Customs (HMRC). This strategy has been renewed periodically to adjust to the changing threat environment and build on progress. Commenting on the strategy’s all-encompassing approach in the 2011 update, HMRC and the UK Border Agency noted that “the renewed strategy is comprehensive, seeking to combine policy and legislative changes, enforcement, collaborative working with stakeholders to address the source, supply and demand for illicit tobacco in the United Kingdom” (HMRC and UK Border Agency, 2011). The strategy reaffirmed the agencies’ commitment to “work with the Department of Health, Trading Standards, Police and other national, regional and local partners to develop joined-up approaches to tackling illicit activity” and European and international governments. In addition to working with public health stakeholders and academics, the strategy also called for the creation of a new anti-illicit joint working group with UK tobacco manufacturers (HMRC, 2011). The March 2015 iteration, Tackling Illicit Tobacco: From Leaf to Light, sets out how HMRC and UK Border Force will continue to target, catch and punish those in the illicit tobacco trade, and describes the aims of creating a hostile environment for tobacco fraud through intelligence sharing

and policy change, and changing perceptions by raising public awareness of the links between illicit tobacco and organised criminality (HMRC, 2015a).

### *Australia*

Australia has established a Tobacco Stakeholder Group to discuss issues of mutual concern in the tobacco industry, including efforts to combat illicit trade. Chaired by an official in the Australian Taxation Office, it also includes officials from the Customs and Border Protection Service, Quarantine and Inspection Service, Department of Health and Ageing and representatives from the major local tobacco companies (Australian Taxation Office, 2015). Participants have used this platform to discuss ongoing government enforcement efforts to combat illicit trade, new policy initiatives (e.g. FCTC Protocol on Illicit Trade) and to share intelligence (Australian Taxation Office 2014).

#### **Box 5.6. The US collaborative effort to combat the illicit trade in tobacco products**

Combating illicit trade in tobacco products requires a collaborative approach drawing on the knowledge and expertise of numerous government agencies, as well as foreign partners. Realising this, the United States Government (USG) created an Interagency Working Group (IWG) in 2014. The IWG consists of agencies within the five departments that have a role in combating illicit tobacco: Treasury, State, Justice, Homeland Security and Health and Human Services. Representatives from these departments provide expertise in the areas of law enforcement, policy, regulation, law, research, and tax administration.

The IWG meets quarterly to facilitate a closer working relationship with not only the partners within the IWG but also international partners. One goal of the IWG is to enhance information-sharing capabilities for future targeted enforcement actions, as well as to learn about the threats related to smuggling illicit tobacco into the United States and best practices to combat illicit tobacco. The IWG will allow a more unified US government course of action to mitigate the importation of illegal cigarettes into the United States.

Experts from the following agencies are involved in the IWG:

- Department of State
  - International Narcotics and Law Enforcement Affairs’ Anti-Crimes Office
  - International Organization/ Economic and Development Affairs (Monitors the WHO FCTC)
  - Diplomatic Security
- Department of Justice
  - Federal Bureau of Investigation (FBI)
  - Bureau of Alcohol Tobacco Firearms and Explosives (ATF)
- Department of Homeland Security
  - Homeland Security Investigations (ICE/HSI)
  - Customs and Border Patrol (CBP)
- Department of Treasury
  - Alcohol and Tobacco Tax and Trade Bureau (TTB)
  - Internal Revenue Service - Criminal Investigation (IRS-CI)
- Department of Health and Human Services
  - Food and Drug Administration – Office of Criminal Investigation (FDA-OCI)
  - HHS Office of Global Affairs
  - Food and Drug Administration (FDA) Center for Tobacco Products

*Source:* Authors

## Industry initiatives

Legitimate manufacturers and suppliers of tobacco products are both affected by the illegal trade of tobacco products. In addition to lost revenues, the illegal trade of tobacco distorts competition in the market and undermines investments in innovation, distribution, brand equity and legal employment (Allen, 2013). Accordingly, the tobacco industry, and in particular some of the largest firms, have various internal programmes, partner-programmes and participate in various initiatives that address curbing the illicit market.

The EU has signed legally binding agreements with four companies to address contraband and counterfeit cigarettes. The agreements were signed between 2004 and 2010 and have a two-pronged approach. The first piece is that the four companies, collectively, pay the participating countries and the EU EUR 2.15 billion. The second piece concerns controlling their products and ensuring that their products are not diverted into the black market. The agreements require the tobacco companies to “supplying only those quantities required by the legitimate market; taking care that they sell to legitimate clients only; [and] implementing a tracking system to help law enforcement authorities if cigarettes are traded illegally” (OLAF, 2015).

Several legitimate manufacturers also maintain various informational and resource-driven webpages and provide assistance to law enforcement. Webpages are geared toward the general public, dissemination of their corporate responsibility or serve as resources for law enforcement.<sup>27</sup> Tobacco companies also participate in law enforcement trainings focused on illicit tobacco, such as a recent one offered to local, state and federal law enforcement officers in the United States and offered by the National White Collar Crime Center.<sup>28</sup>

Tobacco companies have also engaged in capacity building and assistance, such as providing sniffer dogs trained to detect tobacco products to law enforcement.<sup>29</sup> Additionally, industry regularly provides support to law enforcement in a number of jurisdictions, and one company has signed memoranda of understanding with more than 30 countries. In general, the areas of co-operation include information development and sharing, provision of expert evidence and counterfeit recognition trainings to enforcement authorities. In Europe and Canada, one of the largest global manufacturers has entered into formal co-operation agreements that identify best practices and set up a framework for the specific manufacturer and governments to work together to fight the proliferation of illegal tobacco (JTI, 2012). In 2014 alone, one company supplied information that led to the seizure of roughly 1 billion illegal cigarettes, the arrests of many individuals from organised crime groups and the dismantling of illegal factories (JTI, 2015).<sup>30</sup>

