An Exploratory Review of Illicit Tobacco Trade in the Netherlands

Patricia Loubeau Dr. PH.
Fulbright Fellow University of Maastricht and
Professor of Marketing and International Business
Iona College
New Rochelle, NY
Colophon

© 2015, Alliantie Nederland Rookvrij

Reproduction allowed with reference:

ISBN: 978-90-823396-1-1
Preface

The topic of illicit tobacco trade is an important one for tobacco control. The volume of legal and illegal transport of tobacco products across borders has all sorts of implications for the effectiveness of national tobacco policy. Probably the one that stands out is the question how changes in tobacco taxes impact tobacco consumption and hence on the population’s health, and to what extent this might be undermined by illegal tobacco trade. The tobacco industry is known to use the illegal trade argument to prevent extensive tax increases. The issue is politicized, because of the tremendous economic and financial interests that the tobacco industry has with any change in national tobacco policy. It is all the more important to look for good science when we want to know the answer to the question how ‘big’ the problem of illegal tobacco trade is for Dutch tobacco policy. The report comes at a good moment, since the World Health Organization has selected illicit tobacco trade as the theme for the World No Tobacco Day 2015.

It is also an extremely complicated topic. I was therefore excited that Professor Patricia Loubeau, from Hagan School of Business, Iona College, New Rochelle, New York, was awarded a Fulbright Fellowship at our University and indicated that she wanted to work on this important topic. Professor Loubeau had experience with reviewing national tobacco policies in Europe, and wrote a book on tobacco control efforts in the transitional economies of Bulgaria, Romania, Greece and Croatia. Her appointment in the Netherlands put a limelight on the Dutch peculiarities surrounding illegal tobacco trade. I have always strongly believed that when someone who comes from a different culture and background takes a closer look at what is happening in your country, that this will yield many interesting and surprising findings that might be overlooked when the study was done by ‘insiders’.

When Professor Loubeau started her work for this report on illegal tobacco trade in the Netherlands, she began her research with a curious mind, completely open to what she would find. In a relative short period of time, she was able to discover and process an enormous amount of data, both from existing databases and the literature, and from interviews with key informants in the Netherlands and abroad. The resulting report is of tremendous value to put the issue of illegal trade in the Netherlands into perspective. One of the lessons is that smuggling of genuine tobacco products in the Netherlands does not appear to be a large problem. Of additional value are the many suggestions that Professor Loubeau makes for further research, which will hopefully initiate more research into this important area.

Prof. Marc Willemsen, PhD

Department of Health Promotion, Maastricht University, the Netherlands

Dutch alliance for a smokefree society, the Netherlands
## Contents

Abbreviations ........................................................................................................... 5

1. Introduction ............................................................................................................. 6

2. The Evolution of Illicit Trade .................................................................................. 7

3. The Extent of the Problem ....................................................................................... 12

4. Characteristics or Schemes Used to Evade Taxes .................................................... 24

5. Review of the Key Issues Related to Illicit Trade .................................................... 28

6. Policy Options to Combat Illicit Trade ..................................................................... 46

7. Areas for Future Research ....................................................................................... 55

8. Conclusion ............................................................................................................... 57

Appendix A: Interviews Conducted ............................................................................ 58
## Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ANPRS</td>
<td>Automated Number Plate Recognition System</td>
</tr>
<tr>
<td>BAT</td>
<td>British American Tobacco</td>
</tr>
<tr>
<td>CAGR</td>
<td>Compound Annual Growth Rate</td>
</tr>
<tr>
<td>EPS</td>
<td>Empty Pack Surveys</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>FCTC</td>
<td>Framework Convention on Tobacco Control</td>
</tr>
<tr>
<td>FIOD</td>
<td>Fiscal Intelligence and Investigation Service (<em>Fiscale Inlichtingen- en Opsporingsdienst</em>)</td>
</tr>
<tr>
<td>FTA/CPA</td>
<td>Excise Fraud Team/Excise Fraud Co-ordination Group (<em>Fraudeteam Accijns/Centraal Punt Accijns</em>)</td>
</tr>
<tr>
<td>JTI</td>
<td>Japan Tobacco International</td>
</tr>
<tr>
<td>ND(L)</td>
<td>Non-Domestic (Legal)</td>
</tr>
<tr>
<td>OLAF</td>
<td>European Anti-Fraud Office (<em>Office Européen de Lutte Antifraude</em>)</td>
</tr>
<tr>
<td>PMI</td>
<td>Philip Morris International</td>
</tr>
<tr>
<td>SES</td>
<td>Socioeconomic Status</td>
</tr>
<tr>
<td>TTC</td>
<td>Transnational Tobacco Company</td>
</tr>
<tr>
<td>UK</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>US</td>
<td>United States</td>
</tr>
<tr>
<td>UAE</td>
<td>United Arab Emirates</td>
</tr>
<tr>
<td>VAT</td>
<td>Value Added Tax</td>
</tr>
<tr>
<td>WAP</td>
<td>Weighted Average Price</td>
</tr>
</tbody>
</table>
1. Introduction

The illicit trafficking of tobacco is a multibillion-dollar business. It undermines health objectives, imposes additional strain on national health systems, and weakens tax measures designed to decrease cigarette consumption. It also leads to substantial revenue losses to governments and generates financial profits for illegal traders. Article 15 of the World Health Organization (WHO) Framework Convention on Tobacco Control (FCTC) lays out specific responsibilities for signatory governments with respect to tobacco control and illicit trade. Specifically, countries are required to monitor and collect data on cross-border trade in tobacco products including illicit trade, enact or strengthen legislation against illicit trade in tobacco, destroy confiscated counterfeit or contraband tobacco, and adopt and implement measures to monitor and control the distribution of tobacco products. In April 2012, more than 135 Parties agreed on the text of a protocol as a supplement to Article 15 of the FCTC. The Netherlands signed the Protocol to Eliminate Illicit Trade in Tobacco Products on January 6, 2014, three days before it closed for signature. As of 9 January 2014, the Protocol had been signed by 53 states and the European Union (EU). The Protocol will come into force 90 days after the ratification by forty Parties.

The Protocol, which builds upon and supplements Article 15, sets the rules for combating illicit trade in tobacco products through control of the supply chain. It also establishes what constitutes unlawful conduct and sets out related enforcement and international cooperation measures. Under the Protocol, the Parties agreed to establish tracking and tracing for tobacco products and reached agreement on other measures, such as licensing, liability, enforcement, information sharing, and mutual legal assistance.

This exploratory review looks at the current status of illicit tobacco trade in the EU with particular emphasis on the illicit tobacco trade in the Netherlands. The paper discusses the types of illicit trade activities, examines the extent of the problem and enumerates possible solutions. The review is based on publicly available reports and documents, the scientific literature and interviews with stakeholders of the issue. Appendix A outlines the interviews conducted.
2. The Evolution of Illicit Trade

The chief form of illicit trade was at one time smuggling. Merriman defines smuggling as the evasion of excise taxes on goods by circumvention of border controls. Smugglers, like other businessmen, operate to make a profit. Price differentials enable smugglers to profit by purchasing tobacco products in low price markets and reselling them in markets where prices are higher. Through European law enforcement efforts coupled with the policies and technologies of tobacco manufacturers the amount of genuine product, which enters the EU through contraband channels, has been reduced. The problem of counterfeit products and illicit whites (tobacco products that are legally produced in a market primarily to be smuggled into another market) however, has increased.

Illicit trade is now a much broader issue than smuggling. The WHO FCTC 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” (Article 1.a). This illicit trade is characterized by large-scale smuggling, bootlegging, or tax avoidance strategies.

Large-scale smuggling

Large-scale smuggling involves the illegal transportation, distribution and sale of large consignments of cigarettes and other tobacco products. It takes advantage of the temporary suspension of customs duties, excise and other taxes on goods destined for export to a third country. Once transported beyond tax and border controls, smuggled tobacco is generally offered for retail sale in informal markets. Methods for retailing smuggled tobacco vary depending upon the country and the group involved. Contraband cigarettes can be sold either openly or through clandestine networks. In Croatia, smuggled cigarettes are often openly sold by men in public markets and local carrefours as well as in pubs and restaurants. In the Netherlands, the selling of illicit tobacco products is more on a covert basis.

On a practical basis, large-scale smuggling takes advantage of an “in transit” status which allows cigarettes to be sold and shipped for export to non-EU countries with taxes suspended. These untaxed cigarettes never leave the EU, or are properly exported only to be illegally re-imported.

---

**Bootlegging**

Bootlegging is the legal purchase of tobacco in one country but consumption or resale in another country without paying applicable taxes or duties. Joossens *et al* (2000) provide a clear description: In general, bootlegging involves transporting cigarettes over relatively short distances (e.g., between neighboring countries or other nearby jurisdictions). As with the legal activities, significant price differentials between jurisdictions create incentives for bootlegging. In addition, greater corruption reduces the risks associated with bootlegging. Bootlegging is also referred to as small-scale smuggling or mom-and-pop schemes. Although bootlegging is a serious problem, the wholesale transit fraud of large scale smuggling dominates the market for illicit tobacco.

**Legal tax avoidance strategies**

Joossens *et al* (2000) categorize a number of types of legal tax avoidance, including legal cross-border shopping, legal tourist shopping and legal duty-free sales.³ The smoker’s incentive for this type of cross-border shopping depends heavily on the differences in taxes and prices between neighboring tax jurisdictions, the distance the individual lives from the lower-priced area, and the costs of traveling between the two. In practice, it is unlikely smokers are willing to travel long distances at high cost in order to achieve relatively modest amounts of tax savings. According to the World Bank, it is more likely that much of the cross-border shopping in cigarettes occurs when smokers are already across the border for other reasons.³ This strategy is not technically considered illicit trade unless the quantities or frequency exceeds national limits.

Illicit cigarettes that are seized are generally classified in one of three ways: genuine cigarettes that are produced by multi-national manufacturers which are smuggled into the EU (contraband), “illicit or cheap whites” or counterfeit cigarettes.

**Counterfeiting**

The Financial Action Task Force defines counterfeit cigarettes as a product which is an identical copy of a branded product and packaging that is manufactured by parties that do not have the relevant intellectual property rights authorizing them to manufacture such branded products. These products are illicit at the point of production because they have been manufactured without the authorization of the legal brand

---

Counterfeit cigarettes bear a trademark without the consent of the owner of the trademark. In the case of counterfeiting, the holder of the brand name is victimized and in the case of the buyer, if he is unaware of the counterfeit nature of the product, then from a legal, technical perspective, he is a victim of fraud too. In the case of counterfeit cigarettes, the smoker is usually aware of the counterfeit nature of the product as differences in taste and aroma can be detected.

