

Global framework for combating illicit trade in tobacco: The Protocol to Eliminate Illicit Trade in Tobacco Products

A study conducted by Alvarez & Marsal

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Beirut, 28th March 2018



Regie Libanaise Des Tabacs Et
Tombac



Background to this research

- Tobacco products are among the most highly trafficked products in the world, second only to drugs.
- An estimated \$40-\$50 billion in tax revenues a year is being lost to the illicit trade:
 - \$12 billion in the highest taxed European countries and approximately
 - \$10 billion in the USA
- The composition of illicit trade has changed in recent years, exhibiting a significant shift from mainly contraband to counterfeit and illicit whites
- The debate about the relationship between high and increasing taxes on tobacco, illicit trade and organised crime crystallises around two core issues:
 - Relationship between tobacco tax policy, enforcement and illicit trade
 - Alleged involvement of the tobacco industry in illegal trade

Alvarez & Marsal was retained by JTI to take an objective and independent view of the causes of illicit trade, based on the available evidence where it exists and drawing on the informed positions taken by governments, regulators and anti-tobacco activists.

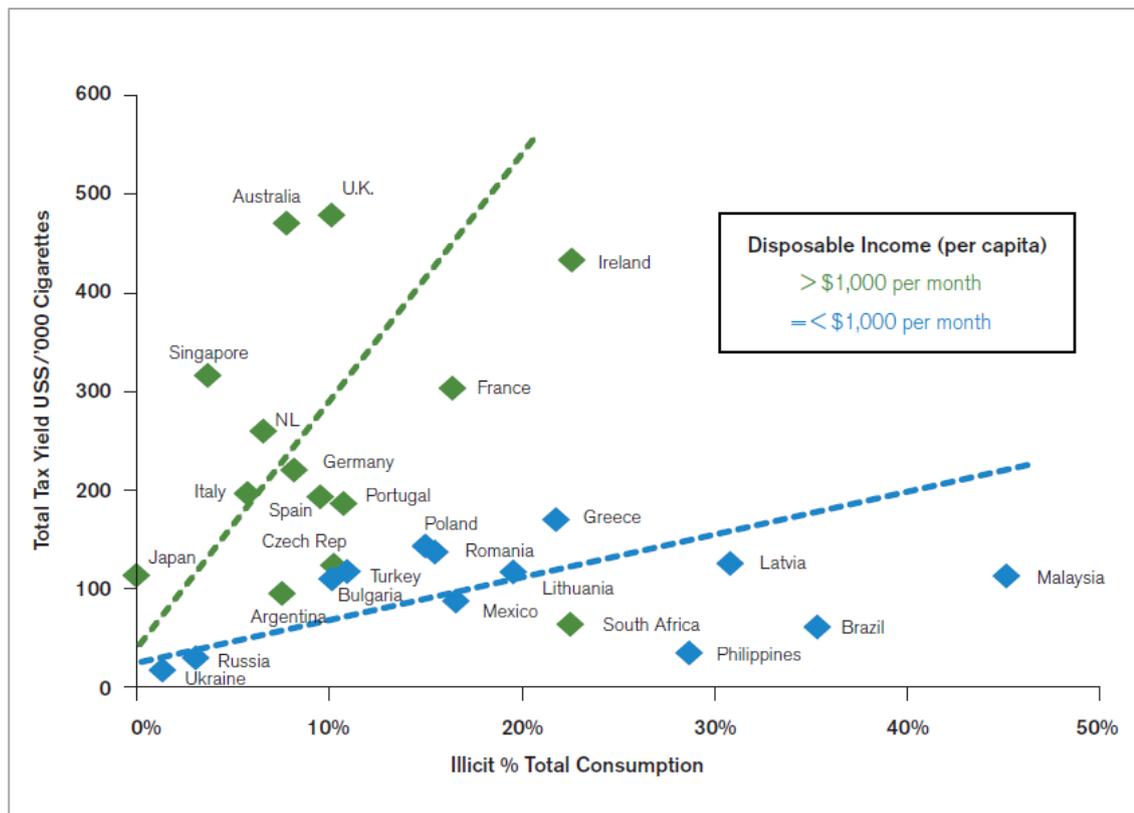
Methodology

- The research has been based on an analysis across a representative sample of 28 countries, including the major global cigarette markets (excluding China)
- The analysis addressed the US state by state where the data are available
- A broad range of global sources* has been used in the analysis, including:
 - EU Excise Tax Tables
 - Euromonitor International Passport
 - The Economist Intelligence Unit (EIU)
 - Business Insider, U.K.
 - KPMG Project Star/Sun
 - Bureau of Economic Analysis
 - The World Justice Project

