

# Illicit Tobacco in the Asia-Pacific Region: Causes and Solutions

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**RTBA**

**DISCLAIMER:** This RTBA Working Paper has been developed to review the current state of illicit tobacco market, and recommend evidence based intervention, within in Asia-Pacific Regions - focussed on APEC & ASEAN regional groupings. The contents of this document have not been formally edited or peer-reviewed, and is circulated for the express purpose of comment and discussion.

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Retail and Trade Brands Advocacy (RTBA) is a coalition of businesses, retailers and trademark holders working to minimise the impact of criminal conduct on the Asia-Pacific trading environment. We unite, mobilise and advocate for effective change with regard to regulatory, financial and taxation issues affecting the supply chain. Working closely with industry constituents, government and regulatory bodies, RTBA works to reduce the economic and governance impacts - both in the Asia-Pacific region and broader global markets - of illicit activities.

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## ABBREVIATIONS

**CPI** Consumer Price Index

**EPS** Empty Pack Surveys

**FCTC** The WHO Framework Convention on Tobacco Control

**FTZ** Free Trade Zone

**OE** Oxford Economics

**OECD** The Organisation for Economic Co-operation and Development

**RTBA** Retail and Trade Brands Advocacy

**SEZ** Special Economic Zone

**UN** The United Nations

**WHO** World Health Organisation

## DEFINITIONS

**ASEAN** Association of South East Asian Nations. Member states include Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam.

**APEC** Asia-Pacific Economic Cooperation. An inter-governmental forum of 21 member economies that promote free trade within the Asia-Pacific region; including Australia, Brunei Darussalam, Canada, Indonesia, Japan, Republic of Korea, Malaysia, New Zealand, The Philippines, Singapore, Thailand, The United States, Chinese Taipei, Hong Kong, China, People's Republic of China, Mexico, Papua New Guinea, Chile, Peru, Russia and Vietnam.

## TOBACCO-RELATED TERMINOLOGY

**Bootlegging** Small-scale smuggling of tobacco products from low-tax jurisdictions - in amounts exceeding regulatory limits - intended for resale in high-tax jurisdictions. Bootlegging falls under the category of Contraband.

**Contraband** Genuine product that is acquired, imported or exported illegally - in defiance of legal border limits or without payment of taxes - for resale in a higher-priced market.

**Counterfeit** Illegally-manufactured imitation of legitimate products, in whole or part, without the consent of the trademark holder.

**Duty-Free** Tax-free purchases made outside the domestic market, contingent upon volume restrictions for importation.

**Excise Tax** An indirect, commodity-based tax applies to goods including tobacco, alcohol and petroleum products.

**Illicit Trade** Any practice Or conduct related to the tobacco supply chain that is prohibited by law, including; production, distribution, possession, sale, purchase and tax-avoidance pertaining to these products.

**Illicit Whites** Cigarettes that are produced for the sole purpose of smuggling and illegal resale into other markets, avoiding import/export regulations and the payment of tax.

**Tax Loss** Government revenue that is less than what could have normally been collected over a particular period, lost due to various forms of tax evasion.

**Resale** Refers to fraudulently-obtained or stolen products entering the illicit market in non-official destination countries.

**Smuggling** The illegal importation of legitimate products - in this case cigarettes and other tobacco products - without paying duties or taxes required by the destination country. Smuggling falls under the category of Contraband.

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# 1 Introduction

The illicit tobacco trade presents a significant threat to all countries in the Asia-Pacific region, as manifold downstream impacts continue to emanate from the multi-billion dollar black market in cheap cigarettes and loose tobacco. Widespread proliferation of lower-cost, unregulated products facilitates increased tobacco consumption, and therefore public harm, whilst disproportionately affecting young and low-income populations; groups most vulnerable to the disease-related consequences of smoking. Malaysia, for example, is bucking global trends with a growing youth smoking rate – in this instance due to rampant tobacco black market<sup>1</sup>. Beyond the social implications resulting from the prevalence of illicit tobacco, the associated tax evasion deprives regional governments of significant amounts of revenue, a figure estimated to be upwards of USD \$5.8 Billion<sup>2</sup> in 2017 alone. A local demonstration shows that black-market tobacco activity cost the Australian Government approximately \$647 million in revenue over the 2017-2018 financial year<sup>3</sup>; a sum that - if collected - could have funded national public health initiatives and/or numerous fire-fighting aircraft in light of the recent bushfire emergency. Furthermore, the illicit tobacco market fuels the flourishing of criminal networks and further weakens vulnerable governance environments, thus nurturing corruption and graft.

It is important to note that the problem is not limited to sovereign borders. China, Vietnam, Indonesia, Singapore and Malaysia have been identified as the lead vectors<sup>4</sup> in the illegal tobacco contagion that has spread across the region. For example, a pack of cigarettes manufactured in China may be transshipped through Singapore, before being sold on the blackmarket in destination countries such as Australia, thereby undermining the laws and public health objectives of the many nations these illegal products flow through. The growing threat of the illicit tobacco trade throughout Asia-Pacific<sup>5</sup> is generally driven by three policy factors - short-term excise policies; disparate and ineffective enforcement at a domestic level; and inconsistent co-operation at a regional level. Combined, these factors have created a multi-faceted problem that makes smoking more available to vulnerable populations, emboldens organised crime groups, and concurrently harms legitimate business and the broader economic markets they operate within. There are, however, patches of hope across the region, with a select group of countries having implemented effective law enforcement and excise strategies to successfully fight the scourge of black market tobacco.

In this report, RTBA explores the scope of the issue, elucidates its causes and outlines a practical pathway to the implementation of effective countermeasures. Drawing on extensive industry experience, comprehensive research and international case studies, we aim to provide a both detailed understanding of the illicit tobacco problem in Asia Pacific and how best to address it.

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<sup>1</sup>Oxford Economics. The Economics Of The Illicit Tobacco Trade In Malaysia. Tech. rep. Oxford: Oxford Economics, 2018.

<sup>2</sup>Oxford Economics. Asia Illicit Tobacco Indicator 2017. Tech. rep. Oxford: Oxford Economics, 2019.

<sup>3</sup>Australian Tax Office. Viewed March 3 2019.

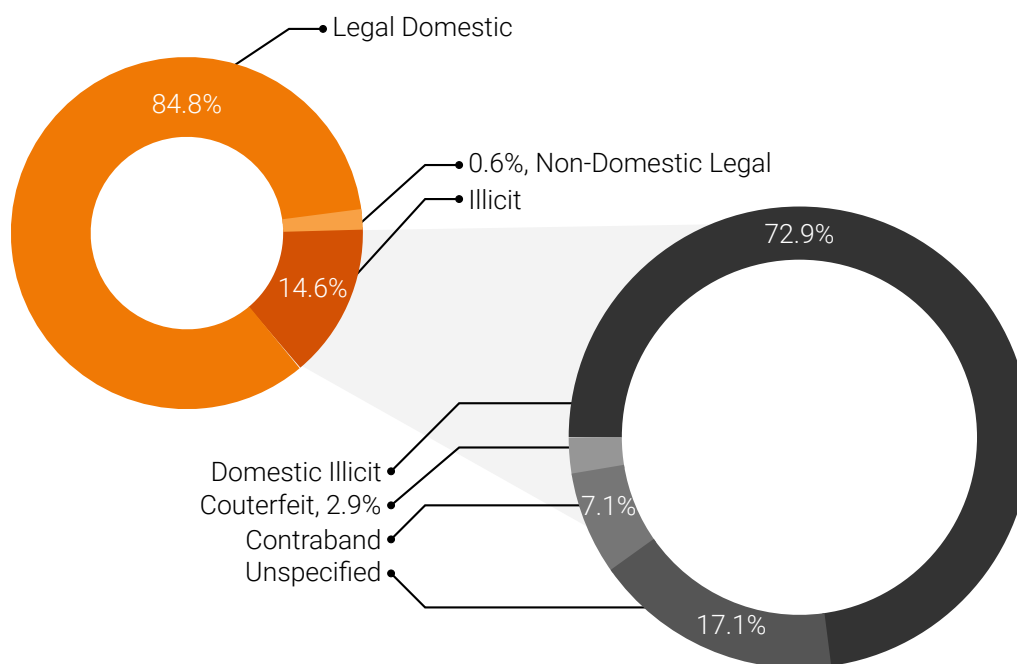
<sup>4</sup>Euromonitor. Illicit Trade in Tobacco Products. Feb. 2018.

<sup>5</sup>Economics, Asia Illicit Tobacco Indicator 2017.

## 2 State of the Illicit Tobacco Market

The size, volume and monetary value of unlawful markets are inherently difficult to estimate due to the clandestine nature of illicit activities. These 'hidden' business operations span from the production of illicit tobacco products to distribution, selling, purchase and possession; involving both direct or indirect participation of individual criminals and organised enterprise. Large-scale activities revolve around tax-evasion schemes through avoiding tobacco laws and regulations, with activities including counterfeiting, disguising product origins, failing to declare local production, using bogus tax stamps and smuggling illicit products across regional borders. Small-scale dealings also form part of the unregulated ecosystem, primarily in the form of cross-border importation of legally-purchased tobacco - in quantities exceeding tax-exempt allowances - to be sold for significant profit in destination countries. Considering these varied criminal methodologies, and their limited visibility to enforcement agencies and market research organisations, consumption statistics provide a valuable surrogate for assessing the scope of the illicit tobacco market. The Asia Illicit Tobacco Indicator 2017<sup>6</sup>, conducted by Oxford Economics, provides a regional consumption overview as follows;

**Figure 1: Composition Of Total Cigarette Consumption 2017**



**REGIONAL MARKET INSIGHTS:**

Illicit Incidence within the regional tobacco market in 2017 was estimated at 14.6% across the 16 markets covered by the Asia Illicit Tobacco Indicator. This is equivalent to 115.9 billion cigarettes where the applicable indirect taxes were not paid. Notably, 12 of the 16 markets included in the research experienced an increase in Illicit Incidence from 2016 to 2017. Seven of these markets exhibited Illicit Incidence levels above 10%; with Pakistan (41.9%), Vietnam (23.4%), Hong Kong (28.6%), Singapore (13.8%), Australia (13.7%) and New Zealand (12.7%) included in this category.