Partially in response to tighter controls on the trade of legally manufactured cigarettes, there has been a serious growth in counterfeit cigarettes. Also, in the late 1990s the Chinese obtained the technology to reproduce the protective holograms on packs of the top of Western cigarette brands. It has been stated that Chinese counterfeiters can mimic Marlboro holograms to perfection.5

China is still the biggest source of counterfeit cigarettes. In 2013, EU Member States reported that 42.8% of counterfeit cigarette seizures entering the EU were from China followed by 36% from the United Arab Emirates (UAE) and 8% from Moldova.6 Interestingly, in the previous year’s report, the EU Member States reported that 76% of seizures of counterfeit cigarettes were from China.7 This may illustrate the vagaries of using seizure data for assessing the volume of trade in illicit cigarettes. Counterfeit cigarettes also come from countries on the eastern border of the EU such as Russia, Belarus and the Ukraine. Many illegal factories have also been discovered within the EU Member States.8 According to Howard Pugh, Project Manager Analysis Work File Smoke at EUROPOL, who on January 22, 2014 testified at the committee meeting for the Department of Budgetary Affairs, “organized crime groups can set up an illegal factory for 6-700,000 euros and the first lorry that leaves the factory pays the outlay”.9 This is reiterated

---


by Calderoni (2014) who states that “according to experts, for instance, the counterfeiting of cigarettes yields profits 40 times the capital invested”.

Of all the categories of counterfeit items in the EU, the top categories of articles detained were cigarettes which accounted for 30.86 % of the overall amount. The retail value of cigarettes seized was €54,274,563. As in former years, of all the counterfeit items smuggled in the EU in 2012, the chief country of provenance and value was China. With respect to the Netherlands, the number of cases remained approximately the same as the prior year at 1852 while the number of intercepted articles between 2011 and 2012 went from 5,086,932 to 1,966,380 - a 61% decrease.

Counterfeit cigarettes are of special concern in the public health arena because they do not follow the same regulatory standards as cigarettes from legitimate manufacturers and there is no regulatory agency monitoring of the levels of tar and nicotine. A number of studies have explored the contents of counterfeit cigarettes. Pappas et al (2007) analyzed 21 different counterfeit samples and suggest that counterfeit cigarettes potentially result in a markedly greater exposure to toxic heavy metals than authentic brands, even after correcting for differences in nicotine intake. Campbell reports that “counterfeit tobacco has also been found to contain arsenic, rat droppings and far more tar and carbon monoxide than legal products”. Research conducted in the Netherlands by the Dutch National Institute for Public Health and the Environment (RIVM) demonstrates that counterfeit cigarettes contain cadmium levels that are five times higher and lead levels that are six times higher than in genuine cigarettes. The Marlboro brand continues to be the major target for counterfeit production.

“Illicit whites”
Non-transnational tobacco company cigarettes that are legally produced but have no legitimate market. These cigarettes, are also known as “cheap whites”. According to the Illicit Trade Report 2012, most of these “cheap whites” are legally produced in the source country and the usual sale to the first purchaser

---

Nevertheless, the overall cigarette consumption at national level does not correspond to the volume of production. Subsequent purchasers of these cigarettes then smuggle the products into the country of destination, often using elaborate routings, to disguise the true source and country of departure of the shipment. Some common brands of cheap whites are “Jin Ling,” “Gold Classic”, “Palace” and “Raquel”. It is now believed that the illicit cigarette market is now dominated by “illicit whites” and counterfeit cigarettes.

According to the proceedings of the Workshop on Cigarette Smuggling at the European Parliament in January 2014, the most seized cigarettes in the EU are Marlboro (it is not known whether the Marlboro cigarettes were smuggled or counterfeit), Jin Ling and Classic.\(^\text{16}\) Jin Ling is a Russian brand of cigarettes produced by Kaliningrad-based manufacturer Baltic Tobacco Company. Jin Ling has no legal market and does no advertising. It is designed to resemble the American brand Camel in color, typeface and layout but it has a picture of a mountain goat instead of a camel on the pack. Jin Ling cigarettes are only produced illegally and are designed explicitly for smuggling. Reportedly Jing Ling cigarettes are sold to smugglers for 20.5 United States (US) cents per pack.\(^\text{17}\)


3. The Extent of the Problem

Cigarettes are a highly taxed commodity; therefore, they are also one of the world’s most commonly smuggled goods.\(^\text{18}\) Goods that are smuggled are most often transformed in some way or like alcohol and tobacco, are consumed. This makes tracking and data collection more complicated. Cigarettes are a prime commodity for smuggling given their small size, high price, addictive nature, very large consumption and high import taxes. On a global and EU level, cigarettes constitute by far the biggest part of seizures of tobacco products.

In scientific literature, scholars who have examined cigarette smuggling and trafficking suggest that there are four main factors for the emergence of the black market and the trade: (1) the difference between duty-free and the legal retail prices; (2) the differences in retail prices among jurisdictions due to differing levels of taxation; (3) the existence of corruption in society as well as customs officials and the long term involvement of organized crime groups in the cigarette trade; and (4) the willingness of cigarette companies to collude in or overlook the smuggling of cigarettes.\(^\text{19, 20, 21}\) Other factors which influence illicit cigarette penetration include borders, trade routes, tourism flow, immigration, consumer tastes, culture and tradition. Smokers of illicit cigarettes tend to be older less-educated males living in rural areas.

Given the possible illicit nature of tobacco trade and the absence of academic studies or official comparable government data, the extent of the global problem is difficult to estimate. Additionally, the topic does not lend itself to reliable and readily available data collection. Various estimates have been offered on the extent of the illicit tobacco problem. The estimates vary greatly in terms of rigor and in the measures used. The extent of the illicit trade problem can be described in a number of ways but most commonly in terms of revenue lost or as a percentage of the total cigarette market. These figures are derived primarily in one of two ways: either based on seizure data or on empty pack surveys (EPS). Data from seizures and EPS provide useful information on the origin of illicit products, but are unreliable for measuring the level of illicit cigarette trade in the EU. Seizure data provide an indication of the trends in the illicit market but they cannot be used to accurately make estimates of the market because they do not take into account the efficiency, number and intensity of law enforcement activities to seize cigarettes, nor the illicit trade of small consignments.

The most quoted and referenced EPS data is the KPMG Project Star survey. KPMG has been contracted since 2005 by Philip Morris International (PMI) to make an independent assessment of the size of the illicit tobacco products trade market in the EU as part of their cooperation agreement with the European Commission and the Member States. The Project Star data has been viewed with a jaundiced eye by much of the scientific community as the report was commissioned to meet the specific terms of reference which are only known to PMI and KPMG. Others, such as the International Tax and Investment Center note that the KPMG study is a good example of a study that “captures the most accurate overall picture”. According to Campaign for Tobacco-Free Kids, the International Tax and Investment Center is funded by major multinational corporations including all of the leading transnational tobacco companies.

Quantitative consumer interviews have also been used to ask consumers if they smoke contraband cigarettes. There is extensive evidence that smokers tend to underreport their smoking levels and underestimate their usage of illicit products. This is particularly true as smoking becomes more and more denormalized. When Salvatore Catania, Head of the Tobacco and Counterfeit Goods Unit at the European Anti-Fraud Office (OLAF), was asked which method he uses to determine the extent of illicit trade, he commented that “officers on the street know what is going on”.

The most robust and developed methodologies combine several of the approaches. It cannot be emphasized strongly enough that there is no completely reliable data about the extent of the illicit tobacco trade.

**Global illicit trade**

According to the Fourth Edition of the Tobacco Atlas, the share of illicit trade in the global cigarette market (estimated 9-11%) has remained relatively stable since 2000. On average, the percentage is significantly higher in low- and middle-income countries than in high-income countries. Joossens et al. (2010) recently updated global estimates of the illicit cigarette trade based on formal and informal sources. According to their estimates, the size of illicit trade varies between countries from 1% to about

---


24 Personal interview with Salvatore Catania, Head of the Tobacco and Counterfeit Goods Unit, OLAF. Brussels, Belgium. February 27, 2014.

40-50% of the market. It is estimated to amount to 11.6% globally, to 16.8% in low-income countries and to 9.8% in high income countries.\textsuperscript{26}

Marlboro remains the most seized brand. It is also the brand most often counterfeited.

\textbf{EU illicit trade}

In the EU, the freeing up of border controls as well as the Schengen agreement have enabled far freer passage for smugglers and bootleggers while liberalization of trade and transport also fosters illicit trade. The EU has estimated that around 10 billion euro are lost to the national and EU budgets each year due to the smuggling of both genuine and counterfeit cigarettes.\textsuperscript{27}

Customs Control in the EU on average inspects about 2% of all containers.\textsuperscript{28} On a single 40 foot container of smuggled cigarettes (10 million cigarettes) the average loss of customs duty, excise duty and value added tax (VAT) is € 1.5 million. In the United Kingdom (UK) the loss would be about three times as big because of the UK’s higher taxes.\textsuperscript{29} The loss in 2013 of the same 40 foot container (10 million cigarettes) in the Netherlands would result in a tax revenue loss of € 2,220,426 (calculation based on a total tax percentage in 2013 of 83.91% and a Weighted Average Price (WAP) of 264.62 per 1000 cigarettes).

According to Martin Banks (2013), as noted in Havoscope, Global Black Market Information, criminal smuggling gangs in the EU sell an estimated 65 billion cigarettes without the payment of taxes. The amount of contraband cigarettes sold by smugglers is equal to 10 percent of the entire tobacco market in the EU.\textsuperscript{30} Salvatore Catania, Head of the Tobacco and Counterfeit Goods Unit at OLAF, notes that currently, the counterfeit and “illicit whites” are increasing in the EU with the “illicit whites” category growing at a faster rate than counterfeit cigarettes.\textsuperscript{31} This is confirmed by the World Customs Organization, noting that, for global tobacco smuggling, seizure figures for “cheap whites” showed a

\textsuperscript{31} Personal interview with Salvatore Catania, Head of the Tobacco and Counterfeit Goods Unit, OLAF. Brussels, Belgium. February 27, 2014.