*A full list of sources can be found in the full report, which is available under https://www.alvarezandmarsal.com/sites/default/files/am_jti-smokingsummary_finalweb.pdf

The research shows a relationship between tax yield and illicit trade globally, suggesting taxation is a key factor

Total tax yield vs. illicit trade, 2015

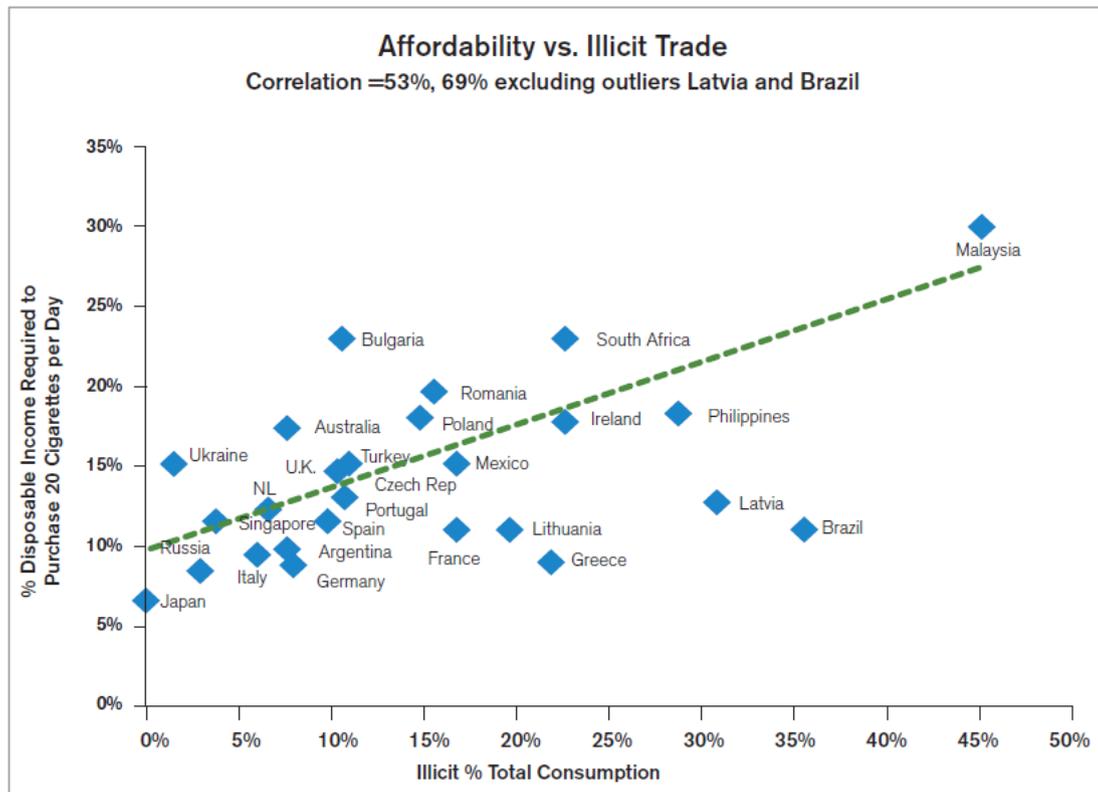


- At first sight from the chart, the results show no apparent overall correlation.
- However, once differences in disposable income levels are taken into account and countries are grouped accordingly, a relationship between tax yield and illicit trade emerges.