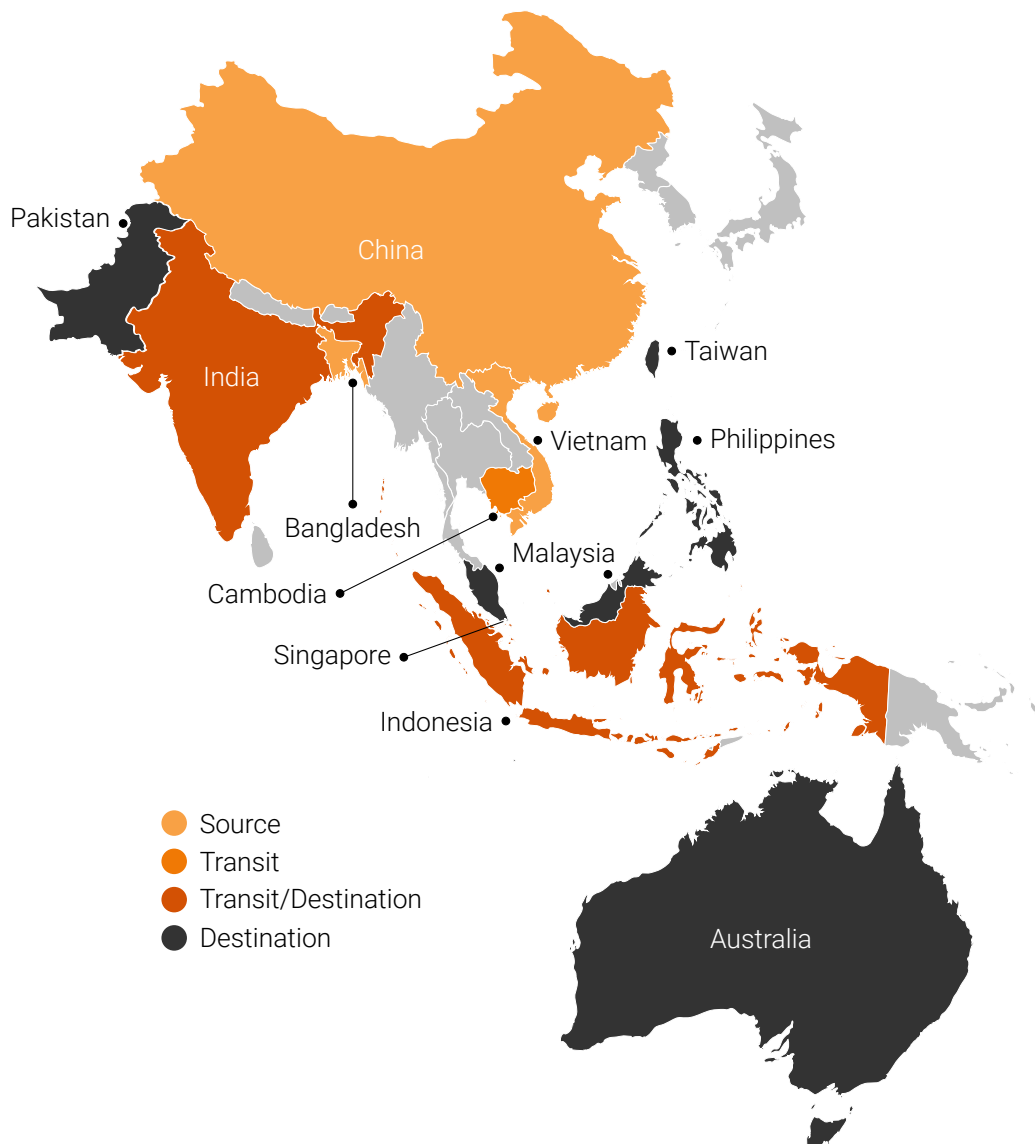
<sup>6</sup>Economics, The Economics Of The Illicit Tobacco Trade In Malaysia.



## 2.1 Mapping Illicit Tobacco Flows in Asia-Pacific

Based on Euromonitor’s Research<sup>7</sup>, China is the world’s largest supplier of illicit tobacco; with criminal parties using Singapore as a key distribution node to ship products onto Malaysia, the rest of Asia and further destinations including Australia. These same trade routes - a mix of clandestine and legitimate - are also used for the smuggling of illicit tobacco products between neighbouring countries. In other countries, such as Bangladesh, the illicit tobacco market is primarily domestic. Similar to black-market consumption statistics, flows of illicit trade are inherently difficult to track; although the following model provides useful insights into the inflows, outflows and movement of illegal tobacco across borders in the Asia-Pacific region;

Figure 2: Main Illicit Tobacco Routes



<sup>7</sup>Euromonitor, Illicit Trade in Tobacco Products.

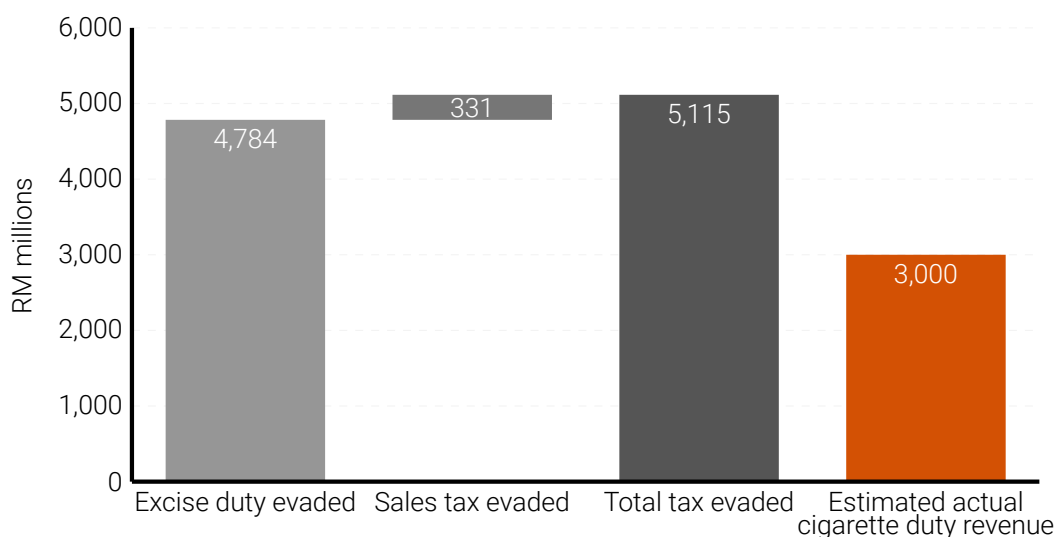
### 3 The Need To Control Illicit Tobacco

The manufacture, smuggling and trade of illicit tobacco are not victimless crimes. Myriad harms result from the growing black-market presence in Asia-Pacific, ranging from the diminishment of government tax revenues to fuelling further criminal activity and styming public-health measures; including youth access restrictions. In a region disproportionately targeted by transnational organised crime groups, taking decisive regional action in addressing the illicit tobacco market is especially pertinent in stemming the flow of unlawful influence into legitimate industries, institutions and infrastructure. The following section details the scope of this destructive influence and highlights the importance of implementing robust prevention and suppression measures.

#### 3.1 Negative Economic Impacts

The trade of illicit tobacco results in substantial revenue losses for governments and legitimate businesses in Asia-Pacific. In terms of revenue alone, total tax loss estimated across 19 monitored markets in the region was over \$5.8 billion USD (\$8.8 billion AUD) in 2017<sup>8</sup>, with nearly 50% of this occurring in just two markets; Australia and Malaysia. Regarding the former, if the amount illicit tobacco purchased in this period had instead been traded through the legal market, this figure would amount to over \$2.1 billion AUD at the average excise rate for 2018<sup>9</sup> according to the Australian Institute of Criminology. With regard to the latter, the estimated excise duty evaded by the illicit tobacco industry totalled around 5.1 million RM (\$1.8 billion AUD) in 2018, an amount over 70% larger than the actual amount collected from legal cigarettes in the same year.

**Figure 3: Tobacco tax evasion in 2018<sup>10</sup>**



Tobacco excise fraud deprives local governments and taxpayers of funds which could otherwise be invested in essential public health services, harm-reduction programs for tobacco products, or further illicit-trade countermeasures. Of additional consequence, illicit activity damages legitimate tobacco-related businesses and, in turn, diminishes the potential revenue collected through legal commerce. The thriving black-market undermines

<sup>8</sup>Economics, Asia Illicit Tobacco Indicator 2017.

<sup>9</sup>Australian Institute of Criminology. Estimating the cost of serious and organised crime in Australia 2016-17.

both regional and domestic economies, impinging on the ability of law-abiding enterprises to operate successfully; and thereby contribute gainfully to GDP, employment and tax revenues in the respective jurisdictions they trade within. International tobacco companies play a role in sustaining economic activity across regional supply chains; requiring significant inputs in the form of raw materials, services, packaging and utilities in the production and sale of tobacco products. It's worth noting that the employment footprint of the legal tobacco sector has substantial economic value, supporting hundreds of thousands of jobs in manufacturing facilities and administrative offices across Asia-Pacific.

Organised crime groups - who illegally supplant themselves as alternative suppliers of cigarettes and loose tobacco in domestic markets - undercut the vast economic benefits provided by legal tobacco businesses; forcing closures of factories and the downsizing of operations in countries most affected by prevalence of illicit tobacco trading. This was unfortunately the case in Malaysia with the recent closure of two major cigarette factories as a result of the illicit trade, costing the Malaysian economy up to 5,750 jobs and up to 0.1 percent of its annual GDP, with the full scope of economic impacts taken into account<sup>11</sup>. Beyond these direct detrimental impacts, in countries that have not shown a dedicated commitment to combating criminal influence on the legal tobacco market, the attractiveness for international investment is also diminished. As a result, the bolstering of anti-illicit tobacco measures will not only curtail the influence, capacity and profitability of criminal parties, but also enhance the regional economic environment; increasing government revenue and supporting tobacco-related health objectives.