Another global manufacturer, which also has agreements with the EU, participates in similar initiatives to counter the illicit trade in tobacco products and engages in supply chain management and know-your-customer requirements. Its Illicit Trade Strategies and Prevention team’s goal is to enhance the understanding of this problem and develop strategies and partnerships to combat the illicit trade in tobacco products. The company has memoranda of understanding with 20 countries, has trained more than 11 000 law enforcement officials and supports public awareness campaigns in 15 countries (Phillip Morris International, 2015).<sup>31</sup>

Industry supports independent research on the illicit trade in tobacco products and cigarette smuggling to inform the policy debate. Representatives also participate in international fora to enhance international co-operation. At least one of the manufacturers



makes significant annual investments in research that attempts to identify the volume and the flows of illicit tobacco. This research is used to help law enforcement block these channels and to help their business in identifying high-risk markets.

According to one tobacco manufacturer, its top anti-illegal trade priority is to prevent criminals and organised crime gangs from diverting its genuine products from the legitimate supply chain (JTI 2015).<sup>32</sup> It has a number of compliance programmes aimed at achieving this objective. For example, their “Know your customer” policy ensures that it is selling products only to reputable customers who are not involved in the diversion of its products into the illegal trade. Its “Know your supplier” programme is aimed at ensuring that their suppliers are not engaged in providing materials, machinery or services to illegal trade operators.<sup>33</sup> This company and the three other manufacturers that have agreements with the EU also have “Know your customer” policies in place, a requirement of their respective agreements.

In addition to the “Know your customer” policies, manufacturers have several initiatives aimed at combating illicit trade. One global manufacturer has been implementing track-and-trace technology on its products at the master case, carton and pack level, to assist in determining the point at which tobacco products have been diverted from their intended route and into illicit channels. By the end of 2015, it will reach 90% coverage capacity of this technology in its world-wide cigarette production. It also has a seizure investigation programme to identify from where genuine products were diverted into the illegal trade and by whom. This programme protects and its customers from conducting business with those involved in the illegal trade. The seizure investigations programme is run at a forensic level, ensuring that the evidential findings of these investigations can be shared and used by partners in law enforcement around the world, including international agencies such as OLAF and Interpol. In addition, the global manufacturer has comprehensive security programmes that specifically lower the risk of product theft during transport, thereby reducing the likelihood of genuine stolen product entering into the illegal market (JTI, 2015).<sup>34</sup> Finally, its compliance team includes an anti-money-laundering policy and programme that is designed to mitigate the risk of having its products used as instruments in the financial systems of money launderers (JTI, 2012).

Another global manufacturer stated that it supports strict regulations and enforcement measures to prevent all forms of illicit trade in tobacco products, including tracking and tracing, labelling, record-keeping requirements and where appropriate, and implementation of strict licensing systems. The company also implemented strong controls in its supply chain, such as track and trace, volume monitoring and customer due diligence procedures. These measures have not only yielded tangible results, but have become the industry standard. For example, between 2006 and 2014, the volume of diverted products belonging to this company that were seized in the EU has dropped by 85% (Georgieva, n.d.).<sup>35</sup> Reportedly, the company has invested over USD 150 million to implement a state-of-the-art tracking and tracing solution to secure its supply chain. With this technology, it has tracked the movement of more than 500 million master cases of its products in over 120 countries, and rolled out technology that enables the verification of the authenticity of individual packs in more than 90 countries. It has also established the Fiscal Compliance Program (FCP), designed to ensure that it does business only with responsible organisations and individuals who share its commitment to comply with relevant fiscal and trading laws (The Business Action to Stop Counterfeiting and Piracy, 2015).

### Additional recommendations for anti-illicit trade initiatives

In addition to multilateral efforts by the international community, individual countries and industry, there are some additional measures that governments could consider when they are creating a strategy to counter the illicit trade in tobacco products. Ideally, strategies will address numerous components of the illicit trade in tobacco and attempt to increase the effectiveness of governance, reduce the ability for individuals to engage in smuggling activities or the consumption of illicit products, and decrease the ease in which illicit actors can exploit the tobacco market and its products. Some preliminary suggestions include capacity building (in particular, programmes and activities aimed at increasing the abilities of law enforcement, border security and prosecutors); increasing the quality, reliability and validity of data concerning illicit tobacco; public awareness and educational campaigns on the threats and harms of illicit tobacco; public awareness and educational campaigns on demand reduction; and supply chain management. Governments may also want to examine the punishments associated with cigarette smuggling and the trade in illicit tobacco, to see if the certainty of punishment and the severity of that punishment correspond with the true harms caused by the criminal activity.

There are numerous ways that governments can improve the effectiveness and abilities of their regulatory and criminal justice systems to decrease illicit tobacco within their jurisdictions.

- Increase the training and awareness of harms and consequences relating to the illicit trade in tobacco products for law enforcement, prosecutors, judges and policy makers. The training needs to be specialised for each type of government official. For law enforcement and customs officials, it would be helpful to develop training that allows the officer to better understand the potential revenues, the weaknesses in the tobacco supply chain, how to access and use the World Customs Organization's and similar organisations' tools to identify trends and exchange information, and how to better utilise intelligence and risk analysis.

Along those lines, specialised trainings should also be developed for the intelligence analysts who assist law enforcement and national security advisors, so they can collect better data, detect trends and analyse the data more efficiently.

For excise control officials, it might be helpful to develop training that allows them to become familiar with the manufacturing process, potential revenue weaknesses, and use credibility techniques, together with audit and physical controls of manufacturing.

Finally, for consumer protection/quality control officials, trainings should focus on identifying illegal products at the retail stage and working with enforcement officials to identify and disrupt distribution chains.