Source: A&M analysis, EU Tax Tables, Industry, Euromonitor, Business Insider UK

Illicit trade primarily arises due to affordability pressure as demonstrated by the correlation between the two measures

Affordability vs. illicit trade, 2015

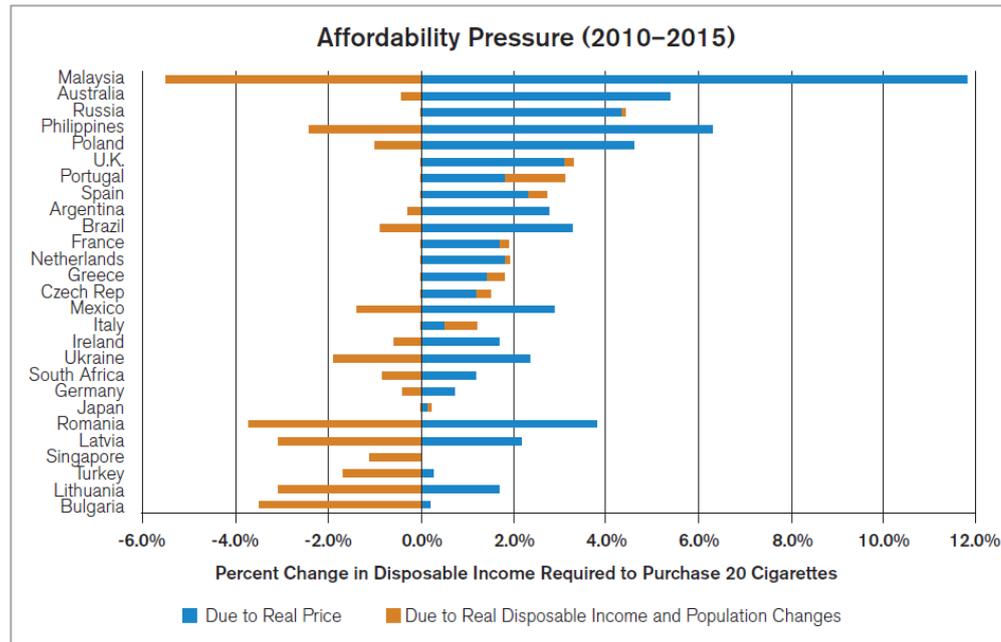


Source: A&M analysis, EU Tax Tables, Industry, Euromonitor, EIU

- An affordability measure was calculated based on % of average disposable income required to buy a pack of 20 weighted average priced or ‘most popular’ legal cigarettes per day.
- Overall, there is a 53% correlation between affordability and illicit consumption as a proportion of the total.
- This rises to 69% if Brazil and Latvia are excluded (which have very high levels of illicit trade due to supply side factors).
- There is a tipping point where a smoker switches to an illicit product - linked to affordability of the legal offering.

Reductions in cigarette affordability have been primarily driven by retail price increases