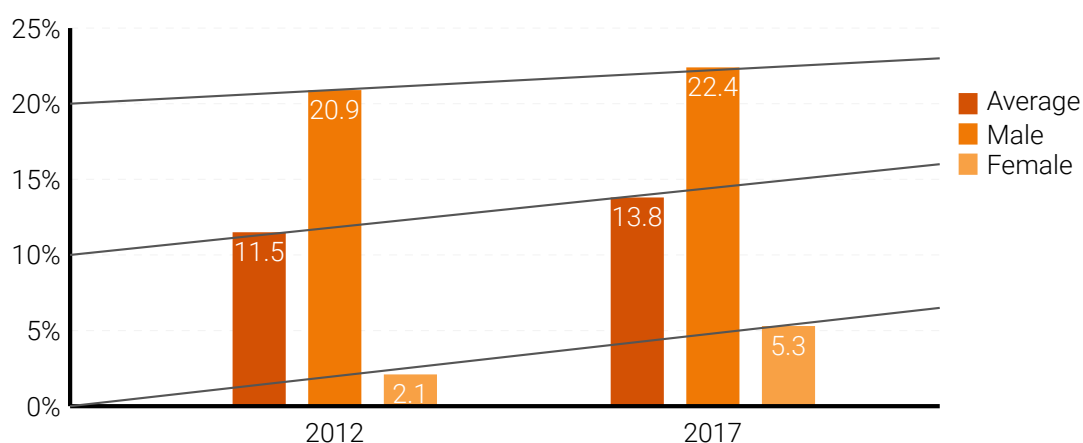
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<sup>11</sup>Economics, The Economics Of The Illicit Tobacco Trade In Malaysia.

### 3.2 Undermines Health Objectives

Beyond the misdirection of tax revenue that could be used to support tobacco-related human health initiatives, illicit tobacco compromises the effectiveness of current measures - including increased tobacco excise taxes and strictly controlled legality - in reducing consumption. The prevalent availability of cheaper alternatives to fully taxed tobacco, and the broader variety of products offered by the illicit market, significantly reduces consumers incentives to quit smoking. The illicit market fosters exposure and addiction to potentially dangerous products, manufactured unlawfully outside the purview of quality controls; in turn increasing the risk of tobacco-related disease and mortality. The unregulated market can also significantly influence the average price of legal tobacco products. According to research cited in the World Bank technical report on illegal tobacco<sup>12</sup>; it is estimated that the illegal cigarette market reduces average cigarette prices by about 4 percent and is responsible for about 2 percent higher cigarette consumption<sup>13</sup>. Counterfeit tobacco products, often sold without required health warnings, along with smuggled or stolen 'original' branded products, are particularly attractive to price-sensitive populations, namely young people and those with low incomes. The Malaysian Ministry of Health institution of Research has reported an upward trend in youth smoking throughout Malaysia, a significant portion of which is enabled by unregulated access to illicit tobacco. In 2012, 11.5%<sup>14</sup> of students between 13-17 were estimated to actively smoke, compared to 13.8% in 2017<sup>15</sup>.

**Figure 4:** Prevalence of current cigarette smokers among Form 1-5 students (12-17 years old) in Malaysia



Aside from this alarming uptick in youth smoking rates, it's also worth noting that the least-wealthy adult contingents make up a large portion of the Asia-Pacific population and tend to be among the highest consumers of tobacco products. Effective subsidy of the purchase price, via illicit trading, compounds the disproportionate vulnerability of this demographic to the economic and health implications of long-term tobacco use. The access and affordability to products that would usually see - in the legitimate tobacco market - reduced consumption due to financial constraints or regulatory controls, undermines the preventative efforts, and therefore public health outcomes, on both domestic and regional levels. As a result, illicit trade in tobacco products serves to de-incentivise cessation, and is a counterproductive influence with regards to harm-reduction efforts.

<sup>12</sup>World Bank Group. *Confronting Illicit Tobacco Trade: A Global Review of Country Experiences*. 2019.

<sup>13</sup>International Union Against Tuberculosis and Lung Disease. *How eliminating the global illicit cigarette trade would increase tax revenue and save lives*. 2009.

<sup>14</sup>Ministry Of Health Malaysia. *National Health and Morbidity Survey (NHMS) 2012: Adolescent Health Survey 2012*. 2013.

<sup>15</sup>Ministry Of Health Malaysia. *National Health and Morbidity Survey (NHMS) 2017: Adolescent Health Survey 2018*. 2013.

### 3.3 Threat To Regional Rule Of Law

The presence of organised criminal networks in the tobacco market not only undermines law and order in particular nations and markets, but acts as a destabilising force in creating the weakened governance environment it thrives within; and profits from. According to the OECD<sup>16</sup>, the threat of criminal activity and corruption is highest in weak regulatory settings, or those where laws are strong but prosecution rates and associated punishments are inadequate in enforcing them. This subversive influence, evident in many Asia-Pacific nations, has manifested in many forms at all levels of regional logistical networks and tobacco supply chains. Illicit players seek to establish control, or effectively abolish, the oversight of authorities in the manufacture, distribution and sale of tobacco products; often through means such as bribery of law enforcement and customs personnel<sup>17</sup>. Corrupt officials may overlook illegal production practices, allow smuggling across regional borders and/or facilitate the illegal provision of required permits and licenses in order to falsely represent repackaged illicit tobacco products as 'genuine new'. In a highly-integrated regional ecosystem, the activity of criminal groups - emboldened by collaborating and complicit enforcement parties - at any point within the supply chain undermines the security, safety and sustainable development goals of all jurisdictions, including those with robust regulatory systems in place. As a result, the linkages between corruption and the trade of illicit tobacco must not be underestimated.



Senior Australian Border security officials warn that non-taxed profits of illicit tobacco products may also be used by criminals to fuel other, more serious crimes, including drug trafficking and terrorism<sup>18</sup>. In a nationally broadcast interview, Australian Federal (ABF) assistant commissioner Wayne Buchhorn, supported by the Australian Border Force (ABF), stated; "I would consider it [a national security threat] because [of] the potential for organised crime groups to attack the institutions of state, whether through corruption or through their infiltration of legitimate supply chains. That has the potential to cause corruption within government agencies and more broadly. So the potential for that to be a national security risk for me is very real"<sup>19</sup>. These comments come following the discovery of Sydney-based smuggling syndicates obtaining fraudulent licenses to operate customs broking agencies and freight depots as a means to import illicit tobacco contraband. Mr. Buchhorn, with enforcement experience in both Australia and Afghanistan, also said there was evidence of an association between local Middle Eastern crime gangs and terrorist organisations, with the proceeds of these crimes being funneled overseas to fund related criminal activities.

<sup>16</sup>Economics, The Economics Of The Illicit Tobacco Trade In Malaysia.

<sup>17</sup>OECD. Illicit Trade: Converging Criminal Networks. OECD Reviews of Risk Management Policies. 2016.

<sup>18</sup>ABC 7.30 Program: Fairfax Media. Interview with AFP Assistant Commissioner, Wayne Buchhorn. 2016.

<sup>19</sup>Media, Interview with AFP Assistant Commissioner, Wayne Buchhorn.

Reflecting the warnings of Australian authorities, the United Nations<sup>20</sup>, OECD<sup>21</sup> and the US State Department<sup>22</sup> have acknowledged the significance of the threat posed to national security by the illicit tobacco trade and its evident association with institutional corruption. Unfortunately, many regional enforcement agencies have yet to take this issue seriously and categorise the nature of the related crimes accordingly; failing to recognise the severity of the illicit tobacco market and, therefore, dedicate adequate resources and commitment for its effective intervention.

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<sup>20</sup>United Nations. Convention against Transnational Organized Crime and the Protocols.

<sup>21</sup>OECD, Illicit Trade: Converging Criminal Networks. OECD Reviews of Risk Management Policies.

<sup>22</sup>United States State Department. The Global Illicit Trade in Tobacco: a threat to national security. 2015.

## 4 Causes, Case Studies And Control Measures

There are numerous factors that contribute to the presence, pervasiveness and perpetuation of the illicit tobacco market. Large discrepancies in tobacco prices and related taxes between regional jurisdictions creates a profitable trading environment for opportunistic criminals to exploit. Illegal trading operations in this black-market is are attractive and profitable in weak governance contexts; areas with institutions vulnerable to corruption, insufficient commitment to countermeasures, low enforcement rates and porous borders between countries - including official customs ports<sup>23</sup>. Illicit tobacco products are also relatively easy to transport and conceal, with physical characteristics provide further logistical advantage to organised criminal groups, especially within compromised transnational distribution networks.

The section covers the primary underlying causes of illicit trade and it's complex dynamics, outlining the interplay between supply and demand for unregulated tobacco products and the role of criminal parties in manipulating both. The associated case studies demonstrate the cause/effect relationship between these factors, followed by RTBA's recommendations for effectively controlling illicit trades and securing supply chains in the Asia-Pacific region.