- In addition to training, policy makers and administrators need to increase their political and financial support for law enforcement and prosecutorial efforts relating to countering the illicit trade in tobacco products. This includes the financial aspects of the illicit trade (i.e. money laundering, trade-based money laundering, wire transfers and tracing back the money). Once the case is brought to court and the defendants are found guilty, the punishments need to fit the true harms and costs of the illicit trade in tobacco products. Recommended

punishments, and laws relating to punishment, may need to be reviewed and updated. Finally, to assist in these efforts and acknowledge the international aspects of the illicit trade, governments may also wish to review and update their internal information-sharing agreements, as well as their multilateral and bilateral agreements concerning law enforcement, taxation, intelligence and any other information needed to combat cross-border/transnational illicit tobacco.

- Governments can implement policies and programmes that decrease demand for the illicit products through public awareness and educational campaigns and programing. Governments may wish to involve several ministries or departments, such as Health, Justice and Education. To educate young people, governments may wish to develop age-appropriate, schools programmes so that youths are aware that by purchasing illegal goods, they are funding large- scale criminal organisations and terrorists. They should be informed that in doing so, they are depriving governments of taxes that pay for services, and increasing the health risks, because the products may not meet health regulations. For non-school age programmes, governments may wish to fund demand-reduction campaigns focused on how the illicit trade in tobacco products funds organised crime and terror groups, facilitates corruption, increases interdiction and law enforcement costs and reduces tax collection – taxes needed to pay for other programmes and services. Governments may consider using popular media programmes to feature storylines about smugglers enticing young people into purchasing illegal tobacco products, or the dark side of cigarette smuggling.

To reiterate, governments may wish to enact public awareness campaigns and training programmes geared toward criminal justice personnel, such as law enforcement, prosecutors, judges and policy makers. In addition to the law enforcement suggestions above, governments may also wish to provide the judiciary, including magistrates, with an awareness training module and guidance that can form part of their continuous professional development materials.

- Governments may want to consider “whole-of-government” approaches to countering the illicit trade in tobacco products. As briefly illustrated above, there are numerous causes and facilitators of this complex illicit trade. Therefore, governments may wish to develop task forces or other dedicated teams of individuals who not only have an expertise in countering illicit tobacco but also the various components need to effectively counter the illicit trade, such as experts in taxation, health regulations, intellectual property, customs, diplomatic efforts, counter-terrorism, transnational organised crime, postal systems and inspectors, prosecutors and traditional law enforcement personnel.
- Governments should consider increasing the quality and quantity of data concerning the illicit trade in tobacco products. To increase the validity and reliability of the data, governments may want to review their collection procedures, coding systems for criminal cases and to use a mixed-methods approach when calculating their illicit markets. Prosecuting illicit tobacco crimes as “illicit tobacco crimes,” and then including those cases in the official arrest, prosecution and punishment statistics, would help increase the quality and quantity of data. Also, to encourage countries to collect statistics relating to the illicit trade in tobacco products, tobacco seizures should be included in the UN Surveys on Crime Trends and the Operations of Criminal Justice Systems survey.

- Implementing supply chain management policies, including know-your-customer policies on acetate tow and other necessities for cigarette production, could decrease the illicit market and detect oversupplying trends and behaviours. In many instances, the excess cigarettes are smuggled internationally. To date, the measures that have been taken by the acetate tow industry (e.g. know-your-customer procedures), have had limited success in deterring the supply of acetate tow to the illicit tobacco trade. On this premise, governments and other members of the international regulatory and enforcement community could significantly reduce the illicit tobacco trade by persuading or requiring acetate tow suppliers to better control their supply chain. Specifically, suppliers of acetate tow and other key inputs should institute or strengthen internal processes that ensure that they only supply in quantities that are commensurate with demand for legal tobacco products in a specific market. Implementing and following know-your-customer and know-your-market policies, and reporting and record-keeping requirements, are some steps that manufacturers could take to reduce the illegal manufacturing of cigarettes. These standards are commonplace in many industries (including banking), as a means to prevent illicit activities.

The supply of illicit cigarettes could be reduced if suppliers of acetate tow and other key inputs institute or strengthen internal processes that ensure that they only supply in quantities that are commensurate with demand for legal tobacco products in a specific market. In order to secure the supply chain, manufacturers and the international community should create and then follow know-your-customer and know-your-market policies and applicable reporting and record-keeping requirements. These standards are commonplace in many industries (including banking) as a means to prevent illicit activities; the acetate tow manufactures and manufacturers of the other components involved in the production of tobacco products should work toward these best practices.

- Utilising the unique opportunities associated with public private partnerships (PPP) to share information and collaborate on strategies to counter the illicit trade may be of value to governments. In 2008, the OECD defined a public-private partnership as “an agreement between the government and one or more private partners according to which the private partners deliver the service in such a manner that the service delivery objectives of the government are aligned with the profit objectives of the private partners, and where the effectiveness of the alignment depends on a sufficient transfer of risk to the private partners” (OECD, 2008).

The purpose of a PPP is to facilitate collaboration against a discrete problem set among entities. A PPP may range in focus from the strategic to the tactical, such as a strategic infrastructure that facilitates information sharing and collaboration. At the operational and tactical levels, PPPs are ephemeral and amorphous. Loose coalitions often form around regional problems. Tactical partnerships are even less structured and may only represent one-way information shared between the tobacco industry and law enforcement. Governments have the responsibility to enforce laws, change policy or otherwise act against the problem set. Industry, however, which has no authority to enforce illicit trade laws or change policy, is often the first to identify the problem and subsequently provide information in support of the solution. Industry can and does develop leads, and provides the information to governments. These leads may result in an arrest, seizure,

sanctions or other actions. While government may be prohibited from sharing information regarding an ongoing investigation, it may be able to confirm the utility of information shared by industry, indicating that action has been taken.