Changes in cigarette affordability during the period 2010-15

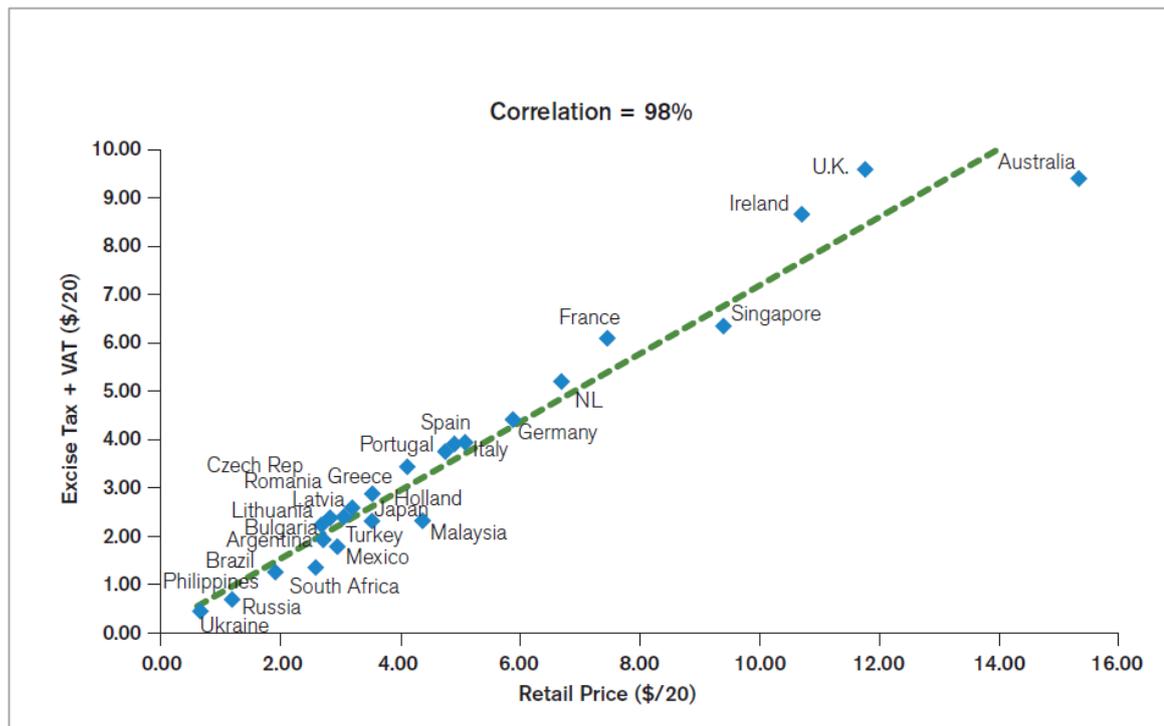


Sources: A&M analysis, EU Tax Tables, Industry, EIU

- The percentage of disposable income required to buy cigarettes depends on both its retail price and disposable income.
- The analysis shows that reductions in affordability have been primarily driven by retail price increases.

Retail price increases have in turn been driven primarily by tobacco tax changes

Taxation vs. retail price 2015

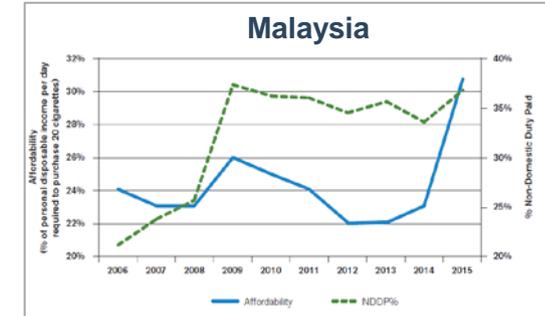
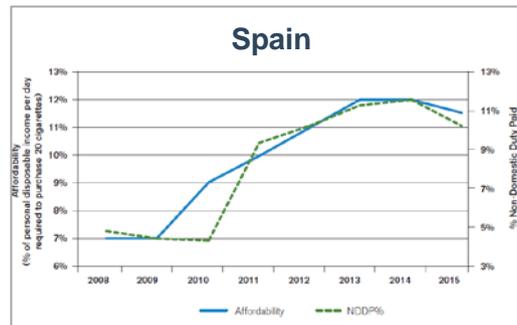
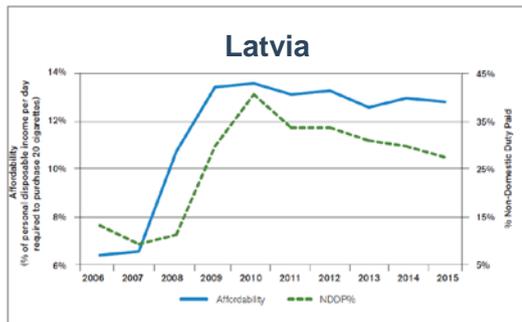
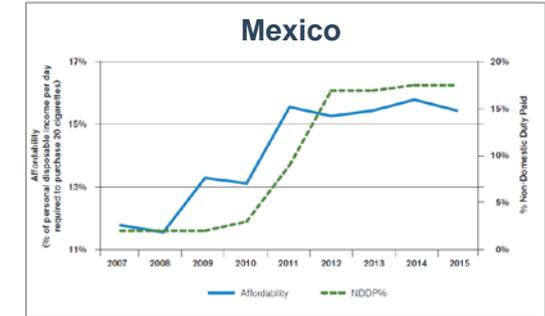
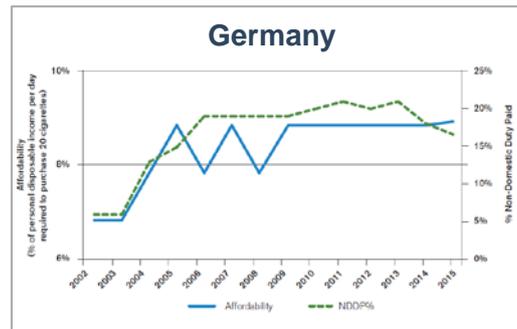
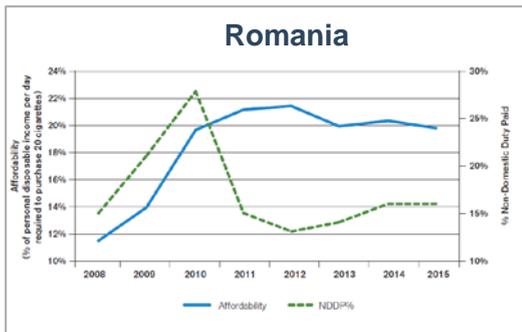