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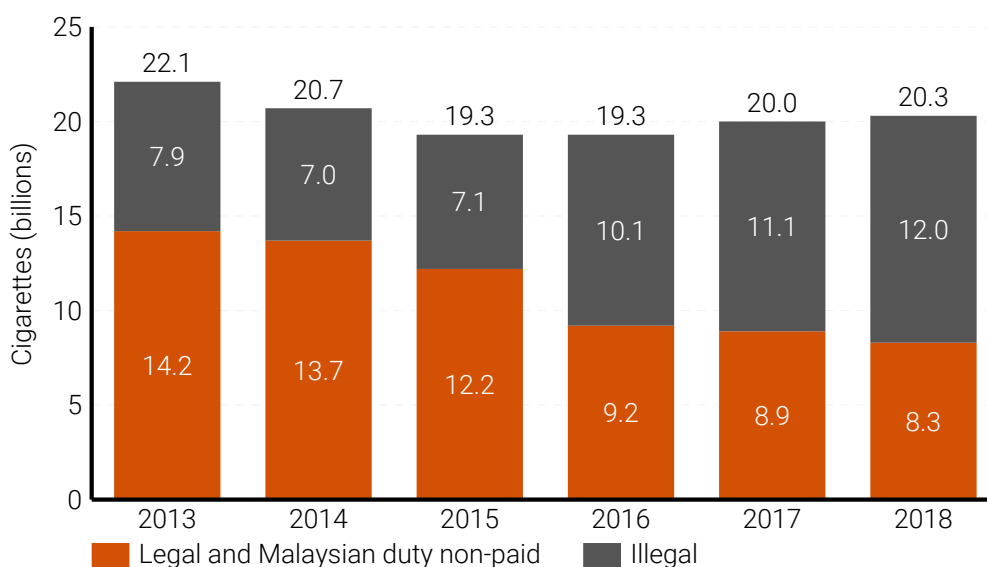
<sup>23</sup>The Transnational Alliance to Combat Illicit Trade (TRACIT). Mapping the Impact of Illicit Trade on the Sustainable Development Goals. 2020.

### 4.1 Key Driver: Market Conditions Conducive to Illicit Trade

In their efforts to reduce smoking rates and generate additional funding for associated health services, in line with the recommendations of relevant public health treaties, many Asia-Pacific governments have significantly increased taxation on legal tobacco. This demand-reduction provision is considered an effective way to bolster excise revenue, discourage consumption and therefore minimise the negative societal consequences of tobacco consumption. As a result of these strong taxation policies in the Asia-Pacific region, the legal tobacco industry has been forced to hike retail prices of tobacco products; in turn reducing both affordability and attractiveness for consumers.

However, it's important to note that these control measures are only effective with regard to the legitimate tobacco market and have, in fact, had an inverse effect for it's illicit counterpart. Illicit enterprise, by definition, operates outside of the regulatory obligations faced by authorised businesses; providing a distinct competitive advantage in high-tax trading environment, reflected in the market current conditions in the Asia-Pacific region. Organised criminal groups are able to leverage the disparity between the price of legal tobacco products - inherently more expensive due to higher taxation and operational costs - and that of the illegitimate, cheaper alternatives they can provide, having evaded such expenses. Tax-driven demand reduction provisions, while reducing demand of legal tobacco products, drive many consumers - particularly those with lower price tolerance - to seek out counterfeited and smuggled substitutes. Following the same premise of restrictive taxation measures, criminal parties also capitalise on pricing dynamics as a key determinant of buyer behaviour, providing low-cost/high-margin illicit tobacco products to fill the emergent market gap. Take the example of Malaysia's excise hikes and the correlating increase in Illicit Tobacco Market share and consumption, outlined below<sup>2425</sup>;

Figure 5: Excise duty and the evolution of illicit trade in Malaysia 2013-2018



<sup>24</sup>Economics, The Economics Of The Illicit Tobacco Trade In Malaysia.

<sup>25</sup>Economics, The Economics Of The Illicit Tobacco Trade In Malaysia.



This research reflects the sentiment shared by New Zealand Governments Tax Working Group, in that excise increases have limited usefulness and can actively contribute to rises in both smoking rates and criminal activity. Their Future Of Tax final report<sup>26</sup>, issued in February 2019, states “The Group’s preference is that, once the current schedule of tobacco excise increases end, the Government prioritise other measures to help people stop smoking before it considers further large increases in tobacco excises”. The Working Group’s Interim Report<sup>27</sup>, also outlined concerns about further tobacco excise increases for the following reasons:

1. Tobacco excise is regressive. There is a substantially higher prevalence of smoking in the poorest areas of our country (New Zealand Health Survey 2016/17). Although increases in the rates of excise may encourage some individuals to cease smoking, the heaviest burden of the excise increases will be borne by low-income earners who continue to smoke.
2. The effectiveness of excise increases appears to be reducing. Regulatory impact analysis prepared by the Treasury in 2016 indicates that reductions in smoking prevalence are expected to be quite small relative to the size of the increases in the excise rates (Treasury 2016).
3. High taxes on tobacco appear to be a factor in an increasing number of robberies and criminal activity.

Additionally, consumer demand and the prevalence of tobacco use is already exceptionally high - by global standards - in Asia-Pacific, which has led to a trading environment in which illicit suppliers are essentially incentivised to expand their production and distribution operations to supply the vast regional market. China has emerged as a primary target for these black-market flows, mainly due to its identification as one of the largest domestic consumer markets for illicit tobacco products; with as many as one third of the world’s smokers being Chinese<sup>28</sup>. With an increased number of potential customers turning to the illicit market for cheaper tobacco, regardless of authenticity, nefarious profiteers have consequently become more sophisticated, organised and well-resourced to service this demand.

<sup>26</sup>Tax Working Group (New Zealand Government). Future of Tax: Final Report, Vol.1. 2019.

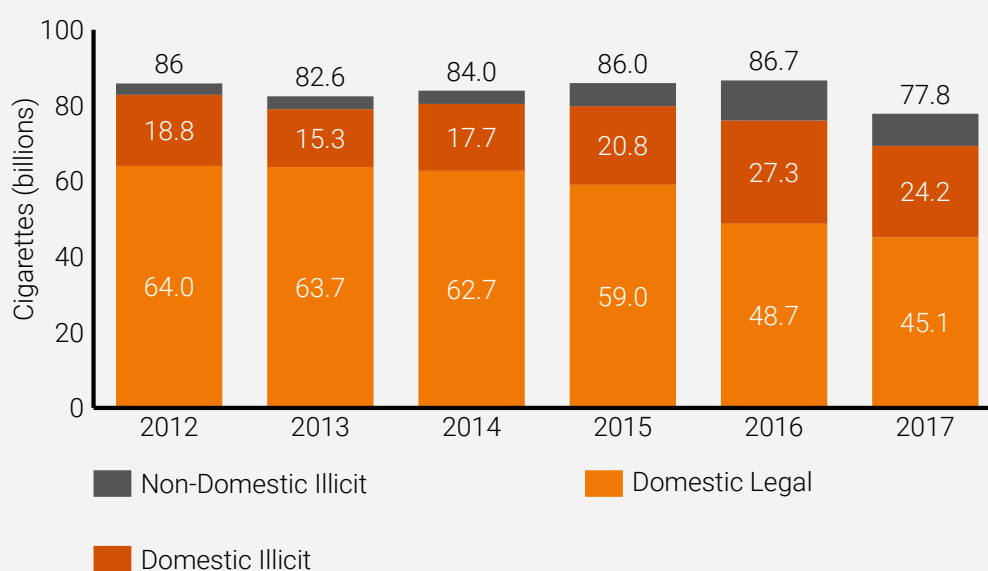
<sup>27</sup>Tax Working Group (New Zealand Government). Future of Tax (Interim Report). 2018.

<sup>28</sup>World Health Organization. WHO global report on trends in prevalence of tobacco smoking 2000-2025, 2nd ed. 2018.

4.1.1 Case Study: Pakistan

Demand for tobacco products in Pakistan has grown significantly over the last decade, driven by higher incomes and a rapidly increasing population - of which nearly 24 million are active smokers across both licit and illicit markets; according to 2018-2019 data<sup>a</sup>. Following the guidance of international health organisations, including the WHO, efforts to dissuade tobacco consumption and raise additional tax revenue were ramped up significantly in 2015; primarily in the form of increased excise duties on legitimate cigarettes. The implementation of these measures did have some effect with regard to the legitimate tobacco market, with 2016 data reflecting a measurable decrease in legal consumption and an estimated increase of around 25% in excise-related government revenue, however, this initial progress had been completely reversed by the middle of 2017<sup>b</sup>. This regression resulted from the consequential spike in opportunistic criminal activity (manufacture, smuggling and distribution); with research indicating illicit tobacco market share growing from 31% to 44% between within a year of enactment (graph below);

Figure 6: Pakistan: Composition of cigarette consumption



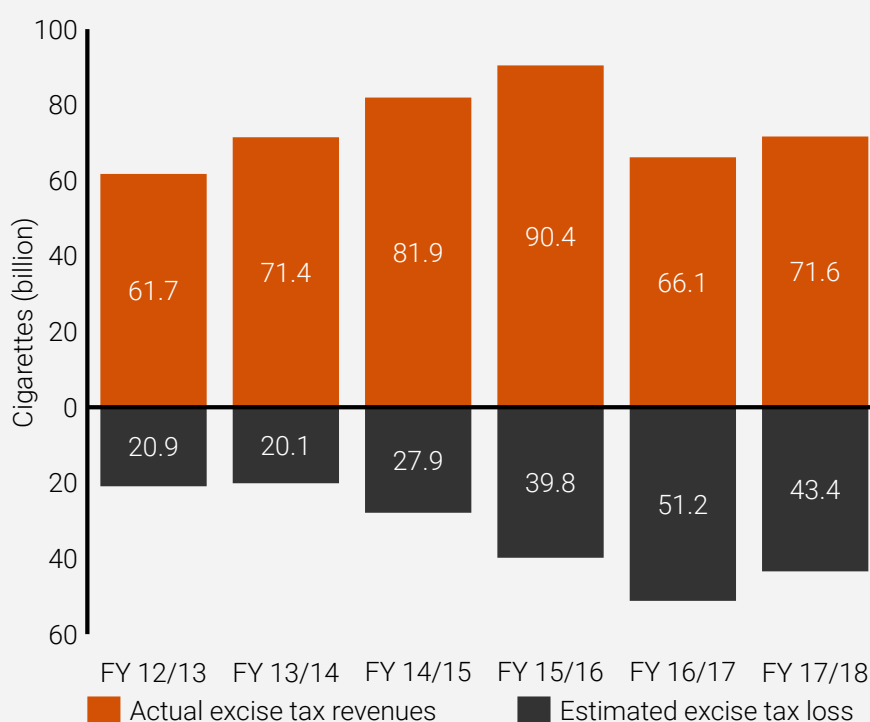
The Pakistan Government subsequently ramped up controls of a number of illicit manufacturers and seized over 1.6 billion DNP cigarettes<sup>c</sup>; although this reaction merely shifted the majority of local production to the clandestine facilities of recusant areas in neighbouring nations such as Afghanistan. Notwithstanding the initial rise in excise revenue and lowering of smoking rates, the subsequent proliferation of non-taxed paid products - given the market conditions created by these policies - Pakistan reached the highest prevalence of illicit tobacco trading in Asia-Pacific; with over 28.4 billion untaxed cigarettes estimated to be purchased and consumed in 2016<sup>d</sup>. At this time, the unintended negative outcomes were compounded resultant net tax losses, heightened risks to public safety posed by unregulated products, and greater flows of illicit revenue used to further the interests and influence of organised criminal enterprise.