The public and policy makers remain largely unaware of the limitations of the best enforcement agencies in the world in tackling this illegal trade, with an average seizure rate in the EU, in 2011, of under 10%. More than 95% of cargo world wide is not scanned and, in Europe, only about 2% of all container traffic is physically examined (Allen, 2013). Whilst enforcement can always be improved, and many agencies do an outstanding job, as long as the profits for criminals and demand for cheap illegal products remain high, the criminals and terrorists will continue to operate in this field. comprehensive cross-government and stakeholder strategy covering all enforcement stakeholders, to tackle supply and covering all health, education and consumer protection administrations to tackle demand appears to have the best chance of success in reducing illegal trade in tobacco products.

## Conclusion

Strengthening public policies to counter illicit trade in tobacco products, whether at the source, in transit, or in destination markets is a key component of improving regulatory compliance, peaceful and prosperous communities and public governance. As briefly described in this chapter, the illicit trade in tobacco products involves a combination of many factors, some of which cannot be easily quantified or measured. Nevertheless, the harms caused by this illicit trade can be substantial, and the illicit actors vary from small-scale smugglers to large-scale criminal operations funding serious organised crime and terrorism. To counter the illicit trade in tobacco products, governments should consider in their crime strategies developing a multi-method approach, including: building partnerships, increasing data validity and reliability, launching educational and public awareness campaigns, increasing capacity building efforts, and prioritising countering illicit tobacco products and its associated crimes.

## Notes

- <sup>1</sup> <http://www.fda.gov/TobaccoProducts/ResourcesforYou/ucm335294.htm>; Broadly, all tobacco products can be split in two large groups: smoking and non-smoking. A smokeless tobacco product is a tobacco product that does not involve a combustion process. Tobacco products for smoking mean tobacco products other than a smokeless tobacco product, and include cigarettes, cigars, cigarillos, roll-your-own tobacco and pipe tobacco. Chewing or nasal tobacco, tobacco for oral use such as snuff and water-pipe tobacco are smokeless tobacco products. There is also a developing market of novel products that contain tobacco but do not fall into any of the traditional categories. Article 2. Directive 2014/40/EU of the European Parliament and of the Council of 3 April 2014 on the approximation of the laws, regulations and administrative provisions of the Member States concerning the manufacture,

presentation and sale of tobacco and related products and repealing Directive 2001/37/EC: [http://ec.europa.eu/health/tobacco/docs/dir\\_201440\\_en.pdf](http://ec.europa.eu/health/tobacco/docs/dir_201440_en.pdf).

- <sup>2</sup> Projections of tobacco production, consumption and trade to the year 2010. Food and Agriculture Organization of the UN. Rome, 2003. <http://www.fao.org/docrep/006/y4956e/y4956e04.htm>. Other smoking tobacco (roll-your-own tobacco and pipe tobacco) is mainly consumed in Middle East/Africa, Western Europe and North America, with Belgium and Netherlands being the countries with highest (over 40%) proportion of cigarette equivalent sales. Smokeless tobacco has significant a share of consumption in the regions like Scandinavia, South Asia (including India, which is the world's largest smokeless tobacco market), or other countries like Sudan, Madagascar or Turkmenistan. The size of the smokeless tobacco market in high-income countries remains relatively stable. <http://www.tobaccoatlas.org/topic/smokeless-tobacco/>.
- <sup>3</sup> The other two components are the acetate tow filter and cigarette paper.
- <sup>4</sup> There are two major types of tobacco blends. Blended cigarettes use a mixture of Virginia, Burley and oriental tobaccos. This type is very popular in the US, most of Europe, Latin America and many Asian countries. Virginia cigarettes are primarily composed of Virginia tobacco, but sometimes contain small amounts of other tobaccos as well. This type is popular in most of the British Commonwealth countries and China. Euromonitor reports that more than half of cigarettes sold in 2013 are Virginia blend, with the rest being American Blend (40%) and other blends.
- <sup>5</sup> According to the World Health Organization (WHO) one in every ten cigarettes and many other tobacco products consumed in the world are illegal, see <http://www.who.int/ctc/mediacentre/news/2015/wtnd2015/en/>, p. 2.
- <sup>6</sup> The estimate was based on their 80-country sample, which represents approximately 90% of the world-wide market. Euromonitor International. Global Tobacco: Key Findings Part 1 - Cigarettes - the ongoing quest for value. July 2015, p. 25.
- <sup>7</sup> They attempted to measure the worldwide market using three different methods and econometric models, mostly involving import and export records as well as population estimates and other independent variables. Merriman, et al. caution that their methods and data can be problematic, such as not including smuggled cigarettes that do not cross international borders or only capturing bootlegging and not wholesale smuggling. Merriman, et. al. (2000).
- <sup>8</sup> There are many formats of cigarettes sold worldwide. They can be categorised by tar content, cigarette length and thickness, type of filter, pack format, number of cigarettes in pack, presence of menthol, etc. The vast majority of cigarettes is sold in packs of 20 sticks, however, consumer packaging of less or more than 20 sticks is also widespread. According to Euromonitor, 90% of cigarettes are sold in the 20-stick format, followed by 10s (which covers almost all the Indian market), 16s and 19s. According to the recently approved EU TPDII, as of May 2017 all packs of cigarettes sold in European Union should contain at least 20 sticks.
- <sup>9</sup> Please see the following studies for specific information on their findings, Chernick, H., and Merriman, D. (2013). Using littered pack data to estimate cigarette tax avoidance in NYC. *National Tax Journal*, 66, 635-668.; Kurti, M., von Lampe, K., and Thompkins, D. (2012). The illegal cigarette market in a socioeconomically deprived inner-city area: The case of the South Bronx. *Tobacco Control*, 23, i13-i22.; Davis, K.,

Grimshaw, V., Merriman, D., Farrell, M., Chernick, H., Coady, M., Campbell, K., Kansagra, S. (2013). Cigarette trafficking in five northeastern US cities. *Tobacco Control*, 0, 1-7.; Merriman, D. (2010). The micro-geography of tax avoidance: Evidence from littered cigarette packs in Chicago. *American Economic Journal: Economic Policy*, 2(2), 61-84.; Wilson, N., Thomson, G., Edwards, R., and Pearce, J. (2009). Estimating missed government tax revenue from foreign tobacco: Survey of discarded cigarette packs. *Tobacco Control*, 18,416-418.