Sources: A&M analysis, EU Tax Tables, Industry (2015)

- Affordability changes have been primarily driven by retail price changes, which in turn have mainly been caused by tobacco tax increases. Our analysis shows a 98% correlation between the two.
- It is reasonable to conclude, therefore, that a clear link exists between tobacco tax increases, which cause erosion in affordability and growth in the illicit trade. This problem is further exacerbated when there is an absence of an effective enforcement regime.

There is also a historical relationship between affordability and illicit trade by country

Selected country data – affordability and excise duty rates



In Romania and Latvia, a rapid affordability decline in the late 2000s due to the need to comply with EU minimum excise rules led to very high levels of non-duty paid products.

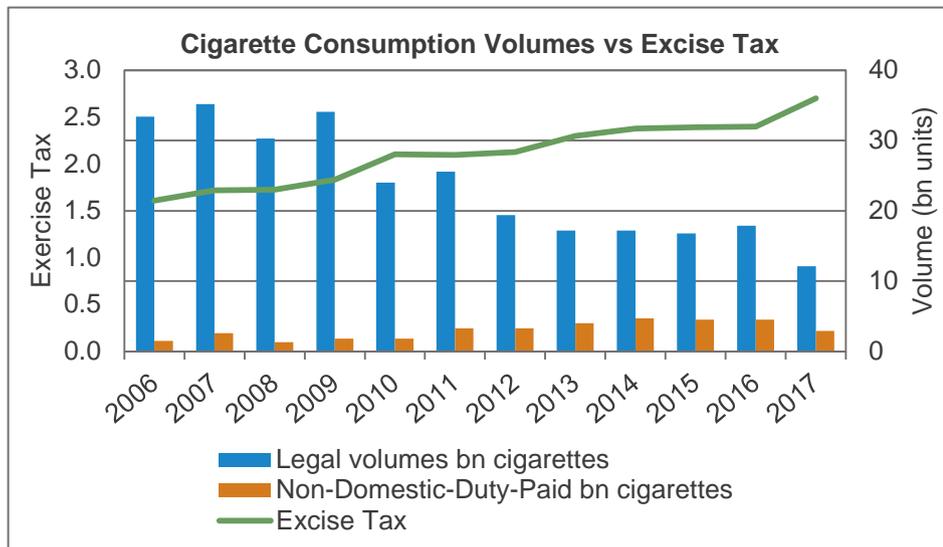
Germany had big tax rises in 2002-05 which resulted in rapid growth of non-domestic duty paid (NDDP) products while a more gradual approach to taxation thereafter led to a stabilisation.

In Spain, large tax increases during an economic crisis reduced affordability and resulted in a significant increase of NDDP products.