Seizures are primarily a function of law enforcement activities and should be viewed as trend data. The following table outlines the OLAF seizure data for the period 2007-2012:

<table>
<thead>
<tr>
<th>Year</th>
<th>Billion cigarettes</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>4.8</td>
</tr>
<tr>
<td>2008</td>
<td>4.6</td>
</tr>
<tr>
<td>2009</td>
<td>4.7</td>
</tr>
<tr>
<td>2010</td>
<td>4.7</td>
</tr>
<tr>
<td>2011</td>
<td>4.4</td>
</tr>
<tr>
<td>2012</td>
<td>3.8</td>
</tr>
</tbody>
</table>


For comparison, the following table outlines the KPMG Project Star data for the same period:

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>8.4</td>
</tr>
<tr>
<td>2008</td>
<td>8.6</td>
</tr>
<tr>
<td>2009</td>
<td>8.9</td>
</tr>
<tr>
<td>2010</td>
<td>9.9</td>
</tr>
<tr>
<td>2011</td>
<td>10.4</td>
</tr>
<tr>
<td>2012</td>
<td>11.1</td>
</tr>
</tbody>
</table>


The KPMG Project Star data shows an increase of 30% over a six year period while the cigarette seizure data showed a decrease of 21% over the same six year period. In summary, based on seizure trends, the problem of illicit cigarettes in the EU is decreasing and based on EPS financed by PMI, illicit trade is increasing. This comparison illustrates the problem of obtaining accurate trend data on the extent of illicit trade in the EU.
If one looks at percentages, the KPMG Project Star Report 2012 estimated 8.4% illicit consumption for 2007, 8.6% for 2008, 8.9% for 2009, 9.9% for 2010, 10.4% for 2011 and 11.1% for 2012. There is a wide range for the percentage of counterfeit and contraband consumption incidence by country in 2012. Slovakia (0.8%), Luxembourg (2.0%), Denmark (2.4%), and Portugal (2.8%) all are at the low range. Latvia (30.7%), Lithuania (27.5%), Iceland (19.1%), Ireland (19.1%), and Estonia (19.7%) are all at the high end. Germany (11.1%), Sweden (11.9%), and the Netherlands (11.0%) are all in the middle of the range.

**Netherlands illicit trade**

The major players in the Netherlands tobacco market are British American Tobacco (BAT), PMI, Imperial Tobacco Group, and Japan Tobacco International (JTI). BAT is the leading player in the market generating a 34.1% share of the market’s value followed by PMI with a 22.6% share. Within the cigarette category, PMI has the highest volume share.

Data on the illicit share of the total cigarette market in the Netherlands varies. The KPMG Project Star Report 2012, commissioned by PMI, notes that, in 2012, in the Netherlands, counterfeit and contraband cigarettes represented 1.64 billion cigarettes out of a total consumption of 14.94 billion cigarettes. This was a 4% increase from 2011. The study further reports that Non-Domestic (legal) (ND(L)), product that was brought into the Dutch market legally by consumers, such as during a cross border trip, increased from 1.41 billion to 1.55 billion or a 10% increase in 2012.

For comparison, neighbor Germany’s counterfeit and contraband cigarettes represented 11.47 billion cigarettes which was an 18% decrease from 2011. The study further reports that ND(L) increased from 8.62 billion in 2011 to 9.50 billion or a 10% increase in 2012.

Neighbor to the South, Belgium had less counterfeit and contraband cigarettes than the Netherlands with 0.88 billion cigarettes in 2012 compared to 0.71 billion in 2011 or a 24% increase. Their share of ND(L) also increased from 0.76 in 2011 to 0.81 billion (7% increase) in 2012.

The KPMG report has been criticized in a number of areas. It has been noted that KPMG followed the terms of PMI in collecting the data and not of the EU Member States, so there was little transparency over the methodology. A review of the KPMG Project Star Report 2012 by Gilmore *et al* raises concern

---

33 KPMG (2013, April 16). Project Star 2012 Results. KPMG LLP.  

34 KPMG analysis based on EPS, Sales of genuine domestic product through legitimate, domestic channels based on Market Sales data and Non-Domestic (legal) research.


37 KPMG (2013, April 16). Project Star 2012 Results. KPMG LLP.  
about the methodologies underlying the data inputs and thus their quality and they suggest that, compared to independent data, Project Star overestimates illicit cigarette levels, particularly where cross-border shopping is frequent.\(^{38}\) With respect to the Netherlands, the percentage of counterfeit and contraband cigarettes and ND(L) remains relatively low compared to much of the rest of the EU.

KPMG recently responded in *Tobacco Control* to the criticisms by Gilmore *et al* (2014) of their report. Fundamentally, they state that the comment that they overstate the extent of illicit tobacco trade is inaccurate as their estimates since 2005 “have correlated within a range given by other organizations, including the UK National Audit Office, Euromonitor, Joossens, and the [International Agency for Research on Cancer], amongst many others”.\(^{39}\)

Aware of the criticisms of data collection using the EPS, the Dutch Tax and Customs Administration has recently attempted to measure illicit trade in the Netherlands using the EPS method yet trying to avoid some of the biases of the KPMG Project Star Report. They found that the percent of illicit tobacco trade in the Netherlands is approximately 11%.\(^{40}\)

Using cross-sectional data from the 2008 International Tobacco Control survey of adult smokers, Nagelhout *et al* (2013) reported that in the Netherlands 2.4% of smokers acknowledged frequent cross-border shopping for cigarettes.\(^{41}\) It is interesting to note that cigarette prices in the Netherlands at that time were €4.63 compared to €4.71 and €4.16 in neighboring Germany and Belgium. This study did not distinguish between legal tax avoidance and illegal tax evasion because the quantities of cigarettes were not ascertained nor was the origin of the purchased tobacco asked from the respondents.

Cross-border shopping can be influenced by a number of factors including regulatory limits, spatial distances, cost of fuel, whether the purchase is deliberate or incidental to other activities such as business or vacation, and language barriers. In the EU, products purchased for individual use by private individuals are subject to excise duty only in the Member State in which they were acquired. Whether or not cigarettes are transported for private use is determined by a set of criteria, including the quantities involved.\(^{42}\) By guideline, persons who travel from another country in the EU to the Netherlands are allowed to bring in up to 800 cigarettes for personal use. Representatives of Dutch customs indicated that


\(^{40}\) Personal interviews with Tax and Customs Administration of the Netherlands / FIOD employees: Peter van den Beukel, Richard Geleijnse, Bert Kok, and Rien van de Kuilen. Rotterdam. March 21, 2014.


there is a very low prosecution rate of individuals who exceed this limit. In general, Dutch customs does not focus a great deal of effort on cross-border ant smugglers. They cite the following example: “if a car is stopped and the quantity of cigarettes exceeds the 800 cigarette amount, if they are all the same brand, if the driver has yellow fingers from chronic smoking and states that the cigarettes are for his personal use, then he is generally left to pass unabated”.\textsuperscript{43} It would only be a serious customs issue if the quantity greatly exceeded the 800 cigarettes limit and there were a variety of brands in the vehicle indicating that they may be for resale.

Dutch customs manpower is limited. About 20,000 checks per year are conducted. These checks involve checks at night shops, water pipe tobacco shops and stopping cars among others. According to Dutch customs officials, only 1% of these checks turn up illicit cigarettes.\textsuperscript{44}

In the Netherlands, close cooperation exists between Customs, the Fiscal Intelligence and Investigation Service (FIOD), the Dutch Coast Guard and the police to detect and reduce the amount of illicit trade in cigarettes. Data on seized cigarettes at the national level is collected by Customs and FIOD as part of the Excise Fraud Team/Excise Fraud Co-ordination Group (FTA/CPA).

The following table illustrates the seizure results of their efforts over the past five years:

\begin{table}[h]
\centering
\begin{tabular}{|l|c|}
\hline
Year & Number of cigarettes (x 1,000,000) \\
\hline
2009 & 210 \\
2010 & 132 \\
2011 & 83 \\
2012 & 62 \\
2013 & 102 \\
\hline
\end{tabular}
\caption{Dutch seizures of cigarettes from 2009-2013.}
\end{table}


In 2013, 102,740,487 cigarettes were seized in the Netherlands. If these cigarettes had been introduced into the Dutch market, the Dutch government would have suffered a loss of 20.8 million euro (excise and VAT) from lost taxes. Of this number, 101,538,520 cigarettes result from 21 major seizures. Small shipments accounted for 1,201,967 cigarettes that were seized by Customs without FIOD intervention. These shipments do not meet the notification, transaction and prosecution guidelines and do not qualify for criminal investigation.\textsuperscript{45} They are not included in the following table, which contains information about the destination, origin and type of cigarettes in major seizures:

\begin{table}[h]
\centering
\begin{tabular}{|l|c|}
\hline
Year & Number of cigarettes (x 1,000,000) \\
\hline
2009 & 210 \\
2010 & 132 \\
2011 & 83 \\
2012 & 62 \\
2013 & 102 \\
\hline
\end{tabular}
\caption{Dutch seizures of cigarettes from 2009-2013.}
\end{table}


\textsuperscript{43} Personal interview with Peter van den Beukel, Team Manager Enforcement, Tax and Customs Administration of the Netherlands. Rotterdam. March 21, 2014.

\textsuperscript{44} Personal interview with Richard Geleijnse, Tax and Customs Administration of the Netherlands. Rotterdam. March 21, 2014.

According to FIOD reports, there is a clear shift from seaside to inland compared to previous years. This may mean that more cigarettes are smuggled into the Netherlands through the inland borders in addition to or in lieu of through the ports.

The following table details the breakdown of the type of seized cigarette in the Netherlands in 2013:

**Table 4: Division of 2013 major cigarette seizures into airside, landside, and seaside.**

<table>
<thead>
<tr>
<th>Division</th>
<th>Quantity of cigarettes</th>
<th>%</th>
<th>Number of seizures</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Airside*</td>
<td>70,000</td>
<td>0.0</td>
<td>1</td>
<td>4.8</td>
</tr>
<tr>
<td>Inland</td>
<td>71,159,000</td>
<td>70.1</td>
<td>15</td>
<td>71.4</td>
</tr>
<tr>
<td>Seaside</td>
<td>30,309,520</td>
<td>29.9</td>
<td>5</td>
<td>23.8</td>
</tr>
<tr>
<td>Total</td>
<td>101,538,520</td>
<td>100.0</td>
<td>21</td>
<td>100.0</td>
</tr>
</tbody>
</table>

* The airside figures involve airfreight. Passengers’ luggage and parcel post by air are not included.

**Source:** FIOD, Tax and Customs Administration of the Netherlands (2014). Annual Report 2013.

What is particularly surprising is that only 0.6% of all seized cigarettes in 2013 were genuine product. The implication here is that, at least during this time period, there was very little smuggling of transnational tobacco company (TTC) products.

As elsewhere in the EU, the problem of illicit whites in the Netherlands is growing and now represents 83% of all seized cigarettes. Of all the cigarettes that were seized, 7% were destined for the UK and 10% for Ireland. Only 6% of cigarettes seized were destined for the Netherlands.46

FIOD and Customs also keep statistics on the origin of the seized cigarettes. Table 6 outlines this information.

---

Twenty-two percent of seizures were from unknown origin. Customs reports that these seizures were mainly from warehouses where no transportation documents were found so the origin cannot be traced. Table 5 and 6 viewed in tandem reveal an interesting point. It is known that in general a very large percentage of illicit whites are produced in the UAE. Therefore, it is noteworthy that in a proportion of 83% of seized illicit whites only 20% is shipped directly from the UAE. This means that a large quantity of illicit whites are smuggled into the Netherlands via other countries. Seizures of “unknown origin” are when seizures are from a warehouse where no transportation documents were found so the origin cannot be traced.