- <sup>10</sup> For a general discussion of their methodology, please visit <http://www.euromonitor.com/research-methodology>.
- <sup>11</sup> For specific information on each country's estimate, please see the footnotes within the Tobacco Atlas, available at <http://www.tobaccoatlas.org/>.
- <sup>12</sup> For a more comprehensive discussion on KRMG's research methodology, please see the "Methodology" section of the Project Sun report, "A Study of the Illicit Cigarette Market in the European Union: 2013 Results," KPMG LLP, London, available at [www.pmi.com/eng/media\\_center/media\\_kit/documents/sun%20report%202013.pdf](http://www.pmi.com/eng/media_center/media_kit/documents/sun%20report%202013.pdf).
- <sup>13</sup> Native American Reservations, located within the United States, have certain sovereign rights. Taxes, especially state imposed taxes, are not collected on Native American Reservations. Lovenheim, M. F. (2008). How far to the border?: The extent and impact of cross-border casual cigarette smuggling. *National Tax Journal*, 61(1), 7-33. (p. 31).
- <sup>14</sup> Beare, M. (2002). Organized corporate criminality - Tobacco smuggling between Canada and the US. *Crime, Law & Social Change*, 37, 225-243.; Joossens, L., & Raw, M. (2008). Progress in combating cigarette smuggling: controlling the supply chain. *Tobacco Control*, 17(6), 399-404. van Duyne, P. (2003). Organizing cigarette smuggling and policy making, ending up in smoke. *Crime, Law & Social Change*, 39(3), 285-317. von Lampe, K. (2005). Explaining the emergence of the cigarette black market in Germany. In P. van Duyne, K. von Lampe, M. van Dijck & J. Newell (Eds.), *The organised crime economy: Managing crime markets in Europe*, (pp. 209-227). Nijmegen, The Netherlands: Wolf Legal Publishers. Von Lampe, K. (2006). The cigarette black market in Germany and in the United Kingdom. *Journal of Financial Crime*, 13(2), 235-254.
- <sup>15</sup> For more information on the agreements between OLAF and the tobacco companies, as well as copies of the agreements, please visit [http://ec.europa.eu/anti\\_fraud/investigations/eu-revenue/cigarette\\_smuggling\\_en.htm](http://ec.europa.eu/anti_fraud/investigations/eu-revenue/cigarette_smuggling_en.htm).
- <sup>16</sup> NAS Report, p 41.
- <sup>17</sup> NAS Report.
- <sup>18</sup> Eastman is one of the companies that produces acetate tow. It lists the various uses here: [http://www.eastman.com/Brands/Eastman\\_Estron\\_Tow/Pages/Overview.aspx](http://www.eastman.com/Brands/Eastman_Estron_Tow/Pages/Overview.aspx).
- <sup>19</sup> NAS Report, p. 41
- <sup>20</sup> NAS Report, p. 41
- <sup>21</sup> NAS Report, p. 114
- <sup>22</sup> For the history of cigarette smuggling across Turkey's borders see Gingeras, Ryan (2014) *Heroin, Organised Crime, and the Making of Modern Turkey*. Oxford University

Press: New York.. For involvement of Italian organised crime in illicit trade of cigarettes see Paoli, Letizia (2003). *Mafia Brotherhood: Organized Crime Italian Style*. New York: Oxford University Press.

- <sup>23</sup> For a more detailed discussion, please see the chapter on cigarettes within the UNODC’s report, pp. 27-32.
- <sup>24</sup> Article 4.1(b) of the Protocol notes that Parties shall “take any measures in accordance with their national law to increase the effectiveness of their competent authorities and services, including customs and police responsible for preventing, deterring, detecting, investigating, prosecuting and eliminating all forms of illicit trade in goods covered by this Protocol.”
- <sup>25</sup> For a list of UNCAC Signatories (140) and Parties (176), please visit <https://www.unodc.org/unodc/en/treaties/CAC/signatories.html>. For a list of UNTOC Signatories (147) and Parties (185) visit [https://treaties.un.org/Pages/ViewDetails.aspx?src=TREATY&mtdsg\\_no=XVIII-12&chapter=18&lang=en](https://treaties.un.org/Pages/ViewDetails.aspx?src=TREATY&mtdsg_no=XVIII-12&chapter=18&lang=en)
- <sup>26</sup> For instance, the World Health Organization has highlighted the importance of the “active involvement of all relevant stakeholders” as countries adopt and implement the Protocol to Eliminate Illicit Trade in Tobacco Products. (World Health Organization. World No Tobacco Day 2015. [www.who.int/campaigns/no-tobacco-day/2015/event/en/](http://www.who.int/campaigns/no-tobacco-day/2015/event/en/))
- <sup>27</sup> The following are sample of various webpages focused on countering illicit tobacco and supported by industry: British American Tobacco (BAT): [http://www.bat.com/group/sites/UK\\_9D9KCY.nsf/vwPagesWebLive/DO6TNKVW](http://www.bat.com/group/sites/UK_9D9KCY.nsf/vwPagesWebLive/DO6TNKVW); Japan Tobacco International (JTI) <http://www.stopillicittobacco.com/index.htm>; Imperial Tobacco, <http://www.imperial-tobacco.com/index.asp?page=934>; Philip Morris International (PMI). [http://www.pmi.com/eng/tobacco\\_regulation/illicit\\_trade/pages/illicit\\_trade.aspx](http://www.pmi.com/eng/tobacco_regulation/illicit_trade/pages/illicit_trade.aspx); [www.stopillegalcigarettes.com](http://www.stopillegalcigarettes.com). Philip Morris USA (PMUSA): <https://www.contrabandtobacco.com/>; <http://www.altria.com/Responsibility/Combating-Illicit-Trade/Pages/default.aspx>.
- <sup>28</sup> For more information about the training, see <https://www.nw3c.org/training/specialty-training/illicit-tobacco>.
- <sup>29</sup> One such example is from Imperial, available at [http://www.imperial-tobacco.com/assets/files/cms/Exane\\_Illicit\\_July\\_1st\\_FINAL\\_PDF.pdf](http://www.imperial-tobacco.com/assets/files/cms/Exane_Illicit_July_1st_FINAL_PDF.pdf); Another example involves Cook County, Illinois (USA)’s Department of Revenue using Philip Morris USA’s canines to conduct 71 investigations in 2013. Cook County Government. (2013, December 13). Cook County Partners with Philip Morris’s Canine Unit to Combat Illicit Cigarette Trafficking, available at: <http://www.cookcountyil.gov/2013/12/13/cook-county-partners-with-philip-morriss-canine-unit-to-combat-illicit-cigarette-trafficking/>. In Romania, a tobacco company signed a co-operation agreement with the National Customs Authority. Support included training, sniffer dogs, and equipment. Available at <http://www.amosnews.ro/arhiva/jti-doneaza-anv-masini-caini-pentru-combaterea-traficului-ilegal-cu-produse-din-tutun-09-12-2010>; <http://www.agerpres.ro/ots/2013/08/08/jti-a-semnat-un-protocol-de-co-operare-cu-politia-de-frontiera-16-01-00>.
- <sup>30</sup> Information provided by JTI, May 2015