In retrospect, the lack of solid evidence for the efficacy of excise-based smoking interventions was elucidated by Pakistan’s experimental tax-policies, and - furthermore - these supply-side measures proved to have counterproductive implications for constraining the illicit tobacco market. These results reflect the earlier academic predictions regarding such measures<sup>e</sup>;

“Several factors contribute to illicit trade in Pakistan, most notably the long and porous border with Afghanistan, poor monitoring and the resulting underreporting of production, the lack of regional partnerships aimed at curbing illicit trade in tobacco products and internal corruption. These factors suggest that cigarette tax increase of the magnitude described above would likely lead to increased tax avoidance and evasion that would reduce, but not eliminate, the public health and revenue impact of tobacco tax increases” (Burki et al. 2013, p.42).

However, the Pakistan Government had much greater success in addressing consumer demand for illegal tobacco products; through the lowering of tariffs applied to legitimate manufacturers to undercut black-market profitability and encourage local illicit producers to formalise operations. In 2017, Pakistan transitioned from a 2-tier tax system, with excessive excise rates, to a more moderate, nuanced and balanced three-tier model. Within the first year following this strategic restructure, The Pakistan Government saw an increase of over 8% in actual excise tax revenue and a reduction of 15% in estimated excise tax loss<sup>f</sup>;

**Figure 7:** Pakistan: Actual government revenues and estimated tax loss



These results attest to the value of taking a circumspect regulatory approach, in the form of reducing excise to a sustainable level, to minimise negative outcomes in situations where unregulated supply is insufficiently controlled; as opposed to short-sighted, excessive and rapid tax hikes. Nevertheless, despite the marked drop in illicit

consumption across 2017 (-14%)<sup>g</sup> in Pakistan, further measures must be taken to reduce the alarmingly high portion of total consumption it continues to represent.

<sup>a</sup>SDPI. Sustainable Development Policy Institute (SDPI) on national treasury versus public health 2018-19. 2019.

<sup>b</sup>American Enterprise Institute Roger Bate. Pakistan's tobacco tax folly. 2018.

<sup>c</sup>Roger Bate, Pakistan's tobacco tax folly.

<sup>d</sup>World Bank Group. Pakistan : Overview of Tobacco Use, Tobacco Control Legislation, and Taxation (English). 2019.

<sup>e</sup>Burki et al. The Economics of Tobacco and Tobacco Taxation in Pakistan. Tech. rep. Paris: International Union Against Tuberculosis and Lung Disease, 2013.

<sup>f</sup>Oxford Economics. Asia Illicit Tobacco Indicator 2017: Pakistan. Tech. rep. Oxford Economics, 2018.

<sup>g</sup>Economics, Asia Illicit Tobacco Indicator 2017: Pakistan.

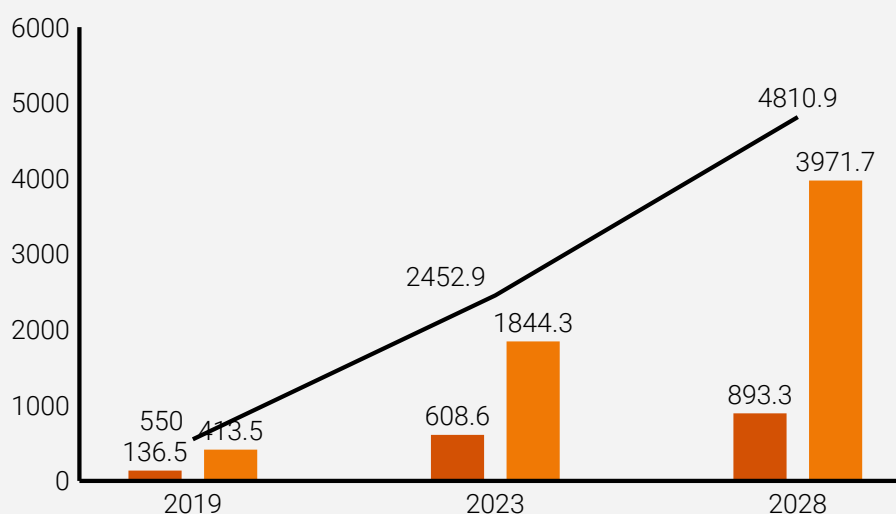
4.1.2 Case Study: Papua New Guinea

In late 2016, following the guidance of a tax review that asserted that “concessional rates on some tobacco products do not appear justified on policy grounds”, PNG’s Treasurer at the time - Patrick Pruaitch - implemented significant tobacco tax increases (significantly above the rate of inflation)<sup>ab</sup>; announced ahead of the 2017 Budget. Pruaitch himself acknowledged the likelihood for this excise hike to generate more crime and, as a result, promised the establishment of a taskforce to counter the imminent problem - though this was not upheld - to the detriment of both the government and broader the public of PNG. This situation exemplifies the sentiment expressed in the previous sections; increasing unaffordability of tax-paid tobacco, in the absence of robust black market controls, fuels illicit growth.

Pruaitch’s successor, Charles Abel, subsequently sought to resolve the problem, in the form of a considerable spike in illicit tobacco activity, that the excessive excise hike had caused. Abel introduced a more sustainable ‘tiered’ taxation approach, in conjunction with proposing an “Illicit Trade Taskforce”. Though the latter made it to Cabinet, the implementation of the Taskforce was unfortunately blocked . Nonetheless, in 2018-19, Abel - the then Treasurer and Deputy Prime Minister - altered the excise regime regarding tobacco to bring in a more nuanced/tiered system, which catered for the purchasing habits of the majority of the population who sought a cheaper product.

The enactment of the tiered excise regime proved to make the tax system fairer; a poignant example that demonstrates how countries can address the illicit tobacco problem without harming the overall tax take. This change in policy was an acknowledgement that the unsustainable tax increases imposed by his predecessor, Mr. Pruaitch, had been regressive on many levels in generating a significant illegal market. Going forward, the PNG Government is well advised to ramp controlling the illicit tobacco trade in order to achieve public health objectives and reduce both current and future revenue losses, as projected below by FTI Consulting<sup>c</sup>;

Figure 8: Impact of illicit tobacco on tax revenues



Concerningly, the current Treasurer, Ian Ling-Stuckey, who took his post in August 2019, has since reverted to calling for the imposition of large tax hikes on tobacco; although - as of writing - these proposed changes are yet to eventuate.

<sup>a</sup><http://www.treasury.gov.pg>.

<sup>b</sup><http://www.parliament.gov.pg>.

<sup>c</sup>FTI consulting. Illicit Tobacco in Papua New Guinea. 2019.

#### 4.1.3 Solution: Diminish Profitability of Tobacco Fraud Through Excise Reform

There is a general consensus among public health experts and policymakers that major increases in the cost of tobacco products is the most effective control modality for reducing consumption, encouraging cessation and preventing individuals from starting to smoke. This assertion is also largely supported by the broader public, however, in reviewing the implementation of higher tobacco taxation in many countries, these optimistic theoretical expectations are not necessarily reflected in the outcomes of its practical application. In part, this is due to the limited evidence of increasing tobacco taxation as an effective, strategic intervention to reduce smoking and raise excise revenue<sup>29</sup>, and the positive causal link between these determining factors has yet to be unequivocally demonstrated.

This runs contrary to the primary argument of regulators in the assumption that restrictive taxation is profoundly efficacious in achieving public health objectives pertaining to smoking reduction<sup>30</sup>. What has instead been shown is the circumvention of tax-based tobacco interventions through consumers turning to lower-cost illegal products, often conflated by researchers as an overall reduction in consumption, which more accurately represents a shift towards an emboldened illicit market. In overlooking these negative implications outlined in detail in the previous section, governments inadvertently play a significant strike stimulating demand for illicit alternatives and functionally incentivising a profitable black-market to service it. This paradoxical phenomena is particularly pertinent with reference to underprivileged consumer sub-groups, as these tobacco control measures, focussed largely on the benefit of these populations, have unfortunately resulted in the greatest associated harms to this socioeconomic cohort.

As a result, RTBA does not support progressive tax rises as a viable pathway to reducing both licit and illicit consumption rates, especially with regards to disadvantaged populations. Following the sentiment reflected in a 2010 UK Government-commissioned review of measures to address tobacco-related health inequalities<sup>31</sup>, increasing prices is - by and large - inconsistent with the well-intentioned rationale underpinning such policies. As such, RTBA instead recommends a multi-year moratorium on further progressive tax rises, in conjunction appropriate adjustments to current excise rates towards a more reasonable and effective level - especially in the highest-taxation jurisdictions such as Australia and Malaysia. Through taking this approach, policymakers in Asia-Pacific are able to both mitigate the aforementioned equity concerns - be that social, economic and public health related - pursuant to increased taxation, and enfeeble the profitability of organised crime groups involved in the illicit tobacco market.

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<sup>29</sup>C.A. Gallet and J.A. List. Cigarette Demand: A Meta-Analysis of Elasticities. *Health Economics* 12(10). 2003.

<sup>30</sup>National Bureau of Economic Research. Excise Tax Avoidance: The Case of State Cigarette Taxes, Working Paper. 2010.