The following table outlines the brand of seized cigarettes in the Netherlands in 2013:

Eight out of the top 10 brands are illicit whites. This would confirm the finding that most of the current problem in the Netherlands is illicit whites as opposed to counterfeit cigarettes or cigarettes from the

Table 6: Origin of seized shipments in the Netherlands in 2013.

<table>
<thead>
<tr>
<th>Origin</th>
<th>Quantity of cigarettes</th>
<th>%</th>
<th>Number of seizures</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>22,724,800</td>
<td>22.4</td>
<td>3</td>
<td>14.3</td>
</tr>
<tr>
<td>Asia (ex. UAE)</td>
<td>21,989,520</td>
<td>21.7</td>
<td>4</td>
<td>19.0</td>
</tr>
<tr>
<td>UAE</td>
<td>20,310,000</td>
<td>20.0</td>
<td>3</td>
<td>14.3</td>
</tr>
<tr>
<td>Others</td>
<td>14,654,000</td>
<td>14.4</td>
<td>4</td>
<td>19.0</td>
</tr>
<tr>
<td>Unknown</td>
<td>21,860,200</td>
<td>21.5</td>
<td>7</td>
<td>33.3</td>
</tr>
<tr>
<td>Total</td>
<td>101,538,520</td>
<td>100.0</td>
<td>21</td>
<td>100.0</td>
</tr>
</tbody>
</table>

TTCs. Only More (JTI) and Marlboro (PMI) are trademarked cigarettes of one of the four major producers. Upon examination, most of those cigarettes proved to be counterfeit.

While in the past, the UAE appeared mainly as a point of transshipment, current information points to its new role as an important production location for other brands.47 The top brand seized in the Netherlands is Richman which is produced in the UAE. Similarly, Marble and Gold Mount are also UAE produced cigarettes.

A note of caution is advised when interpreting data and basing assumptions on data arrived at from seizures of cigarettes. Given that the number of seizures can be relatively small yet the quantity of cigarettes seized can be large, data can be skewed by a few additional or fewer seizures of any type.

Generally there are three types of countries in the illicit trade process: source countries of illicit cigarettes, countries that are mainly transit routes and destination countries. Mixed countries can be found in more than one of these categories. A country such as the Netherlands can be a destination country, a source country and a transit country for illicit trade.

- Press releases and anecdotal cases are definitely not the best source for information on how smuggling activities are organized. However, even a brief survey of the seizures contained in the popular press provide some information about the country of origin and destination together with nationalities of persons involved. The following six specific cases illustrate the problem of illicit trade in the Netherlands: In February 2014, Police arrested nine Bulgarian nationals and seized 3,600 kilos of tobacco and 2.3 million cigarettes in a raid on an illegal cigarette factory in Aalsmeer, 13 km southwest of Amsterdam. The factory was housed in a warehouse and fitted out with machinery to make cigarettes and a large generator for electricity.48
- In July of 2013, five people were arrested following the discovery of six million smuggled cigarettes in a warehouse in Brielle near Rotterdam. This raid involved four Dutch nationals and an Irish man and was made following a tip-off from EU fraud investigators.49
- In October 2002, there was an attempt to smuggle on a ferry out of Latvia to the Netherlands semi-prepared products for the production of cigarette packages and cigarette blocks with the

---

brand name “Regal”, “King Size” and “Made in England”. These semi-prepared packing materials were declared to customs as coated and non-coated cardboard.50

- In July of 2007, Police staff of FIOD in the Islands district, located more than 10 million illicit cigarettes in a shed in Oude-Tongue. The load came from Greece and was destined for the UK. The cigarettes were hidden in boxes inside refrigerators. Three suspects were arrested, a 41-year-old Rotterdammer, a 38 and a 47-year-old man without fixed residence. If the cigarettes had been brought into the Dutch market, 1.5 million euros of state taxes would have been lost.51

- In April 2013, nine were arrested in an illegal cigarette factory and charged with tax evasion and the production of illegal cigarettes after raids on warehouses in Landgraaf and Heerlen. Some 5,000 kilos of tobacco, apparatus for making cigarettes and five million illicit cigarettes were seized in the raids. FIOD dismantled this factory. The gang was producing cigarettes for the Netherlands as well as exporting the cigarettes to Italy, Germany and Switzerland without paying duties. Cigarettes from this factory were found in various places in the Netherlands. The cigarettes that were produced for the Netherlands were of the counterfeit variety.52

- In September 2013, 87,000 cigarettes were seized at Hull in the UK. They were hidden inside a specially-adapted fuel tank of a lorry cab. The driver was arrested and later released without charge, although the lorry and cigarettes were seized and were disposed of by the UK Border Force. The container had come from the Netherlands. Officers became suspicious when the paperwork was found to be false and the delivery address was fictitious.53

According to Yvo Hermans, Investigator for Tobacco and Counterfeit Goods at OLAF, the Netherlands is considered primarily a transit country with most of the matters of concern centering on the port of Rotterdam.54 Van Dijk (2009) reviewed 43 randomly chosen case files of tobacco-related crime in the Netherlands in 2005. Although not conclusive due to the small sample size, in 13% of those cases the Netherlands was the only mentioned country of destination. In another 7% the Netherlands was figured

as one among several countries of destination. Sixty percent of all seized cigarettes in his sample were seized in Rotterdam. It is interesting to note that the FTA/CPA in the Netherlands had in 2013, their highest percentage of seizures inland as opposed to at ports.

In general, seizures at seaports continue to represent the highest seized quantities in the EU. Since not all cargo containers can be inspected, risk analysis is used to focus on those containers that have a higher likelihood of containing illicit tobacco. Data on seizures in Rotterdam was located for 2006 and show that at that time some 70% of duty not paid tobacco products were bound for the UK.

According to representatives from OLAF, duty free zones are another area of concern in the Netherlands.

Illicit trade can be sold openly or covertly. In Germany for example, the cigarettes are generally sold by street vendors operating near underground stations. In Croatia, cigarettes are often sold in bars and restaurants and in public markets. In the UK, smuggled cigarettes are sold door to door in public housing developments, or from fast food shops or car trunks, According to representatives of OLAF, cigarettes are sold more covertly in the Netherlands. Illicit cigarettes can be sold among friends or people who know one another or at football matches or in less open areas. The Chinese diaspora in Rotterdam have been linked to the distribution of counterfeit Marlboro cigarettes in the Netherlands. More commonly, the end point seller of illicit cigarettes in the Netherlands is an elderly or middle aged pensioner.

---


60 Personal interviews with anonymous FIOD Intelligence Officers.
4. Characteristics or Schemes Used to Evade Taxes

Illicit trade schemes profit by evading taxes and can originate at each point in the tobacco supply chain. A range of schemes have been used to evade taxes and duties on both genuine and counterfeit tobacco products. There are almost as many permutations and combinations of schemes as there are smugglers. Illicit trade schemes exist at the import level, export level, manufacturer, distributor, and at the retail level. In some cases, middle men are not even aware that they are smuggling goods.

Figure 1 presents a simplified supply chain for the movement of cigarettes through a legal market in the EU and Figure 2 presents the opportunities to divert tobacco products into the black market.

Figure 1: Legal market for cigarettes.
The black arrows represent opportunities for illicit trade which can occur at any point along the supply chain. Most smuggling involves cigarettes moving out of the untaxed distribution chain and entering the final end-market illegally, often through a third country. This can happen by legal export followed by illegal re-import or cigarettes in transit may be diverted from the legal to the illegal distribution chain.

Cigarettes are typically packaged in groups of 20 per pack and then assembled into cartons containing 10 packs, or 200 cigarettes. International cases typically contain 10,000 cigarettes. In the Netherlands, there often are 19 cigarettes in a pack. In the Netherlands, it is obligatory for every tobacco product to feature a banderole or duty-paid mark on which the price and the pack size in number of units
is stated. With the exception of internet sales, customs and law enforcement agencies focus primarily on large scale smuggling efforts.

The majority of cigarettes are transported under the camouflage of legal trade.\textsuperscript{61} Representatives of OLAF were queried about some common methods used by smugglers to move illicit trade. For security reasons, they were not able to offer any specific comments on the Netherlands. They did offer the following four general scenarios as typical of common methods of illicit trade:

- **Scenario A:** A large sailing vessel leaves Port Said, Egypt, with a container load of cigarettes destined for export to Togo. The ship stops 40-50 kilometers outside of Trapani, Sicily, in international waters. During the night, multiple small fishing boats and speed boats go to the mother vessel and unload cigarettes for illegal importation. The smugglers are careful to keep their large sailing vessel outside the 12 kilometer national limit to stay in international waters.

- **Scenario B:** An old ferry loaded with cigarettes stops in a small harbor on the coast of Croatia in the middle of the night with its radar turned off. Multiple lorries roll on and roll off with loads of smuggled cigarettes. The smugglers use an old ferry with not much value. In the event it is seized they have not lost much.

- **Scenario C:** A bonded warehouse in the Netherlands contains 1000 master cases of legal cigarettes. Small amounts (10-15 cases at a time) are removed from this private warehouse and the paperwork does not match with respect to ingoing and outgoing amounts.

- **Scenario D:** A smuggler of “illicit whites” passes them through the Port of Rotterdam, the busiest port in Europe. The load was supposed to contain “kindergarten equipment” but was instead full of cigarettes. The volume of products matches the capacity and the persons in control are fit and proper in terms of not being the subject of criminal conviction or investigation. This shipment was not identified as high risk and therefore was not chosen for inspection.

Representatives of PMI offer the following scenario of how their cigarettes could be diverted into the illicit market: Cigarettes are produced legitimately at a factory in the Ukraine. Cigarettes could be destined for Africa via Spain and also for local consumption in the Ukraine. A third level distributor, for example at a kiosk in the Ukraine, re-packages the cigarettes and illegally sends them to Germany.

Another opportunity for illicit trade is in the so called “free zones”. Before a taxed product like tobacco is “officially” imported into a country or is being held for export it is held in a “free” zone. The duty does not have to be paid until the cigarettes are “released for consumption”. Smugglers take advantage of an “in transit” system used in free trade zones and other shipping centers, which allows for

temporary tax suspension while the tobacco is en route to a third country. As a result of lax controls, cigarettes get “lost” along the way, with serious numbers failing to arrive at their intended destination. OLAF representatives provide the following example: In the Netherlands, there is a free zone of control type 2 at Schiphol Airport which is a defined and enclosed geographical area. Many other free zone warehouses exist throughout the country. In a free zone of control type 2, the goods can be stored for an unlimited period of time. When goods are stored under customs control, the import duties and other import taxes owed upon import are not paid upon storage. These levies only become payable at the moment when the goods are removed and released into free circulation. Control takes place on the basis of the stock accounts of the operator of the free zone. In addition, physical inspections can be carried out as well. The administrator and/or the operator are responsible for the goods. These “free zone” warehouses are vulnerabilities in the system of maintaining firm control on the stock of cigarettes in the Netherlands.