<sup>31</sup> Information provided by PMI. May 2015.

<sup>32</sup> Information provided by JTI, May 2015

<sup>33</sup> More information on JTI’s “Know your Customer” policies can be found in their agreement with the European Union. The agreements are available at: [http://ec.europa.eu/anti\\_fraud/investigations/eu-revenue/japan\\_tobacco\\_2007\\_en.htm](http://ec.europa.eu/anti_fraud/investigations/eu-revenue/japan_tobacco_2007_en.htm) and [http://ec.europa.eu/anti\\_fraud/documents/cigarette\\_smug/2007/co-operation\\_agreement.pdf](http://ec.europa.eu/anti_fraud/documents/cigarette_smug/2007/co-operation_agreement.pdf)

<sup>34</sup> Information provided by JTI May 2015.

<sup>35</sup> Comment made by Kristalina Georgieva, European Commissioner for International Co-operation, Humanitarian Aid and Crisis Response, at EU Parliament Plenary session, video available at <http://www.europarl.europa.eu/ep-live/en/plenary/video?debate=1431970271748>.

## Annex 5.1. A methodology on measuring illicit trade in tobacco\*

\* Note: The following material was provided by KPMG for explanatory purposes.

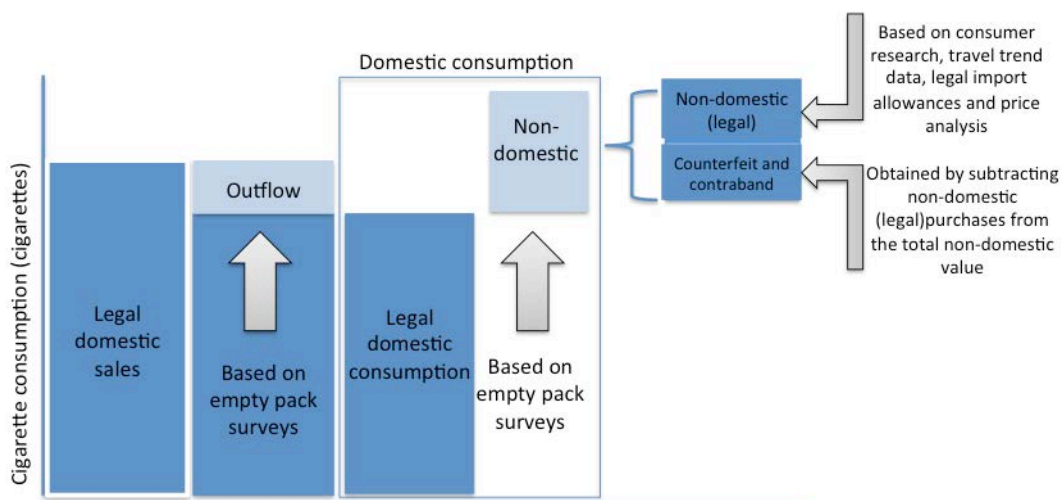
KPMG has produced an annual report on illicit cigarette consumption in the EU since 2006 ('Project STAR'). In 2013 it was renamed 'Project SUN' and was conducted on a pan-industry basis for the first time. Project SUN is a bottom-up analysis of the illicit tobacco trade with the methodology consistently applied since its inception. This is done by undertaking one of the largest consumer markets studies of its type in the world. The inclusion of major tobacco products firms also allowed counterfeit volumes to be identified for all four of the major tobacco manufacturers.

An overview of the Project SUN methodology is shown in Figure 5.3. The project uses an iterative model which takes the legal domestic cigarette sales for all of the EU Member States as a starting point to estimate legal domestic consumption and then uses the results of empty pack surveys (EPSs), again conducted in all of the EU Member States, to estimate the quantum of outflows to other countries and non-domestic inflow volumes. The output of this provides an overall estimate of cigarette consumption in each of the Member States, including both domestic and non-domestic volumes. The non-domestic portion of consumption is then classified as either legal or counterfeit and contraband (C&C), based on the results of analysis using consumer research studies, travel and tourism trend data, smoking incidence data, border sales information and a variety of other data sources.