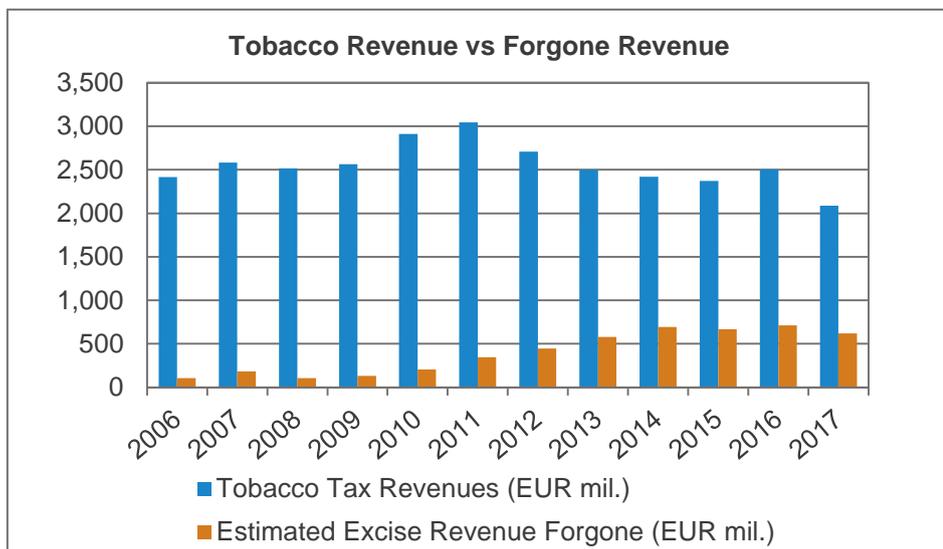
In Mexico, a 34% excise hike in 2011 resulted in a sharp increase in illicit trade. Malaysia has had high illicit trade since a series of high tax increases during the 2000s, most recently climbing to above 50% after a 37% excise hike in November 2015.

Source: various; A&M analysis

Greece (case study) has seen a significant increase in illicit trade following tobacco tax changes



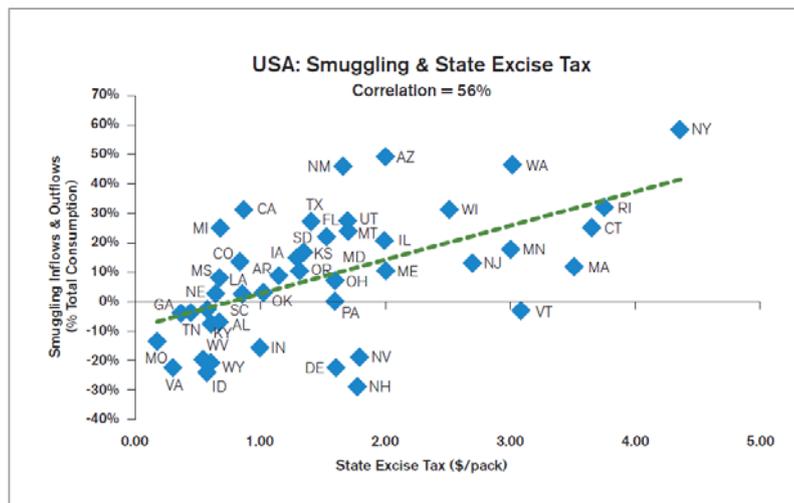
- The excise tax changes from 2012 have significantly impacted the cigarette market.
- It appears that tax adjustments were not matched by investment in enforcement resulting in heightened illicit use. This contrasts significantly with pre-2012 illicit use, which was almost non-existent.
- Available data suggest that the increase in excise duty resulted in a reduction in tobacco revenues.



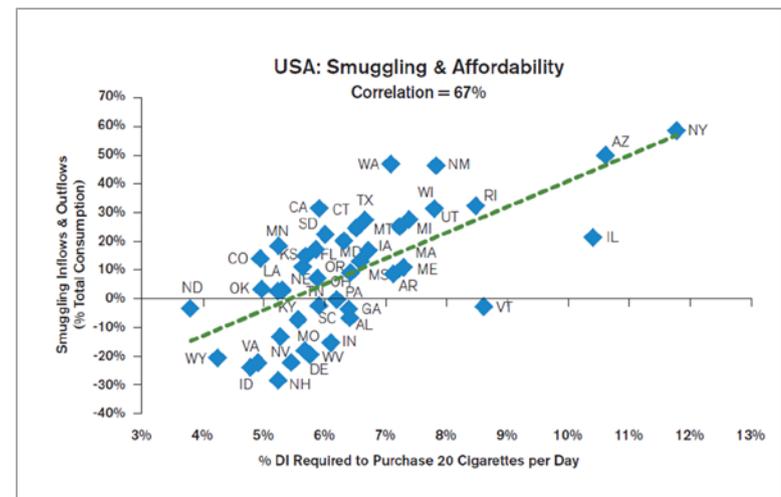
Sources: A&M analysis, EU Tax Tables, TAXUD