According to Richard Geleijnse, Tax and Customs Administration of the Netherlands, requirements to get a permit for a bonded storage area have recently been strengthened but still remain fairly loose.62

---

5. Review of the Key Issues Related to Illicit Trade

Taxation

The taxation of tobacco products continues to remain the most effective policy to reduce tobacco consumption and improve public health. According to the WHO (2013), only 14 countries and one territory with 166 million people have increased their tax rates to sufficiently high levels in the past five years, and only six countries with 29 million people have done so in the past two years.

Studies focusing on how changes in price affect cigarette consumption often estimate the price elasticity of cigarette demand (the percentage change in consumption associated with a 1% change in price). For example, the study by Nguyen et al (2012) found that, for cigarettes, the short-run price elasticities of demand obtained ranged from $-0.30$ to $-0.40$ (i.e., a 10% increase in real cigarette price will reduce cigarette consumption by 3–4%). These studies, among others, have shown that increases in cigarette taxes are an effective tool in reducing consumption. Specifically, Townsend et al (1994) found that men and women in lower socioeconomic groups are more responsive than are those in higher socioeconomic groups to changes in the price of cigarettes. Youth are also more sensitive to price changes.

The level and structure of a country’s tobacco taxes are key determinants of the levels and patterns of prices of tobacco products, and consequently of patterns of purchase and use. In general, specific tobacco excise taxes are favored by public health advocates as being the most effective for reducing tobacco consumption.

Tobacco taxation in the Netherlands is largely governed by the EU tobacco taxation laws, which set the framework for all the EU countries. Dutch tobacco taxation is further specified mostly through the Dutch Law on Excise Duties and implementing regulations.

---

69 Ding, A. (2003). Youth are more sensitive to price changes in cigarettes than adults. The Yale Journal of Biology and Medicine, 76, 115-124.
Smith et al (2013) describe the common types of tobacco taxes as follows:

“Ad valorem tobacco excise
A tax based on a percentage of the retail price. This type of tax tends to widen price differences between cigarette brands, making expensive brands relatively more expensive. From a policy perspective, ad valorem taxes are attractive because they automatically increase with industry price increases and are implicitly linked to inflation. However, ad valorem excise allows industry to control tax levels by keeping prices low (e.g., companies could lower their prices in response to a tax increase, reducing the impact of the tax increase and thereby lowering the associated public health benefit).

Specific tobacco excise
A fixed tax per cigarette. This type of tax works by adding a fixed, monetary tax to every cigarette, regardless of its baseline price. It reduces price differences between brands, benefitting manufacturers of more expensive cigarettes and mid-price brands. For this reason, and because specific taxes tend to increase consumer prices relatively more than ad valorem excises, leading to higher reductions in consumption, it is generally favored for tobacco control purposes. Specific excises also provide more predictable revenue for governments. From an industry perspective, this type of structure allows companies to raise the base price of products (and therefore boost profit) without increasing the tax and, because they are not automatically linked to inflation, specific taxes may decline over time in real terms (unless a link to inflation is built in or policymakers regularly increase tobacco taxes).

Import duties
Taxes paid on imported goods to a country/region. Duties may be applied to raw tobacco and/or tobacco products and may be calculated on a specific or ad valorem basis.

[VAT]/sales taxes
Tobacco products may also be subject to more general consumer taxes, such as VAT (usually calculated on an ad valorem basis).”

---

The EU requires its members to apply a combination of a specific tax (a fixed euro amount per 1000 cigarettes) and ad valorem tax (that is, a tax expressed as a percentage of retail price) and sets rules for the allowable share of specific taxes in final tax burden. The EU also requires excise taxes to be a certain minimum: both as a value measured in euro, and as a fraction of price. Rather than testing that each brand sold in the Netherlands complies with the minimum, the EU assesses compliance by examining the excise tax on a particular reference price every year. Since 2011, the reference price is the WAP of cigarettes, calculated as the total value of all cigarettes released for consumption divided by the total quantity of cigarettes released for consumption. Member states are obliged to ensure that the excise tax (specific and valorem tax amount) that they levy on the reference price (weighted average selling price) as of January 1, 2014 exceeds a minimum percentage (60% in 2014). In addition to the excise taxes, cigarettes are subject to the VAT.

Decisions about the correct tax rate for tobacco products are complex and inextricably linked with several different economic realities. The WHO has produced a technical manual on tobacco tax administration intended to be useful to tax administrators at the Ministry of Finance level. WHO notes that of all tobacco-product taxes, excises are the most important for achieving the health objective of reduced tobacco consumption, since they are uniquely applied to tobacco products and raise the prices of these products relative to the prices of other goods and services. If the primary purpose of the tax is to discourage consumption of cigarettes, a strong case can be made for specific excises. Specific excise taxes work by adding a fixed monetary tax to every cigarette regardless of its baseline price. The disadvantage of this type of tax is that tobacco companies can raise prices without increasing the tax. From a revenue stream perspective, a more predictable stream of income is available to a government with specific taxes. Since 2011, the percentage of ad valorem tax has decreased in the Netherlands and specific excise has increased. This results in a relatively positive tax strategy from the viewpoint of decreasing consumption. The disadvantage of this tax structure for the Netherlands is that it does not automatically keep pace with inflation. Inflation in the Netherlands and other countries is usually calculated as the percent change in the Consumer Price Index from one year to the next. In 2011 and 2012, the inflation rate in the Netherlands was 2.4%.

---


Blecher et al (2013) analyzed trends in excise taxes, real price and affordability of cigarettes in Europe. In 2010, approximately 1.5% of per capita Gross Domestic Product was required to purchase 100 packets of cigarettes of the cheapest brand in the Netherlands. At that time, among the EU-15, only in Luxembourg, Austria, Denmark, Finland and Spain were cigarettes more affordable.75 Blecher et al further analyzed the average annual growth rate in real cigarette prices and income from 2004 to 2010. During this period, the average annual growth rate for cigarette prices exceeded that for income in the Netherlands.

Table 8 outlines the taxes on the most popular brand of cigarettes in the Netherlands.

<table>
<thead>
<tr>
<th>Table 8: Taxes on the most popular brand of cigarettes in the Netherlands.</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prices of Marlboro, pack of 19</td>
<td>€ 5.40</td>
<td>€ 6.00</td>
<td>€ 6.00</td>
</tr>
<tr>
<td>Total taxes (incl. VAT) as a % of WAP</td>
<td>78.45%</td>
<td>83.91%</td>
<td>77.91%</td>
</tr>
<tr>
<td>Specific excise tax per 1000 pieces (as a % of WAP)</td>
<td>54.91%</td>
<td>64.19%</td>
<td>59.60%</td>
</tr>
<tr>
<td>Ad valorem excise (as a % of TIRSP)</td>
<td>7.57%</td>
<td>2.36%</td>
<td>0.95%</td>
</tr>
<tr>
<td>Value added tax (as a % of TIRSP)</td>
<td>15.97%</td>
<td>17.36%</td>
<td>17.36%</td>
</tr>
</tbody>
</table>

TIRSP = Tax included retail selling price.  

As previously stated, higher tobacco excise taxes are recognized as the most effective policy tool to raise tobacco prices and effect reductions in tobacco consumption. Article 6 of the WHO FCTC obliges Parties to implement tax policies that contribute to the health objectives aimed at reducing tobacco consumption. Countries in the EU have raised taxes on tobacco products to discourage use and increase revenues. Overall, the mean average price per pack of twenty cigarettes (US$) has increased in Europe from 3.70 in 2010 to 5.87 in 2012.76

Nguyen et al (2012) looked at aggregate demand for tobacco products in 11 EU Member States in relationship to price. Their specific country analysis of the Netherlands (Figure 3) clearly shows the strong negative effect of price on cigarette consumption *ceteris paribus.*77

---

The WHO Technical Manual on Tobacco Tax Administration suggests that nations impose tobacco excise tax levels that amount to at least 70% of the retail price.78 As appears from Table 8, the Netherlands currently does not comply with this percentage. In 2011, the Netherlands had the fifth highest minimum cigarette excise duty (specific and ad valorem excise, excluding VAT) in the EU79. They were exceeded by the UK, Bulgaria, Estonia, and Poland. In 2014, seventeen countries exceeded the Netherlands in this minimum cigarette excise duty.80

The regulation of cigarette taxes in the Netherlands is done by the Ministry of Finance rather than the Ministry of Health so the implication is that taxes are seen mostly as a way to generate revenue rather than to discourage tobacco use. When representatives of the Tax and Customs Administration were asked if cigarette taxes are primarily a public health strategy or a revenue producing strategy, they clearly indicated that the primary purpose was to raise revenue for the government.81 Currently the excise duty rates are adjusted on an annual basis to account for changes in the weighted average price in order to

---

ensure that the specific duties account for 76.5% of the total tax burden. Earmarking the tobacco tax revenues to designate it for tobacco control activities and for health-related expenditures is not in place in the Netherlands. Particularly appropriate might be the earmarking of tax revenues to subsidize the provision of nicotine replacement products and other smoking cessation services for the poor, further reducing the perceived regressivity of taxes. The World Bank has examined the issue of tobacco taxes and notes that earmarking tobacco taxes for activities to reduce tobacco use generates even larger reductions in tobacco use and improvements in health than the tax increase alone.82

Cross-border and illicit trade in tobacco products can undermine public health objectives by avoiding excise taxes and increasing the availability of these products to consumers at lower cost. Tobacco smuggling can lead to higher levels of corruption. Illicit cigarette trade is also highly profitable for TTCs allowing them to circumvent tobacco taxation.

The equity characteristics of a tax are also important. There has been some dispute over the fairness of tobacco taxation and tax increases. Tobacco taxation has at some point been considered regressive. The World Bank describes tax that disproportionately falls on the poor and raises income inequality as regressive.83 Jha and Chaloupka (1999) elegantly explain the issue of tobacco taxation and its effect on the poor in their seminal work for the World Bank:

“There is concern that as taxes are raised, poor consumers will spend more and more of their income on cigarettes, resulting in significant family hardship. Even with contracted demand, it is true that if poor consumers continue to consume more tobacco than the rich, they will also pay more taxes. However, numerous studies show that people on lower incomes are more responsive to price changes than people on higher incomes. As their consumption falls more steeply, their relative tax burden will fall compared with that of the rich consumer, even though their absolute payments will still be greater”.84

---


According to Jha and Chaloupka then, since smoking is more common in Europe among lower than higher socioeconomic status (SES) groups, the relative tax burden on lower SES groups will be less.