<sup>31</sup>M. Marmot and R. Bell. Fair society, healthy lives. *Public health*, 2012.

## 4.2 Key Driver: Insufficient Regional Cooperation and Commitment to Control Measures

With regard to addressing the trade of illicit tobacco products, there are a number of existing control instruments at the disposal of Asia-Pacific nations, providing proven pathways for successful regulatory, enforcement and administrative efforts. In a transnational context, the effectiveness of such regulatory frameworks is not only correlated with the level of commitment and compliance of participating parties, but also the degree of cooperation between jurisdictions in upholding the provisions provided. In Asia-Pacific, these metrics are concerningly low; compromising anti-illicit enforcement initiatives across the entire region. The fact is, despite the stringent adherence efforts of a small number of regional agencies and authorities, the utility of these cross-border regulatory frameworks remains limited by the greater contingent of those who willingly eschew their responsibility in combating the shared challenge of illicit tobacco.

One such platform is the World Health Organization (WHO) Protocol to Eliminate Illicit Trade in Tobacco Products<sup>32</sup>, outlining robust governance measures for the protection of local, regional and global tobacco supply chains. Falling under Article 15 of the broader WHO Framework Convention on Tobacco Control<sup>33</sup> (WHO-FCTC), the protocol functions as an international treaty in its own right, outlining comprehensive supply-side provisions for controlling the illicit tobacco market in particular. These intervention directives include enhanced licensing requirements for contracting parties, producers and distributors; greater enforcement in free trade zones; and the implementation of enhanced traceability systems. In September 2018, the Protocol became international law following the requisite ratification of 40 countries, with signatories legally-bound to work cooperatively with other participating stakeholders to implement the policies presented wherein.

Unfortunately, while many countries in Asia-Pacific have signed the Protocol to Eliminate Illicit Trade in Tobacco Products - and enact the policies of the framework - the majority have yet to do so<sup>34</sup>. The evident resistance can be attributed to a number of interrelated factors, including inadequate jurisprudence, underestimation of the threat posed by illicit tobacco, insufficient enforcement capabilities, an absence of regional accountability, a lack of political will, and/or a negative perception of benefits proportional to the required investment. However, despite the inherent complexities of harmonising the numerous parties involved, a concerted effort to overcome these challenges remains pivotal in the enactment of both the Protocol the broader regional enforcement response.

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<sup>32</sup>World Health Organisation. WHO Protocol To Eliminate Illicit Trade In Tobacco Products. 2013.

<sup>33</sup>World Health Organisation. WHO Framework Convention on Tobacco Control.

<sup>34</sup>Organisation, WHO Framework Convention on Tobacco Control.



#### 4.2.1 Case Study: United Kingdom

The illicit tobacco crime environment in the UK is like that of many countries within the Asia Pacific region; in that organised crime largely controls the illegal importation and distribution of the product. The illicit market has also been driven by the high UK tobacco taxes compared to their European neighbours<sup>a</sup>.

The lessons from the United Kingdom's response to illicit tobacco can be adopted by law enforcement agencies in Asia-Pacific. The UK first dedicated adequate resources to understanding and accepting the scale of the problem. This led to the informed development of appropriate policy and action, namely the establishment of a National Illicit Tobacco Strategy. This initiative, guided by adherence to international protocols outlined above, is now known as its "Leaf to Light" strategy<sup>b</sup> and is an example of world's best practice. Led by the relevant UK government departments, Treasury and Immigration, coordinated enforcement action has resulted in the containment and reduction of the problem to controllable levels<sup>c</sup>. It has also protected the government's revenue via legitimate tobacco products. Dedicated domestic and international intelligence, coupled with an investigative response methodology, has raised the risk to criminals of being caught and deterred other opportunists from participating in the crime type.

According to the UK Strategy, the key components of targeting, catching and punishing those involved in the illicit tobacco market are<sup>d</sup>; Creating a hostile global environment for tobacco fraud through intelligence-sharing and policy change; Undermining the profitability of the fraud at all point in the supply chain from production to retail; Getting tougher on those involved through sanctions; and Changing public perceptions and reducing tolerance of the fraud in the UK. As part of our analysis of the UK's illicit tobacco countermeasures - which many agencies in Asia-Pacific can glean useful insights - RTBA has identified the following elements as the most contributory to the success of the response;

- The UK have long recognised illicit tobacco as a significant revenue evasion issue.
- They determined that this law enforcement issue required a substantial law enforcement response and the two logical departments, Treasury and Immigration, developed an illicit tobacco policy drawing on, guiding and coordinating their combined resources.
- The UK has signed the WHO Protocol to Eliminate Illicit Trade in Tobacco Products.
- HMRC and the UKBF have close to 1,000 experienced, skilled and trained analysts and investigators working together to combat Illicit Tobacco.
- HMRC and UKBF have the full suite of covert electronic police powers and tools in their fight against illicit tobacco.
- HMRC has over 40 staff strategically placed offshore to identify and intercept illicit tobacco before it reaches the UK.
- UK legislation is appropriate to address the problem at all points along the border continuum, "From leaf to light".
- UK agencies interact with and gain valuable intelligence from the tobacco industry. These interactions are regulated via memoranda of understanding.

- UK agencies have strictly monitored enforcement measures.
- The UK seize approximately 1.3 billion cigarettes per year and dismantle over 70 organised crime groups, conducting hundreds of prosecutions.<sup>e</sup>

The UK agency primarily responsible for illicit tobacco, HMRC, has made successful representations to the UK Government requesting funding on a 'return on investment' basis. It must be remembered that HMRC have all the police powers and highly effective domestic and international structures, so they can legitimately claim to use the extra funding wisely. HMRC have been able to prove to the UK Government that they consistently meet their projected targets with this funding. Law enforcement agencies in Asia-Pacific have the capacity to emulate the successful policy interventions of the UK, especially when considered through the lens of lost revenue and the potential for such programs to be self-funded through their effective implementation. As the UK case demonstrates, domestic and international activity and collaboration with a range of stakeholders, at home and abroad, is warranted in confronting the illicit tobacco trade.

<sup>a</sup>European Commission. Excise Duty Tables: Part III – Manufactured Tobacco.

<sup>b</sup>HM Revenue, Customs, and Border Force. Tackling Illicit Tobacco: From Leaf to Light - The HMRC and Border Force Strategy to Tackle Tobacco Smuggling. 2015.

<sup>c</sup>The World Bank Group. 'United Kingdom: Tackling Illicit Tobacco'. A Global Review Of Country Experiences. 2019.

<sup>d</sup>Revenue, Customs, and Force, Tackling Illicit Tobacco: From Leaf to Light - The HMRC and Border Force Strategy to Tackle Tobacco Smuggling.

<sup>e</sup>Group, 'United Kingdom: Tackling Illicit Tobacco'. A Global Review Of Country Experiences.

#### 4.2.2 Case Study: Australia

In recent years, Australia has made efforts to address some aspects of the trade in illicit tobacco and dedicating resources to the cause. One such example is the formal establishment of the ABF-led Illicit 'Illicit Tobacco' Taskforce (ITTF) on July 1 2018<sup>a</sup>, which had been in development since 2016. The positives aspects of this Taskforce include;

- It's formation and ongoing funding shows that the government, acknowledges the threat of illicit tobacco;
- It brings together the skills and powers of several Federal agencies that have responsibility in the area of illicit tobacco;
- It attempts to leverage the resources of international counterparts in the region;
- It has increased the rate of seizures at the border as well as detecting illegal tobacco crops domestically.

Despite this increased focus on the illicit tobacco market within Australia, it continues to grow. The 2018 KPMG report into illicit tobacco<sup>b</sup> found a decline in illicit tobacco from 15% to 14.1%. Unfortunately, this still represents a significant loss to Australian small businesses and more than \$2 billion in lost excise revenue to criminal organisations in 2018<sup>1</sup>. Industry analysis of 2019 figures suggests a significant increase in the illegal tobacco market in 2019. In their submissions to the Parliamentary Joint Committee on Law Enforcement Inquiry into Illicit Tobacco, several government agencies highlighted their concerns:

The Australian Tax Office - "The illicit tobacco market is primarily supplied by organised criminal syndicates. The profits which these syndicates make from the sale of illicit tobacco fund their lifestyles and allow them to continue to engage in criminal behaviour well beyond the sale of illicit tobacco."<sup>c</sup>

The Australian Border Force - "Serious criminal actors and organised crime groups make significant profits from the importation and distribution of illicit tobacco in Australia. Australian businesses selling tobacco that complies with legislation are undercut by businesses and individuals selling illicit tobacco at a lower price."<sup>d</sup>

The Australian Tax Office - "Tobacco duty forms a significant component of the final price of tobacco products, and products that enter into home consumption without duty collected can be sold at amounts significantly less than legal tobacco. This price differential creates an opportunity for suppliers of illicit tobacco to supply discounted products that find a ready market while providing a profit."<sup>e</sup>

Police Federation of Australia - "Another issue that is becoming indisputable, is that the high rate of tax on tobacco is making its illegal sale, very attractive to the crime groups who are using the proceeds of illicit tobacco sales to fund other criminal activity. Unfortunately, it is also attractive for dependent smokers, especially those on low incomes, who are unfortunately being drawn into this illegal world. Indeed, many people regard illicit tobacco as almost a "victimless crime". However, given the control exercised by organised crime gangs, it is far from victimless."<sup>f</sup>

Based on RTBA research, improvements could be made to the Australian Government's Taskforce operations to enhance its effectiveness in suppressing illicit tobacco activity, including;

- Acknowledging that regulatory reform, including excise increases, drive illicit tobacco availability;
- Strengthening the widespread use of police powers in all jurisdictions to surveil, covertly monitor and dismantle the organised crime groups involved;
- Pursue the assets accumulated by criminals from this activity more rigorously;
- Compile a comprehensive strategy to harden the supply chain, not only at the border, but along the whole distribution and retail network, and;
- Properly define, coordinate and attack the Federal border responsibilities with the downstream State-based community problems.