KPMG's use of both the empty pack surveys and consumer research incorporates two of the three main recommended ways of estimating illicit tobacco trade, as published by the IARC <sup>(2)</sup>. These are firstly observation methods and secondly, large consumer surveys, whilst other data sources such as seizures and smoking prevalence are used as corroborating evidence.

Critiques of the project have centred on the representativeness of the empty pack surveys and on the potential under reporting of the cross-border non-domestic legal trade. Care has to be taken to ensure both of these potential areas of data skew are managed and adjusted for. In addition, the EPSs are expensive to run and therefore only conducted between one (e.g. Denmark, Finland) and three (e.g. France, Italy) times a year. As a result, adjustments have to be made to the EPSs to ensure unusually high readings are not simply seasonal abnormalities.

Figure 5.3. Project SUN (STAR) methodology



Source: KPMG, 2015.

## Market type

The selection of the appropriate research method for measuring illicit trade depends largely on the structure and type of tobacco products in the market. Research should therefore be tailored to the industry structure as far as possible. To categorise the market types:

- Pack market: Markets for which both legal and illicit products are largely sold in packs of manufactured cigarettes. These can vary significantly in size from 10 packs (United Kingdom and Italy)<sup>1</sup>, to 25 packs (Australia).
- Stick market: Markets where cigarettes are often sold by stick. Packs will also exist but often illicit products will be sold in unbranded bags of sticks. Parts of Asia have these characteristics (such as Papua New Guinea) as do parts of Canada.
- Loose tobacco market: Some markets historically have a significant proportion of loose or hand-rolled tobacco in their legal and illegal industries. Examples include Germany, United Kingdom and Australia.

## Research methods

### *Empty Pack Surveys with Non-Domestic Legal Research*

This method is principally appropriate for conventional western pack markets. It does not cover loose tobacco or stick markets.

As a method of measuring illicit tobacco trade for manufactured cigarettes, EPSs are the only market research method that relies purely on physical evidence (avoiding the variability of consumer bias in interview-based methods). Empty pack surveys should be conducted on a consistent basis across all markets in question, allowing for direct

comparison of data and the packs collected form a broad and representative geographic footprint. Their use has a number of significant advantages if the following best practice is followed:

- The volume, sampling method and frequency of pack collections must enable a robust sample
- The sample size and locations collected in each region must be representative of the population within that region, whilst the overall sample must be representative nationally.

In most countries, the domestic EPS results tend to mirror the market shares of the major tobacco manufacturers, suggesting the sampling method results in an accurate representation of the wider market. Where this is not the case a re-weighting exercise should be undertaken.

The measurement of non-domestic legal (ND(L)) purchases must subsequently be determined to remove the legitimate product from the EPSs' calculation of total non-domestic consumption. This can be done through an independent consumer survey. The purpose of the survey should be to measure purchasing habits rather than consumption, in order to avoid the under-reporting typical of consumption surveys and to include any 'gift purchases' from non-smokers. Respondents should be asked about the number of trips made in the year, the destinations and the volume and brands of cigarettes purchased. The surveys are weighted according to gender, age and region to ensure a representative sample of the national population in each country is obtained. Travel statistics should be used to cross check the survey results as well as an analysis of border sales hotspots, where appropriate (e.g. north eastern border of France with Belgium).

### *Strengths and weaknesses*

Empty pack surveys give the highest likelihood of representing a fair estimation of the domestic and non-domestic product being consumed in a market. However great care needs to be taken to ensure the sampling methods are representative of the entire smoking population, not only urban-dwellers and highly populated areas. They remain the only known method to avoid the significant problem of consumer under-reporting<sup>(2)(3)</sup>.

Empty pack surveys greatest strength, the fact that they are based only on physical evidence, is also a weakness. The packs themselves cannot give much information about the sources of illicit product or the split between non-domestic legal and illicit<sup>(4)</sup>. This is why they should be used in conjunction with reliable estimates of non-domestic legal product as well as corroborated with Customs' intelligence and other estimates.

A common criticism of the empty pack survey is that it samples discarded cigarette packs rather than household waste and therefore overstates non-domestic incidence. Sampling for household waste is impractical in most countries but is undertaken in Germany. The German survey, known as a Yellow Bag Survey (YBS), is possible in Germany because household waste is sorted, mainly for the purposes of recycling, which makes it possible to separate cigarette packs from other waste.

Typically, the YBS provides a larger sample than an equivalent EPS, whilst collecting from waste disposal centres results in the collection of packs from both household waste and public bins. The YBS is therefore likely to give a more representative result compared to the EPS.

A comparison of the EPS and YBS methodologies was undertaken by KPMG in 2008 and 2009. Four quarterly waves of the EPS were undertaken in 2008, with two further waves in 2009 (Q1 and Q3). Collection was undertaken in 52 cities across Germany. The non-domestic incidence measured by the EPS was only 1.2 percentage points higher in 2008 (21.1% versus 19.9%) and only 0.4 percentage points higher in 2009 (19.7% versus 19.3%)<sup>(5)(6)</sup>. Consequently, we concluded that the EPSs are a reliable measure of non-domestic incidence, with marginal differences likely due to difference in timing of samples, the rural-urban share of the surveys and the total number of packs collected.

### *Pack swap surveys*

Pack swap surveys are particularly useful in markets that contain a significant proportion of sticks or where empty pack surveys are not feasible for other reasons. The pack swap methodology involves collection of current packs or sticks from respondents in return for relevant incentives. Pack swaps can be conducted in retail outlets and other populous locations, and can also be collected from home visits. Care of course needs to be taken to ensure social and geographic samples are representative and that the sample size is large enough.