It has been suggested that in fact cigarette taxes may produce a progressive impact because the rich decrease their smoking only slightly in response to a price increase and the poor decrease theirs substantially.\textsuperscript{85} Further, the health benefit of a tax increase is distinctly progressive because it will induce a much larger share of the poor to quit than the rich.

Further, since poor people are more likely to smoke and be tempted by cheaper prices, illicit tobacco that is under-taxed undermines efforts to quit smoking and exacerbates health inequalities.

\textbf{The role of the tobacco companies}

The Dutch tobacco market is a very large market with total revenues of $5.7bn in 2012 representing a compound annual growth rate (CAGR) of 1.9\% between 2008 and 2012. The CAGR is the annual return calculated based on each year's previous balances where each previous balance includes both the original principal and all interest accrued from prior years.\textsuperscript{86} In comparison, the German and Belgian markets grew with CAGRs of 2.9\% and 2\% respectively, over the same period, to respective values of $36.7bn and $4.9bn in 2012. Cigarettes is the largest segment of the tobacco market in the Netherlands, accounting in 2012 for 62.5\% of the market's total value. In 2012, the Netherlands accounted for 2.6\% of the European tobacco market value,\textsuperscript{87} down slightly from 2.7\% in 2010.\textsuperscript{88} As a revenue stream for the tobacco companies, the Netherlands represents a larger share than its neighbors Germany and Belgium.

The market in the Netherlands is concentrated with three top players collectively accounting for 80.1\% of the total market value. Given the dominance of the large players, BAT (whose brands include: Lucky Strike, Kent, and Pall Mall), PMI (whose brands include: Marlboro, Chesterfield and L&M), and Imperial Tobacco (whose brands include: Davidoff, West, and Lambert & Butler), and advertising restrictions, new legitimate entrants would be dissuaded from entering the market. This is not the case with illicitly traded cigarettes.

In the early 2000s, a lawsuit was filed against PMI and JTI by EU Member States, accusing these companies of organizing illicit trade. In 2004 and 2007, the suits against PMI and JTI respectively were dropped in return for an enforceable and legally binding agreement. In 2010, cooperation agreements without settlement were concluded with BAT and Imperial Tobacco. The key features of these agreements are base payments and seizure payments. PMI, for example, agreed to make payments in the event of any


\textsuperscript{86} Best defined by example. If you invest $100 today and make 5\% in the first year and reinvest ($105) and make 8\% in the second year, the compound annual growth rate is 6.489\%.


seizures over 50,000 genuine cigarettes in the 10 EU countries that were party to the lawsuit (including the Netherlands). The agreement also required PMI to control future smuggling through a range of measures, which included controlling the distribution system and contractors supplied, and implementing tracking and tracing measures. Similar agreements were concluded with JTI, BAT, and Imperial Tobacco. In reality, very few seizures qualify for payment. In 2013, several researchers contacted the governments of the 27 EU states to collect information, under each country’s Freedom of Information Act, about how much money was received under the terms of the agreement, if the money was used to combat illicit trade, and how much specifically came from seizures of over 50,000 smuggled cigarettes. Publically available information is noted to be sparse. Only a few countries responded with some information and the Netherlands was not among them.89

There was overwhelming evidence in the 1990s and beyond that smuggling formed part of the TTCs’ earlier business model in the EU and elsewhere. Given that the percent of genuine seized cigarettes in 2013 in the Netherlands was less than 1%, it is doubtful whether this practice continues on a large scale in the Netherlands today.

The tobacco industry may have an incentive to classify seized cigarettes as counterfeit because no seizure payments are made when seized cigarettes are counterfeit. Customs officials, in some cases, rely on the industry to determine whether cigarettes are counterfeit or genuine. Concern has been expressed in the public health sector that it is counter-intuitive to have the TTCs classify their own cigarettes. OLAF representatives counter that the industry would not be likely to misclassify cigarettes as the potential payment is low compared to the potential negative publicity that would incur if they were found to be misclassifying cigarettes. Further, OLAF representatives note that cigarettes in question can be sent to a laboratory in the UK where the source of the tobacco can be identified.90

The tobacco companies use a number of arguments to counter tax increases on tobacco. They claim that the tax is regressive, unfair, results in negative economic impact and leads to increases in illicit trade. It is well known that the tobacco companies tend to exaggerate the scope of illicit trade as a counter argument against tobacco control measures. Smith et al (2013), in a meta-analysis of studies to examine industry efforts to influence tax levels, identified key industry tactics.91 They found that TTCs effectuate their arguments by establishing front groups, securing credible allies, direct lobbying and publicity campaigns.

90 Personal interview with Salvatore Catania, Head of the Tobacco and Counterfeit Goods Unit, OLAF. Brussels, Belgium. February 27, 2014.
Illegal cigarette trade (genuine product) is also highly profitable for the TTCs as it allows them to circumvent tobacco taxation and increase consumption. In fact, the tobacco companies are among the main stakeholders benefiting from cigarette smuggling. The tobacco companies consistently argue that tax increases create more illicit trade. There is no scientific evidence offered by the tobacco companies to support this claim. In fact, the overall level of smuggling is higher in countries that have lower cigarette prices (generally countries with a lower tax rate).92 The UK has some of the highest tobacco taxes in the world and on some brands tax accounts for up to 88% of the recommended retail price.93 The fall in the illicit trade in the UK has continued despite rising tobacco taxes and consequent high prices in the same period. Similarly, the example of Spain is impressive. Spain had both lower tobacco taxes and more smuggling than most other European countries in the mid-90s, due largely to lax enforcement of tax laws and active criminal networks. When Spain raised tobacco taxes and strengthened law enforcement, particularly on the Andorra border in the late 1990s, smuggling declined dramatically while tobacco revenues increased by 25%.94 Today, Spain continues exhaustive checks at its borders, particularly those with Gibraltar.

Evidence shows that factors other than tax and price are more important determinants of the illicit tobacco trade.95 If in fact higher taxes led to an increase in illicit trade and the tobacco companies choose to pass on the entire tax to the consumer and raise their profit margins in response to higher taxes, then they should bear some responsibility for the rise in illicit trade.

Further to this point, the website on the relationship between illicit trade and tobacco taxes that was developed by the Dutch Associations for Smoking Tobacco and the Cigarette Industry states:

“However, excise-taxes are sometimes abruptly and substantially increased. Firstly to provide the government with more revenue. Moreover, during previous years a need for influencing behavior has arisen. Increasing the price of tobacco products has become a strategy to reduce the number

---

of smokers. The turmoil that such increases in price cause in the normal and the regulated market, can have detrimental consequences”.

It further goes on to say that “any artificial increase of prices by, for example, tax increase, makes trafficking more profitable. The higher the taxes, the greater the risk of smuggling and counterfeiting”.

It has been suggested that the tobacco companies use a method called “forestalling” to minimize the impact of tobacco tax increases. Immediately prior to a tax increase, the tobacco companies will release for consumption large/excessive volumes of tobacco products. Creating overstocks released for consumption prior to a tax increase leads to a large tax avoidance and reduces revenue collection for the Member States. Florian Müller, Senior Manager Government/Stakeholder Relations, Corporate Affairs of PMI, denies that this strategy is ever used by PMI.

Another argument made by the tobacco companies is that increased taxation leads to decreased consumption and therefore decreased employment in the tobacco sector. Tobacco company representatives often suggest that tax increases will result in job losses, noting that many are employed in tobacco growing, manufacturing and distribution. The European Tobacco Sector report produced by Nomisma for PMI notes that “excessive regulatory initiatives tend to stimulate the illegal trade, which is already a significant problem in the EU tobacco market, which in turn may also affect employment levels in the legitimate tobacco sector”.

With respect to tobacco growing, there is essential no farming of tobacco leaves in the Netherlands nor are there any first processing plants. Tobacco in the EU is farmed primarily in Italy, Bulgaria, Poland, Spain and Greece.

In 2012, the share of tobacco distribution by value in the Netherlands was almost equally split between supermarkets (25.7%), convenience stores (19.5%) and service stations (18.6%). None of these three types of firms are likely to be substantially affected employment wise by decreased consumption as tobacco products are not their primary business.

---


98 Personal interview with Florian Müller, Senior Manager Government/Stakeholder Relations, Corporate Affairs, PMI. Lausanne, Switzerland. March 22, 2014.


In the EU, the factory manufactured cigarette production is highly concentrated in geographical terms. Only a few Member States (the United Kingdom, Poland, Netherlands and Germany) account for more than 50% of the total EU production. The number of enterprises in the Netherlands in 2010 that manufactured tobacco was 17 with 3092 employees.\textsuperscript{101} The Netherlands is the second largest tobacco producer for export in the world following Germany\textsuperscript{102} with a PMI major production plant in Bergen op Zoom. Allegedly, the plant in Bergen op Zoom was located in this area after the Dutch government offered attractive investment credits to build an “economic development zone” as well as a favorable tax deal on sales for export. The PMI plant in Bergen op Zoom employed 1375 FTEs in 2014.\textsuperscript{103} Seventy billion cigarettes were produced per year in Bergen op Zoom, with approximately 5 billion for consumption in the Netherlands. The balance were shipped for consumption to Japan, Spain, France, Italy, and a number of small boutiques batches.\textsuperscript{104} The PMI plant in the Netherlands was the largest of their nine plants in the EU, followed by the plant in Berlin, Germany. On April 4, 2014, PMI announced that the plant in Bergen op Zoom would close in the second half of 2014. A company spokesman, Drago Azinovic, President for the EU region at PMI, noted:

“The severe decline in the tax-paid EU cigarette market has led to today’s (4 April) regretful announcement in Bergen op Zoom. While the decline is partially driven by societal and economic factors, PMI has consistently expressed its concern over the negative impact of excessive fiscal and regulatory policies, which create a prolific environment for the criminal organizations involved in the illegal cigarette trade. Unfortunately, new regulations affecting the industry such as the recently agreed EU Tobacco Products Directive do nothing to address this growing problem”\textsuperscript{105}

Production was discontinued from September 2014 onwards. Over 1200 positions were eliminated at this plant.

Imperial Tobacco produces fine cut tobacco in Joure, the Netherlands, and employs about 300 people. Another Dutch manufacturer, Heupink & Bloemen Tabak BV in Ootmarsum manufactures Black Devil Rose among other tobacco products. Black Devil is a leading brand among flavored cigarettes.


\textsuperscript{103} Personal interview with Mathijs Peters, Director Corporate Affairs the Netherlands, Philip Morris Benelux BVBA. Bergen op Zoom. March 22, 2014.

\textsuperscript{104} Personal interview with André Vermeiren, Plant Manager Philip Morris Tobacco Plant. Bergen op Zoom. March 22, 2014.