The AFP is the agency that is primarily capable of pulling together international cooperation strategies due to their International network of liaison officers and their comprehensive understanding of the nature of global crime and how to prevent and disrupt it. The track record of the Australian Government shows a willingness to invest substantial funding to agencies to help increase their enforcement and compliance efforts, in order to make anti-crime targets and expected tax receipts are realised. Some recent examples of these strategic initiatives include:

1. “Trusts Taskforce”: In the 2013–14 Budget, the government provided \$67.9 million over four years to the ATO for targeted compliance action against people evading tax via trusts<sup>g</sup>. This measure was estimated to increase revenue by \$379 million over the same period, i.e. a projected 5.6 to 1 return on investment. The return outcome, as result of this Taskforce, exceeded optimistic expectations.

2. In 2016, the Australian Tax Office (ATO) received an additional \$678 million over four years, with an expected return of \$3.9 billion over the same period<sup>h</sup>. This funding was provided to create a 1,300-strong taskforce. Again, these figures represented an expected 5.7 to 1 return on investment.

3. Project Wickenby, a fully funded multi-agency taskforce and Australia’s largest tax recovery project, ran for 10 years from 2006. It recouped \$985.7m of the estimated \$2.2 billion in identified tax liabilities and again secured more revenue than it cost to run<sup>i</sup>. There is also evidence proving that Project Wickenby’s work did more than just recoup funds, as its interventions also improved taxpayers’ willingness to comply with their taxation obligations and showed that people in Wickenby’s sights voluntarily lodged more accurate tax returns and paid more tax than they did previously. It could therefore be said that the enforcement action taken by Project Wickenby changed behaviors, deterred potential tax evaders and prevented future revenue losses.

However, Australia has some of the highest tobacco-related taxation rates and relative sales prices (see figure below<sup>j</sup>) in the world, leading to an lucrative attractive market for illicit traders. With further Federal tax hikes announced to go into effect successively over coming years, Australian policy makers would be wise to take the criminal element - and the likelihood of emboldening illicit tobacco activity - into account before implementing such measures.

<sup>a</sup>Australian Border Force. [www.abf.gov.au/about-us/taskforces/illicit-tobacco-taskforce](http://www.abf.gov.au/about-us/taskforces/illicit-tobacco-taskforce).

<sup>b</sup>KPMG. Illicit Tobacco in Australia 2018 Full Year Report. 2019.

<sup>c</sup>Australian Tax Office. Submission: Inquiry into Illicit Tobacco Parliamentary Joint Committee on Law Enforcement. 2019.

<sup>d</sup>Australian Border Force. Submission: Inquiry into Illicit Tobacco Parliamentary Joint Committee on Law Enforcement. 2019.

<sup>e</sup>Office, Submission: Inquiry into Illicit Tobacco Parliamentary Joint Committee on Law Enforcement.

<sup>f</sup>Police Federation of Australia. Submission: Inquiry into Illicit Tobacco Parliamentary Joint Committee on Law Enforcement. 2019.

<sup>g</sup>Australian Tax Office. [www.ato.gov.au/general/trusts/in-detail/compliance/tax-avoidance-taskforce-trusts/www.abf.gov.au/about-us/taskforces/illicit-tobacco-taskforce](http://www.ato.gov.au/general/trusts/in-detail/compliance/tax-avoidance-taskforce-trusts/www.abf.gov.au/about-us/taskforces/illicit-tobacco-taskforce).

<sup>h</sup>Australian Tax Office. [www.ato.gov.au](http://www.ato.gov.au).

<sup>i</sup>Australian Tax Office. <https://www.ato.gov.au/General/The-fight-against-tax-crime/News-and-results/Project-Wickenby-results/>.

<sup>j</sup>KPMG, Illicit Tobacco in Australia 2018 Full Year Report.

#### 4.2.3 Solution: Establishment of Exemplar-Led Anti-Illicit Tobacco Task Forces

Given the scale of cross-border trade in Asia-Pacific, cultivating cross-border cooperation must be treated as the predominant priority for all anti-illicit measures. Aligned enforcement partnerships are essential to the effective control of illegal products flows across jurisdictions, transit points and commercial markets within the supply chain. Reflecting the directives presented in Articles 20-31 of the WHO Protocol<sup>35</sup>, strategic multinational alliances provide a mechanism to facilitate the cooperative effort required for the successful development and implementation of countermeasures.

Building upon the guidance of these relevant Protocol provisions, RTBA recommends the establishment of specialised sub-regional, regional and trans-regional task forces in order to operationalise and coordinate a unified front to tackle the shared illicit tobacco problem. As previously mentioned, individual domestic governments cannot address regional issues - including the trade of illicit tobacco - in isolation, therefore the Task Force model is particularly effective in such a cross-border context. Organised coalitions have the additional benefit of unifying disparate forces around a common objective, thus forming a unified front in tackling the illicit tobacco problem through coordinated international conventions and proven best practices. Task force members - both individuals and organisations - are also able to identify the strengths and limitations of other participating parties, and as a result, can leverage resources to minimise the disparity in relative enforcement capacities. The sharing of specialised expertise and experience in this manner enhances the effectiveness of broader regional control measures, as well as local enforcement responses, especially with leadership of agencies with proven track records of successfully addressing illicit tobacco.

Furthermore, the formation of aligned partnerships encourage multi-level buy-in to regional initiatives, as they provide positive pressure for unhelpful agencies to join participating agencies in dedicating necessary resources to anti-crime efforts. Task Forces are also effective in garnering the support and involvement of regional media, industry stakeholders, relevant NGOs and the broader public in supporting enhanced enforcement and reducing demand - and therefore consumption - of unauthorised products. In this case, positive shifts in the attitudes of civil society are achieved through clear and cogent communication of the risks pertaining to consumer-side participation in the illicit tobacco market.

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<sup>35</sup>Organisation, WHO Protocol To Eliminate Illicit Trade In Tobacco Products.

### 4.3 Key Driver: Border Management, Security and Enforcement Capacity Gaps

Enhancing regional trade has been, and continues to be, a major development priority in Asia-Pacific; driven largely by the efforts of ASEAN & APAC bodies. These ambitious integration initiatives aim to liberalise the movement of goods, services and capital between member countries - and have been largely successful in stimulating rapid fiscal growth and cross-border connectivity. While the loosening of intra-regional barriers through multilateral free trade agreements and substantial infrastructure investments have provided significant economic benefits for regional markets, these same measures have also increased their vulnerability to transnational criminal activity. This phenomena can be attributed to a disproportionate focus on facilitating regional exchange without a parallel commitment of resources to securing expanded trade routes against the influence of unlawful parties.

The evident failure of many regional agencies in addressing the challenges posed by rapid logistical development is underscored by the fact that, while many illicit products - including tobacco - are smuggled through unauthorised trade routes, the majority flows through legitimate infrastructure and transit points. As a result of the dramatic increase in the number of regional ports over recent years, there are now more opportunities for criminal players to covertly trade across borders, and the capabilities of customs authorities to monitor, detect and intercept this illicit trade activity has consequently been stretched. This is particularly true within Free Trade Zones (FTZs), as trafficking networks are most prevalent in these areas due to characteristically vulnerabilities in border management. Organised criminal groups are known to use FTZ as major illicit trade hubs, taking advantage of typically lighter regulations, weaker inspection procedures, inconsistent traceability systems and limited coordination between local and regional law enforcement agencies.

In Asia-Pacific, illicit tobacco traffickers exploit these susceptible trade routes, with major flows moving from 'source' countries (including Vietnam, Thailand, Malaysia and China), through key transit nodes (notably Singapore), to lucrative regional 'destination' markets, including Australia and New Zealand. This trend highlights the importance of robust port security, especially in FTZs, to prevent opportunistic smugglers from usurping integrated logistical networks - meant to enable authorised commerce - to efficiently distribute their goods to large regional markets; at the cost of compromising national security, legitimate trade markets and public health outcomes. Port security is a vital component of the effective prevention of transnational flows of illicit goods, including tobacco products. In Asia-Pacific, the rapid expansion in the number of national points of entry as a result of inter-regional development efforts, has magnified the challenge for law enforcement agencies to monitor and intercept illegal trade activity. Even the most secure customs posts lack the faculty to inspect an adequate quantity of shipments; and therefore are hamstrung in their abilities to detect, seize and prosecute in light of the vast volumes of illicit tobacco products circulating the region. It is well established that criminal organisations seek to exploit weak and inconsistent border controls, with vulnerable land-, sea- and airports a vital component in facilitating the movement of dangerous and restricted cargo between jurisdictions. As a result, black-market interventions for tobacco - extending to other counterfeit consumer goods and narcotics - requires a concerted effort in building robust border control capacities across Asia-Pacific.

It's also worth noting that specific guidance regarding FTZs can be sought through existing legal instruments, such as the OECD Free Trade Zone Standard<sup>36</sup>; which has been agreed by the OECD Council of Ministers and will be implemented by all OECD members. This particular standard procedure is the leading piece of work in the field, encouraging greater transparency and customs controls in Free Trade Zones.

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<sup>36</sup>OECD. Recommendation of the Council on Countering Illicit Trade: Enhancing Transparency in Free Trade Zones. 2019.

### 4.3.1 Case Study: Singapore

Singapore's ports are among the busiest transit hubs in the world, serving -collectively - as an international trade gateway between Asia, Europe and North and South America. Unfortunately, Singapore is also a major node for transnational illicit trade. According to the International Tax and Investment Center (ITIC), "cigarette smuggling syndicates exploit Singapore's system of approximately forty Licensed Warehouses to operate their global smuggling transit systems"<sup>a</sup>. Although Singapore has taken a hard-line stance on illegal behaviour - including corruption - they have yet to prioritise the control of goods, both licit and illicit, flowing through their ports. As a result of the former, Singapore is ranked highly in the Transparency International Corruption Perception Index, however, this assessment does not take into account the negative downstream impacts of Singapore's lax regulations on the crime environment in destination countries; and in reality should score much lower. In the absence of a more circumspect indication of the actual consequences of loose regulation at Singapore's loosely regulated transit points, there is - unfortunately - diluted impetus for assuming accountability taking necessary domestic action to rectify this issue. Singapore's inaction on port regulation was further evidenced in 2017 when the government sought to water down their already weak customs laws; especially so in Asia-Pacific within the context of various regional FTZs. After being roundly criticised by many countries, including the USA, they back-tracked on this plan.