In the US, there is a correlation between smuggling and both state excise tax and affordability

US State view– affordability and tax relationship to illicit trade



Sources: Americans for tax reform (Global Tobacco Networking Forum)

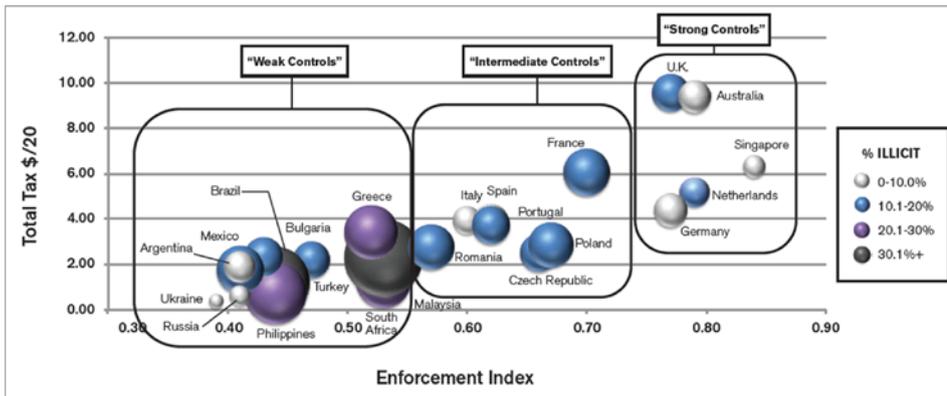


Sources: A&M Analysis, Americans for tax reform, Bureau of Economic Analysis, US Dept. of Commerce, The AWL

- Due to very wide differences between states in retail pricing, taxation, disposable income and smuggling inflows/outflows, analysis has to be carried out at the state level
- Data from 47 states shows a 56% correlation between state cigarette smuggling and state excise tax rates.
- There is a further and stronger correlation of 67% between cigarette smuggling and affordability.

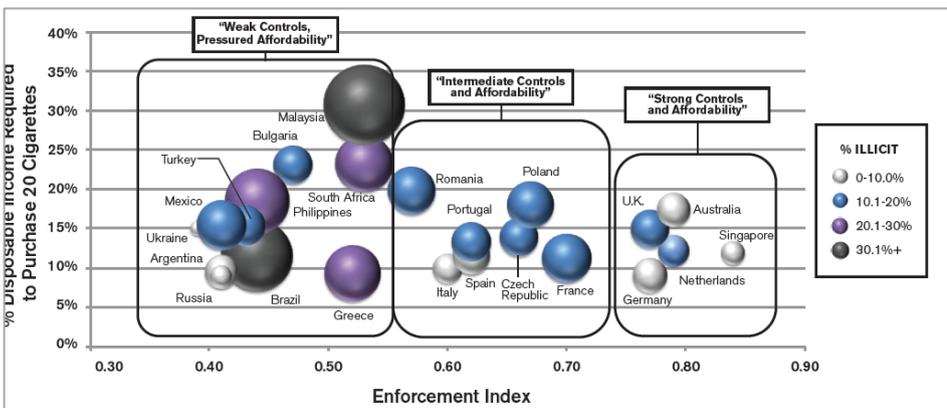
Strength of enforcement versus incentives for illicit supply influence the level of illicit trade

Enforcement & illicit trade



- Enforcement tends to be highest in more developed countries, where tax rates and tax burdens also tend to be higher.
- There is a clear link between the level of enforcement and the level of illicit trade as a % of total consumption - lower levels of enforcement tend to yield higher levels of illicit trade.