\textsuperscript{105} PMI in Talks to close Bergen op Zoom factory. Tobacco Journal International. \url{http://www.tobaccojournal.com/PMI_in_talks_to_close_Bergen_op_Zoom_factory.52314.0.html}, accessed on April 14, 2014.
Adopted EU regulations to restrict tobacco products with flavoring will affect this factory’s production and could result in a decreased need for Dutch workers. Heupink & Bloemen Tabak BV currently employs only about 94 workers. Tobacco manufacturing in the Netherlands could be expected to remain flat or even decrease as consumption is decreasing, and production is highly efficient, capital intensive and consolidated.

With respect to the labor force in the cigar industry in the Netherlands, data from PMI note that in 2010 there were 4 cigar plants in the Netherlands employing 674 workers. This information could not be independently corroborated from the European Cigar Manufacturers Association.

However, as Warner (2000) has noted, an economic presence of tobacco does not imply an economic dependence on tobacco. Many of the jobs that are counted in estimates of the economic contribution of tobacco are far from dependent on tobacco, but rather involve tobacco in some limited way, often indirectly (e.g. retailers who sell tobacco products among many other products). Only tobacco manufacturing can be considered truly dependent on tobacco and given the capital intensive nature of tobacco product manufacturing it is likely that there will be a minimal effect on jobs following a tax increase.

The World Bank in a study on the economics of tobacco use notes that a fall in tobacco consumption that leads cigarette manufacturers to cut some jobs does not necessarily cause a fall in total employment. They note that money no longer spent on cigarettes will be spent instead on other goods and services, generating new jobs to replace those lost from the tobacco industry.

The tobacco companies have had a long history of predicting that any new regulation that decreases consumption will affect production and employment. In 2001, when the EU toughened regulation on packaging and tar levels in cigarettes, PMI officials in Europe said the new rules “might force the company to shift manufacturing from the Netherlands, Germany, and Portugal to plants in non-EU countries”. It is anticipated that the tobacco companies would again try to make a strong argument with politicians that tobacco companies make a strong contribution to the economy of the Netherlands and that tobacco control legislation should not have an untoward effect on their industry. The fact that the Netherlands fell into recession from 2012 to 2013, which led to rising unemployment, especially

among young people makes this a very strong argument. The total contribution of the tobacco company to the economy of the Netherlands is not known.

The tobacco industry is consistently against tax increases as it decreases consumption and market share but also because it affects their pricing abilities. Pricing power and strength have always been an important tool for the industry and has contributed to their classification as a “defensive stock” par excellence. Increased taxation in some cases forces tobacco companies to reduce their prices to offset the tax increase and thus may cause them to reduce their earnings estimates and subsequent stock price.

The aspect most often cited in efforts to explain the cigarette illicit trade is the alleged role of the tobacco industry. It has been argued by some that a cigarette black market of any significance is imminently linked to large-scale smuggling and that large-scale smuggling would not be possible without at least the tacit connivance of cigarette manufacturers. Historically, there is overwhelming evidence of tobacco industry involvement in illicit trade on a global basis. All of the major tobacco companies have been implicated in smuggling activities and have been the subject of several legal cases to determine the extent of their involvement. The tobacco companies have used the illicit market as another channel of distribution for their brands. It does appear, however that since the early 2000’s there is a shift from tobacco industry product to counterfeit cigarettes and illicit whites. Anna Gilmore, at the EU Committee on Budgetary Control / Policy Department for Budgetary Affairs hearing (2014), stated that this shift is over played by the tobacco industry and that they still have involvement in the smuggling of cigarettes. Gilmore went on to say there is evidence that tobacco company brands are still leaking into the illegal market as they are failing to control their supply chain. She cited a case of JTI leaking illegal cigarettes into the market in Syria. She further cited the 2008 case of PMI, JTI, Imperial Tobacco, and BAT producing and importing 30 billion cigarettes in the Ukraine beyond what the country can consume, fueling a 2 billion black market that reaches across the EU. Gilmore further detailed TTCs’ involvement in smuggling to and through Bulgaria between 2000 and 2010 as evidence of continued involvement in smuggling.

Plain packaging

Plain packaging is the removal of trademarks, logos, colors and graphics, except for the government health warnings and for the brand name, presented in a standardized typeface. It is considered by the public health community to be consistent with the intention to ban all tobacco promotions and presents a low cost option to tobacco control.

Australia, with the enactment of the Tobacco Plain Packaging Act in 2011, became the first country in the world to require tobacco products to be sold in plain packaging.\textsuperscript{115} Claims by the major tobacco companies that the law violated the Australian constitution were dismissed by the High Court of Australia in 2012. International disputes (based on WTO agreements and a bilateral investment treaty between Australia and Hong Kong) are still pending. Studies comparing existing branded cigarette packs with plain cardboard packs bearing the name and number of cigarettes in small standard font, found plain packs to be significantly less attractive.\textsuperscript{116} Specifically, Hammond (2010) reviewed the evidence on plain packaging and found three primary benefits of plain packaging: increasing the effectiveness of health warnings, reducing false health beliefs about cigarettes, and reducing brand appeal especially among youth and young adults.\textsuperscript{117}

Tobacco organizations posit plain packaging will threaten intellectual property rights (their trademark) as well as ease the ability of illegal tobacco manufacturers to replicate legitimate products resulting in higher incidences of illicit trade. PMI has also claimed that enacting plain packaging would violate New Zealand’s international trade commitments and contradict positions previously articulated by the Government in the international trade arena.\textsuperscript{118} A report by Imperial Tobacco to the UK Department of Health consultation on standardized packaging of tobacco products states: “Standardized packaging would make it easier and cheaper to produce counterfeit products for smuggling. Counterfeiters would only need one printing "blank", as the packaging of the different brands will become so similar that only a simple modification - to the name - will be needed to use the same packaging for every brand of cigarette”.\textsuperscript{119}

PMI, in an even stronger response notes: “Plain packaging will increase the levels of illicit


\textsuperscript{119} Imperial Tobacco (2012, August 6). Bad for Business; Bad for Consumers; Good for Criminals. Standardised Packaging Is Unjustified, Anti-Competitive and Anti-Business. A Response to the UK Department of Health Consultation on Standardised
tobacco in the UK, open the floodgates to “illicit whites,” and make cheap unregulated tobacco easily accessible to children”.\textsuperscript{120} Rowell \textit{et al} (2014) analyzed newspaper articles over five years and found that shortly after the possibility of standardized packaging was announced, the tobacco companies began and have subsequently continued, placing stories in the press that exaggerate the extent of illicit penetration in the UK.\textsuperscript{121}

Joossens (2012), in a report for Cancer Research UK, notes that manufacturers of “illicit whites” and counterfeit cigarettes, which now dominate the illicit trade market, do not even try to copy legitimate brands.\textsuperscript{122} Therefore the tobacco companies’ claims about plain packs and smuggling are irrelevant to a large part of the current market for illicit tobacco. Further, this argument appears counter-intuitive given that counterfeiters try to benefit from the brand recognition associated with premium brands.\textsuperscript{123}

There is no question that branding is powerful. Branding and packaging are an integral component of marketing strategy for any organization and especially for tobacco manufacturers. Packaging is a way of stimulating consumer demand, through visual appeal in the case of impulse purchases or new smokers. Consumer behaviorists tell us that users of branded consumer products, are paying for a cachet, a look, an image. Plain packaging dilutes brand equity and reduces the added value endowed on cigarettes as a result of the brand. Branding is a marketing tool that the TTCs are likely to guard strongly. It seems likely that they believe that prices would be hard to maintain among plain packs and consumers would downtrade over time, thus threatening profits. The incentive to buy an expensive brand would, for some, be reduced if the brand in question looks no better than a cheap one. In other words, the tobacco companies fear that plain packaging will lead to the specter of commodification of the cigarette as a product.

---


\textsuperscript{121} Rowell, A., Evans-Reeves, K., & Gilmore, A. B. (2014). Tobacco industry manipulation of data on and press coverage of the illicit tobacco trade in the UK. Tobacco Control, 23, e35-e43.


In Australia, Imperial Tobacco has tried an old tobacco company trick to get around advertising restrictions and to avoid the effect of plain packaging. They have printed on some of their cigarette packs “It’s what’s on the inside that counts”\(^{124}\).

While some countries in the EU are in favor of the introduction of plain packaging, the Netherlands has expressed opposition to this policy.\(^{125}\) It should be noted that representatives of PMI as well as Dutch Customs Officials that were interviewed believe that plain packaging will increase contraband cigarettes. In the Netherlands, warning labels currently cover at least 30% of the front and 40% of the back of the cigarette package. That still leaves 70% of the front and 60% of the back of the package for branding. Following transposition of the revised EU Tobacco Products Directive (by May 2016 at the latest), health warning labels will cover 65% of both the front and back of cigarette packages, as well as 50% of the lateral surfaces.

**Internet sales**

Under normal circumstances, if cigarettes are sold to private customers on the internet, the excise duties must be paid on the rates of the country where the customer lives. Internet sites have become a core channel of distribution of illicit cigarettes as it allows the selling and shipping of small quantities of cigarettes undetected by Customs Officials. According to a report in the Euromonitor International, there are numerous websites offering international brands at 50% below the retail price.\(^{126}\) Internet sales can involve the sale of duty-paid cigarettes from low-tax countries and the sale of contraband and counterfeit cigarettes. Of particular concern is that the internet sale of tobacco products is not subject to strict controls in terms of age-verification.

In the Netherlands, when cigarettes are attempted to be purchased via internet, a pop-up advises that the purchaser must pay Dutch taxes. In reality, it is difficult to track and prosecute the sellers of internet cigarettes in the Netherlands as the advertisers may not be the actual seller of the cigarettes. The sales information from one internet site may be transmitted to a second or even third party site. Most often the sites are abroad and the cigarettes are sent by post. The FCTC Protocol encourages each party to consider banning retail sales of tobacco products through internet-, telecommunication- or any other evolving technology-based modes of sale.

The US can be an example of best practices in this area. In the US, the US Bureau of Alcohol, Tobacco, Firearms, and Explosives, along with several state attorneys general, reached an agreement with


all major credit card companies and PayPal to ban credit card payment processing for internet cigarette vendors. A similar agreement was reached with all major private delivery companies, such as UPS and FedEx. In the US in 2010, cigarette purchases through the US Postal Service was banned.\textsuperscript{127}

**Country corruption**

Illicit tobacco is not only stimulated by price differentials and other factors but it is consonant with general corruption. Corruption and organized crime are linked to cigarette smuggling and tobacco smuggling can lead to higher levels of corruption. In countries, corruption therefore can be a predictor and facilitator of smuggling. Merriman \textit{et al} (2000) found that transparency (lack of corruption) in a country is negatively and significantly correlated with the level of tobacco smuggling.\textsuperscript{128} They go on to say that “the perceived level of corruption statistically explains more of the variance in expert’s estimate of cigarette smuggling than do cigarette prices”.