#### *Strengths and weaknesses*

This type of survey can be an excellent way of gaining both physical evidence and consumer feedback. It also enables the research agency to deal with stick products and other tobacco products. However the survey may suffer from under reporting as seen in refusal rates and in the answers to ‘frequency of purchase’ questions. There is also the potential risk of respondents selectively offering packs for the swap.

### *Consumer surveys*

Evidence of illicit trade is often gathered from straightforward consumer surveys performed either via the web, via telephone contact or via a drop and collect questionnaire. The outputs of these surveys vary considerably. In some cultures survey respondents feel comfortable with sharing information about their illicit consumption; but in others they clearly do not as evidenced by wide disparities between other surveys, Customs' detection rates and reported consumer rates of illicit. Overall, consumer surveys have historically under-reported tobacco consumption, especially in countries where tobacco consumption has become increasingly socially less acceptable. For example, the Australian Institute of Health and Welfare highlight the possibility of under-reporting in their ‘National Drug Strategy Household Survey’,<sup>7</sup> primarily as some respondents did not answer smoking related questions. In addition, the Australian Bureau of Statistics suggested social pressures likely account for such under-reporting.<sup>8</sup> Illicit tobacco consumption is likely to be under-reported to an even greater degree. However, consumer surveys can be used usefully to corroborate the results of other surveys if the questions are about purchase behaviours rather than only consumption estimates.

#### *Strengths and weaknesses*

Consumer surveys have a great deal to add in terms of tracking the consumption behaviours and purchase patterns of illicit consumers. However as an absolute measure of the illicit quantum in any given market they have been found to underreport by up to 25-35%,<sup>9</sup> and should therefore be used as supporting rather than leading evidence.

### ***Mystery shopping***

This technique attempts to survey what brands and tobacco product types are available on the open market. Interviewers can either question consumers as they leave retail outlets, or they can act as consumers themselves. Where researchers have to masquerade as consumers, this can be a higher risk type of research. Also care should be taken to select a representative sample of outlets, including informal outlets such as markets. Care should also be taken in establishing times of day and week in which to visit, again to ensure the survey is representative of consumers' own experience.

#### *Strengths and weaknesses*

Mystery shopping can provide excellent data on the availability, prices and modality of illicit selling of product. However it cannot produce in itself a representative quantum of the illicit products' consumption in that market. Once again it is a technique that should be conducted in conjunction with others to produce a rounded picture of the illicit consumption in a market.

### ***Rolling papers analysis***

This technique is specific to the loose tobacco market. Historically the illicit loose tobacco market is very difficult to research because little evidence exists after the product has been consumed. Therefore most methods for sizing the illicit trade quantum of loose tobacco have tended to rely on consumer interviews only. Rolling papers analysis proposes that a check for this method be produced alongside these surveys. The method analyses the total market for rolling papers and establishes a total potential market for rolling tobacco based on an assumption of tobacco use per paper. Care has to be taken to take account of wastage (papers spoiled), other uses (such as marijuana), and the variability of the amount of tobacco in each rolled cigarette.

#### *Strengths and weaknesses*

Whilst the logic is sound for rolling papers analysis, the degree of variability given the factors listed above produces a wide range of potential market sizes. Therefore this method acts only as a 'sense check' for the quantum of illicit loose tobacco.

### ***Customs and other law enforcement detections***

Our colleagues in customs and law enforcement produce a rich vein of data from the excellent work they do in detection of criminal activity and enforcement of anti-trafficking and smuggling laws. Often data associated with these detection events are shared publicly and are tracked on an annual basis by the relevant law enforcement organisations. We have found that this data can act as an excellent form of collateral for the market research listed above. However care must be taken to avoid over representing the data as consumption data: these detections can only show a proportion of the illicit market. A problem exists in establishing what proportion these detections represent of the total illicit market. Detections depend as much on the performance of the customs or law enforcement agency as they do on the presence of illicit activity and the ingenuity of the smugglers.

### *Strengths and weaknesses*

Customs and law enforcement data should be used as a form of collateral for the presence and types of illicit product in a market. They should not be used as an estimation of the total quantum of consumption of those products.

### Suitability of research methods for different types of market

Table 5.2 below summarises the research methods for measuring different types of tobacco product markets. These findings are of course subject to significant variability depending on geography, legality, cultural behaviours and other research considerations.

**Table 5.2. Methods for measuring tobacco product markets**

	Pack market	Stick market	Loose market
EPS + ND(L)	P		
Pack swap		P	
Consumer Survey	S	S	P
Mystery Shopping	S	S	S
Rolling Papers			S
Customs Data	S	S	S

*Note:* Key: P = primary source of illicit quantification; S = secondary source of illicit quantification

### Notes

<sup>1</sup> Following a European Parliament vote in February 2014, the sale of 10 packs will be banned across the EU by 2016. The minimum pack size in EU countries other than the United Kingdom and Italy is currently 19 / 20 packs.

<sup>2</sup> Warner, Kenneth E., “Possible Increases in the Underreporting of Cigarette Consumption”, *Journal of the American Statistical Association* (1978)

<sup>3</sup> Gallus et al, “Temporal changes of under-reporting of cigarette consumption in population-based studies” (2011)

<sup>4</sup> “Tax avoidance and tax evasion”, Chapter 8 - *Handbooks of Cancer Prevention*, IARC (2011)

<sup>5</sup> Ipsos Yellow Bag Surveys, 2008-2009

<sup>6</sup> Ipsos Empty Pack Surveys, 2008-2009

<sup>7</sup> “National Drug Strategy Household Survey”, Australian Institute of Health and Welfare, 2010, 2013

- <sup>8</sup> “Profiles of Health, Australia, 2011-13 – Tobacco Smoking”, Australian Bureau of Statistics, June 2013
- <sup>9</sup> Gallus et al, “Temporal changes of under-reporting of cigarette consumption in population-based studies” (2011)



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