Affordability vs. enforcement



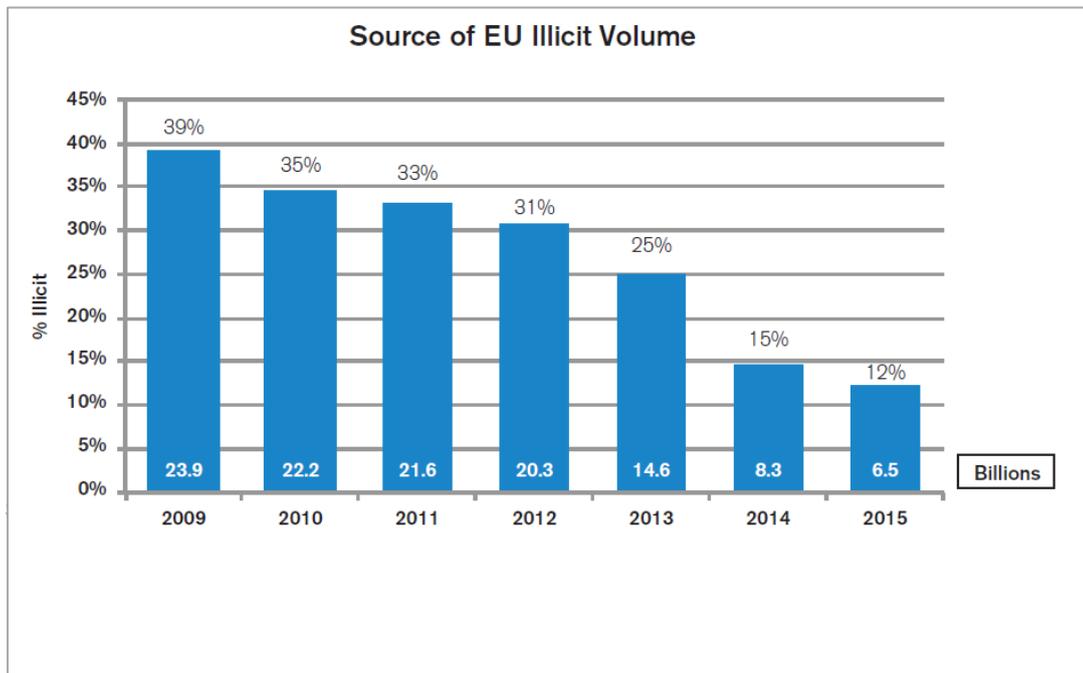
- Where affordability is pressured and/or enforcement is weak, higher levels of illicit trade occur.
- Where affordability is less pressured and enforcement stronger, lower levels of illicit trade result.

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

Enforcement Index: Composite index comprising degree of regulatory enforcement and effectiveness of the criminal justice system

With the significant trend to counterfeit and illicit whites, tobacco companies are net losers from illicit trade

Genuine EU sourced illicit product as a % of total EU illicit product, 2009-15



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

- Accusations used today that the major tobacco companies benefit from illicit trade stem primarily from historical data
- During the period 2009-15, agreements between the four major tobacco companies and the EU have reduced genuine EU sourced illicit product by approx. 75%.
- Major tobacco companies have no economic interest in illicit trade as it erodes or cannibalises volumes and profits from their legally sold products.

There have been some notable successes and the most effective are those where collaboration is most robust

- The most effective solutions to tackle the illicit trade have involved collaboration and coordination between:
 - Government (fiscal policy, regulation, enforcement)
 - Health community (e.g., education campaigns)
 - Industry (intelligence, expertise)
- Pressure against government collaborating with the industry in the fight against illicit trade misrepresents FCTC Article 5.3 and is counterproductive:
 - The objectives of the FCTC Protocol to eliminate illicit trade in tobacco products and major tobacco companies are aligned
 - FCTC Article 5.3 does not prohibit governments from interacting with tobacco companies

Notable AIT successes:

- 2015 & 16 JTI information led to the seizure of ~ 2 billion cigarettes globally.
- Imperial Brands helped law enforcement agencies seize 2.5 million kilos of illegal tobacco worth €375m and four illegal production lines.

Conclusions

- High and increasing levels of tobacco taxation have been the principal catalyst for growth in the illicit trade, absent parallel strengthening of enforcement.
- Tax increases have been the main cause of increased pressure on the affordability of cigarettes – with some affected consumers seeking alternative, more affordable and, if necessary, illegal products instead of quitting.
- Widely differing levels of tobacco taxes generate attractive profit opportunities for smugglers.
- The most effective solutions for tackling illicit trade involve:
 - Coordination and cooperation between government authorities and the legitimate tobacco companies
 - Reinvesting 1 - 2% of the potential additional tax revenues from tobacco tax increases in strengthened enforcement

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