Currently, the majority of search and examination resources of customs agencies in Singapore are dedicated to incoming goods; a structure designed to counter the greatest threats to national security in the form of 'seriously dangerous' goods entering their country. This myopic approach creates vulnerability at the border for goods that are imported and "said" to be transhipped. Those outgoing containers are unlikely to be examined and the risks are passed on to destinations beyond Singaporean borders. The lack of examination of outgoing goods allows criminals to falsify documentation, un-pack and re-pack containers and enter the original goods, including tobacco, into the domestic market. International cooperation is not adequately integrated in that authorities at the arrival location can immediately notify the country of criminal transshipment and as a result, this gap in the supply chain is being exploited by illicit parties in numerous countries.

Although Singapore selectively enforces some elements of the Protocol to Eliminate Illicit Trade in Tobacco Products<sup>b</sup>, as of March 2020, the government is yet to formally ratify it. As such, the compromised transparency of goods being shipped invites criminal permeation and undermines the confidence of foreign businesses will place in the Singaporean system; potentially seeking out alternative, more secure delivery routes. It is therefore in the interest of the Singaporean government and all regional trading partners to securing borders against all manner of illicit flows, including that of tobacco.

<sup>a</sup>International Tax and Investment Center (ITIC). The Illicit Trade in Tobacco Products and How to Tackle It. 2012.

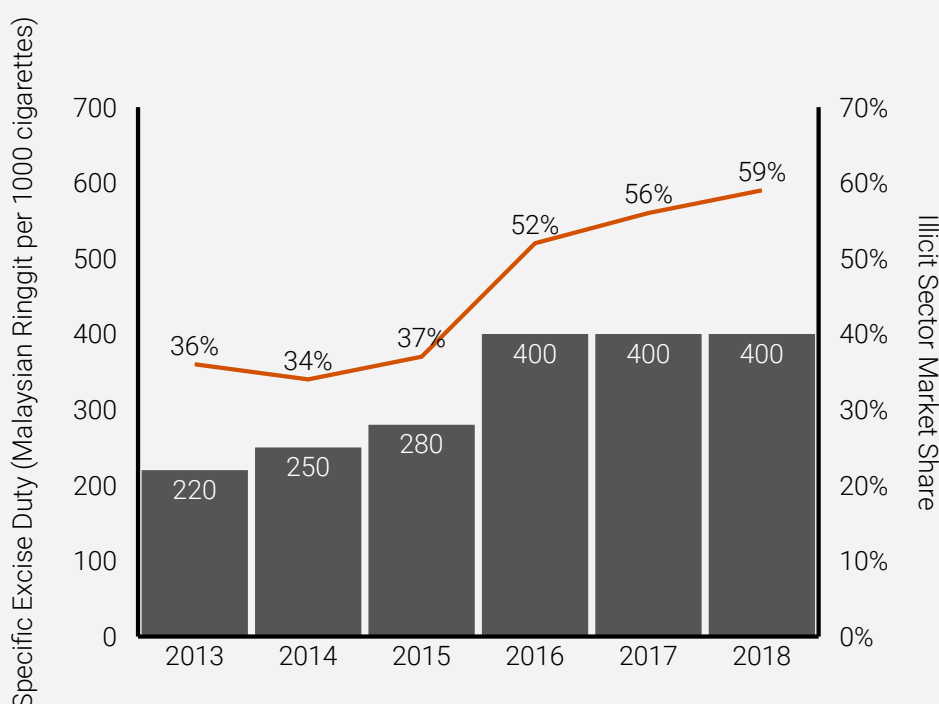
<sup>b</sup>Organisation, WHO Protocol To Eliminate Illicit Trade In Tobacco Products.



### 4.3.2 Case Study: Malaysia

The ubiquitous availability of illegal tobacco through national borders is a key driver behind the prevalent black-market in Malaysia. The large volume of contraband tobacco, primarily in the form of illicit whites, is produced cheaply in surrounding areas and sold into the lucrative domestic market, made so following substantial excise hikes on illicit tobacco in 2015. According to research by Nielson and the Confederation of Malaysian Tobacco Manufacturers, illegal cigarettes comprise an estimated 58.9% of total sales in 2018<sup>a</sup>; making Malaysia the largest consumer of illicit tobacco in the world.

**Figure 9:** Excise Duties and the Evolution of Illicit Trade in Malaysia 2013-2018



Cormac O'Rourke, managing director of JT International Bhd (JTI), has described the current problem of illicit tobacco trade in Malaysia as surpassing crisis levels, and has called for immediate action to curb such activity; "While the Customs Department is tasked with leading the enforcement, the sheer size of approximately 12 billion sticks of cigarette sold annually indicates that more needs to be done and a collective multi-agency approach is now desperately required to improve the situation"<sup>b</sup>.

Much like Singapore, Malaysia's borders are vulnerable to criminal exploitation and nefarious use as key smuggling routes for illicit inflows and outflows, again largely due to an insufficient enforcement capability of customs authorities. Transshipment remains a serious concern for the movement of illicit tobacco through Malaysia, both domestically and regionally, especially given the large number of entry points used to transport illegal products from neighbouring countries including Vietnam, Indonesia and the Philippines<sup>c</sup>. In conjunction with

RTBA's recommendations for banning tobacco transshipment across the whole of Asia-Pacific in the following section, shifting towards appointing a single port for the importation of cigarettes should be a high governmental priority for the effective control of illicit products crossing Malaysia's borders.

<sup>a</sup>Economics, The Economics Of The Illicit Tobacco Trade In Malaysia.

<sup>b</sup>The Star. Malaysia is world No.1 consumer of illegal ciggies. 2019.

<sup>c</sup>Economics, The Economics Of The Illicit Tobacco Trade In Malaysia.

### 4.3.3 Solution: Fortify Law Enforcement Controls At Border Entry Points

Again drawing from the supply-side provisions outlined in the WHO-FCTC<sup>37</sup>, RTBA suggest the implementation of key law-enforcement measures to secure the regional supply chain of tobacco-related products; specifically those detailed in the Protocol. First and foremost, a broad modernisation of customs equipment is required at regional border posts; in regards to both technological capacity and adequate quantities to service the expanded number of entry and exit points. Upgraded detection devices can significantly improve the chances of law enforcement in identifying illicit tobacco products both falsely presented as genuine and/or clandestinely concealed within larger authorised shipments. When coupled with improved customs practices - including identification training for suspicious cargo, the development of risk profiles for targeting inspections and the endowment of greater powers upon agency personnel to confiscate illicit goods, dispose of them, and charge offenders in real-time; the efficiency of law enforcement will be greatly improved at both border points and various stages of the supply chain.

Strengthening regional border control necessitates increased investment in customs-related technology and associated human resources, prioritising the security and enforcement capacities of main trade ports in Asia-Pacific. Among the available solutions, those most effective - as identified by RTBA - include;

- Integrated reporting systems for streamline cross-border communication between 'source', 'transit' and 'destination' countries of black-market goods, whilst simultaneously reducing the impacts of human error common throughout current administrative processes;
- Automated manifest collection and storage processes for relieving the administrative burden on customs officials and reducing the impacts of human error;
- X-ray scanners at key border points for augmenting the capability of customs officials in finding and identifying illicit cargo concealed within shipments, and;
- Track-and-trace platforms, which comply with the Protocol, for verification and visibility tobacco products across the supply chain, from manufacture to importation and purchase.

To ensure successful implementation of these technologies, and facilitate coordinated communication of intelligence between regional agencies, will also require additional training for border security personnel and improvements to customs administration; including securing excise stamps, updating record-keeping procedures and fortifying licensing requirements.

Reductions to duty-free allowances should be applied in order to address the challenges posed by lax restrictions on the volume and frequency regarding the legal importation of tobacco products; a portion of which is on-sold illegally in domestic markets. Particularly in FTZs and SEZs, tightening these limits will have a significant effect on combating smaller-scale tax avoidance in the region. Lastly, banning transshipment of tobacco products and/or enhancing risk-profiling processes regarding transhipped goods can be utilised in order to ensure such cargo is more rigorously examined and accompanying documentation is accurate.

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<sup>37</sup>Organisation, WHO Protocol To Eliminate Illicit Trade In Tobacco Products.

#### 4.3.4 Conclusion

The negative effects of illicit tobacco are significant and widespread across Asia-Pacific; compromising the safety and security of numerous nations, legitimate business sectors and countless consumers. Adequate control of the spreading illicit tobacco trade remains a major challenge in the region, especially given the fragmented and ineffective measures currently in place. As a result, a swift and substantial commitment is required to minimise further harmful impacts and the furtherance of organised criminality. In order to tackle both the supply and demand of illicit tobacco products, RTBA has identified the following as immediately-executable, strategic recommendations for regional governments:

1. Appropriately recognise the size, nature and urgency of the illicit tobacco problem;
2. Enhance enforcement capacity and increase punitive powers of relevant agencies;
3. Increase international cooperation and intelligence sharing capabilities;
4. Establish national/regional strategies and legislative measures to curb illicit trade;
5. Strengthen vulnerable border points and secure inter-regional supply chains;
6. Commit to implementing sustainable fiscal measures regarding tobacco, and;
7. Establish dedicated task forces to drive and lead enforcement campaigns.

Given the transnational nature of illicit tobacco activity, it's imperative for policy makers, law enforcement agencies and legal tobacco businesses to employ such measures in lockstep. The trade of illicit tobacco is a common adversary of all countries in Asia Pacific, but as this report has highlighted, it can be successfully confronted by a concerted, coordinated and sustained response; and the threats posed to public health outcomes, national economies, tax revenues and vital governance can be swiftly mitigated.

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