Transparency International is a global network including more than 90 locally established chapters. The goal of this organization is to fight corruption in the national arena. Transparency International published a 2013 Corruption Perceptions Index. The Corruption Perceptions Index measures the degree to which public sector corruption is perceived to exist in 177 countries around the world. It scores countries on a scale from 0 (highly corrupt) to 100 (very clean). In 2013, the Netherlands scored 83 out of 100 and was ranked 8\textsuperscript{th} out of 177 countries. This is compared to its neighbors Belgium and Germany who scored 75 and 78 respectively.\textsuperscript{129} Corruption, therefore, in the Netherlands is not perceived as being a significant problem.

Further, it appears that the Netherlands, as applies to much of northern Europe, is not a country where street selling is culturally acceptable. It can be postulated that low levels of country corruption and the absence of prevalent street selling may be explanatory variable as to why illicit trade is relatively low in the Netherlands.

**Geography**

Some European countries such as Greece, Croatia, Bulgaria, and Italy are particularly vulnerable to smuggling given their geography. Waterways are often more difficult to control from the viewpoint of smuggling than land borders and the total length of the Dutch coastline is somewhat more than 400 km. Further, countries that border countries that have lower tax rates, such as the Netherlands, also tend to


be more vulnerable to smuggling. Currently, the Coast Guard with Customs staff patrol the Dutch coastline. It is rumored that one of the smaller Dutch islands currently has some involvement with illicit trade in cigarettes and is being scrutinized by authorities. Unlike the Croatian coastline along the Adriatic Sea, the North Sea waves are too strong to be very viable for smugglers using speed boats or small fishing boats.

The Netherlands sits in a corridor for illicit trade. Much of the illicit trade is coming from the EU Eastern and North-Eastern border (Latvia, Lithuania, Estonia, and Poland for example) and Russia and Belarus. This vulnerable corridor is between the East and the high cigarette tax area of the UK. Table 6 shows that 22% of the cigarettes seized in the Netherlands in 2013 had their origin in Germany. It is likely that Germany was not the primary originating country but that the cigarettes came initially from countries further east. In some of these cases, both the Netherlands and Germany were probably transit countries for illicit whites on the way west.
6. Policy Options to Combat Illicit Trade

Because smuggling is a global problem, concerted action at the international level is required. This will be achieved through the Protocol to Eliminate Illicit Trade in Tobacco products under the FCTC. This Protocol has not yet been ratified by the Netherlands. This agreement includes the following measures: overt and covert marking of tobacco products so that they can be tracked from manufacturer to point of sale; obligations on manufacturers to control the supply chain of their own goods; and licensing of participants within the supply chain to ensure that they can be monitored effectively and have their licenses revoked if they are found to be dealing in illicit products. It should be noted that the investigation of cases of illicit trade is a complex process often requiring international cooperation. Although investigations at the EU level have been stream-lined in recent years, OLAF reports that in 2012, the duration of investigated cases took on average 22.6 months.\textsuperscript{130}

Strict control of the channels of distribution of cigarettes is key to controlling the illicit tobacco market. Much of the responsibility for this now rests with the tobacco companies themselves. As Luk Joossens pointed out at the European Parliament in January 2014, “an independent system where the national authorities control the data should be introduced, which will be possible when the Tobacco Directive comes into force. It cannot be controlled by the tobacco industry”.\textsuperscript{131}

Licensing all participants in the channel of distribution and tracking systems

The tobacco companies and others have to be stopped from importing cigarettes to phantom markets or to markets where exportation vastly exceeds estimates of consumption. In order to make the TTCs responsible and liable for chain of custody markings, it has previously been suggested that manufacturers print a unique serial number on all packages of tobacco products which would identify the date, location, and manufacturer of the product. Intermediate traders would also need to be identified and noted. As part of this system of accountability, it has been suggested that all parties involved in the cigarette trade who handle the product as it moves from the manufacturer through the distribution channels to the ultimate consumer parties be licensed. These include manufacturers, exporters, and importers, wholesalers, transporters, warehouses, and retailers. Licenses assist in identifying and monitoring the


various actors in the tobacco industry and facilitate anti-smuggling enforcement. Conditions can be attached to licenses: they can be suspended for breach of the conditions or tobacco laws. Licenses can help pay for enforcement. Retailers in the Netherlands are not licensed like they are in France or Austria. Caution needs to be exerted to be sure that the price of the license would not be so prohibitive that it would be used primarily as a revenue producer for the government or that licenses would be restricted to only a small number of firms.

**Introduce enhanced tax stamps**

According to the Framework Convention Alliance, new digital tax stamps, using invisible ink and featuring a unique, covert (hidden) code with data for each cigarette pack, make it harder for criminals to manufacture fakes (and are preferable to paper tax stamps). Paper stamps are easily counterfeited and they have a security deficiency as they can be stolen in the period between printing and application. The digital stamps contain encrypted information which can be read using a portable scanner. This allows enforcement officials "to distinguish real tax stamps from even the most sophisticated fakes". With enhanced tax stamps, monitoring scanners are placed at all production facilities. These scanners read the tax stamps and electronically transfer the information to the Ministry of Finance. Consequently, the tax administration agency receives live reports on how many packs of cigarettes are produced, in which factories, what the brands are, when the products are produced, and other useful information for tracking. The cost of these systems are high but it seems that they could easily pay for themselves in increased revenue.

**Higher trafficking penalties**

Because tobacco taxes account for a large share of price and because tobacco products are relatively lightweight, the potential monetary gains from smuggling can be quite large. An EU working staff document looking at this issue states that the types and levels of sanctions to combat fraud in the EU are often too low, and in any event strongly diverging across the Member States. In addition to the variance among EU Member States of the gravity of the penalties, they vary in terms of the approach to sanctioning (administrative or criminal). In one Member State, the maximum sentence for the most serious cases of such offences might be imprisonment for up to one year, while in others perpetrators can receive

---

The differing penalty structure allows smugglers to choose their point of entry where the lowest sanctions apply. This has been described as “penalty shopping”.

In the Netherlands, illegal tobacco trade transgressions come under the Article 337 of the Penal Code and Article 102 of the Law on Excise Goods. These laws and penalties are described below:

---

**Article 337 of the Penal Code**

1. He who intentionally imports, transits or exports, sells, offers for sale, distributes, delivers or stocks:
   a. false, falsified or illegally manufactured brands,
   b. goods, which themselves or on their packaging falsely bear someone else’s trade name or someone else’s trade mark,
   c. goods which falsely indicate origin or the name of a particular place, featuring a trade name,
   d. goods, on which themselves or on the packaging of which someone else’s trade name or someone else’s brand, albeit with a slight deviation, is imitated or e. goods or components of goods which falsely have the same appearance, or with subordinated differences, as a drawing or model to which someone else owns the rights,
   is punished with imprisonment up to one year or a fine of the fifth category.

2. Not punishable is he who stocks some goods, parts thereof or bearing trademarks as defined in the first paragraph, exclusively for their own private use.

3. A criminal who has made his profession of and is found guilty of committing a crime as mentioned in the first paragraph, is liable to imprisonment up to four years or a fine of the fifth category.

4. If by committing the crime as mentioned in the first paragraph, fear of danger to persons or property exists, the responsible person is liable to imprisonment up to four years or a fine of the fifth category.

Fines of the fifth category = up to €81,000

---

**Article 102 of the Law of 31/10/1991 on Excise goods**

1. A person who violates the legal provisions that tobacco products which are put on the market for consumption need to bear the prescribed excise tax stamps, will be punished with a fine of the third category.
2. A person who intentionally violates the prohibition referred to in the first paragraph, is punished with imprisonment of up to two years or a fine of the fourth category.

<table>
<thead>
<tr>
<th>Fines of the third category</th>
<th>€ 8,100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fines of the fourth category</td>
<td>€ 20,250</td>
</tr>
</tbody>
</table>

Customs officers in Rotterdam were asked to recall the highest penalty that was administered for illicit trade in the Netherlands. They noted that in the Netherlands the highest penalty of recent memory is five years in prison but this was an arrest for illicit cigarettes in combination with the drug ecstasy.\(^{134}\)

Tobacco taxation laws in the EU should be revised so that penalties for smuggling are stiffened. The European Commission originally proposed full harmonization of excise duties on manufactured tobacco.\(^{135}\) A harmonization of the relevant offences and sanctions would increase legal certainty and thus facilitate prosecution. A proposal for this is currently being evaluated at the EU level. The Protocol defines appropriate penalties as those that are “effective, proportionate and dissuasive”. Equally as important as the penalties is additional attention from customs officials so as to render tobacco smuggling financially unappealing. Ideally, the risks for smuggling should outweigh the benefit. Smugglers, like other businessmen, operate to make a profit and if the cost of doing business is too high they will stop. Penalties should also be aimed at the multinationals, import/export companies and all intermediaries.

Along with increased penalties, there should be an increase in public awareness about prosecutions. Where the general public becomes aware that laws are not being complied with and no consequences arise, there is a gradual erosion of respect for legislation and enforcement authorities. If people rarely hear of arrests and successful prosecutions of those involved in illicit trade, then the perception will spread both that enforcement authorities are ineffective and that the law doesn’t really matter.

---

\(^{134}\) Personal interview with Rien van de Kuilen, Intelligence Officer, FIOD. Rotterdam. March 21, 2014.

Tracking tobacco product packages

In early November 2012, the more than 140 Parties to the WHO FCTC adopted a protocol for combating illicit trade through, among other measures, a global tracking and tracing system.\(^\text{136}\) This section has often been referred to as “the heart of the protocol”. The main source of illicit product is legally manufactured and exported cigarettes which end up being sold duty not-paid somewhere else, sometimes in the market they were exported from. Tracking and tracing means monitoring the route taken by such products through their supply chains by means of technology such as tax stamps (either paper or digital), bar codes, and radio-frequency identification. The need for aggregation of packaging (i.e. linking pallets to master cases to cartons) is fundamental. Tracking refers to the ability to monitor the route being taken by products through the supply chain (from pack to carton to master case to pallet all the way to the customer) and tracing refers to re-creating the route already taken by products through the supply chain. Best practices suggest that real time data transmission to the Ministry of Finance from all production lines should be part of the system. A tracking and tracing system needs to be established within five years of entry into force of the Protocol.

It should be noted that tracking and tracing technology will not apply to counterfeit or illicit whites, although identifications of a duty paid pack, such as a tax stamp, do enable a retailer (or a customer) to distinguish the legal from the illegal product, should s/he be interested in so doing.

The use of technology for tracking and tracing is not yet widespread. The two systems that are receiving the most attention are the Scorpios system applied in Brazil and Codentify, developed and used by PMI.

PMI has been successful at developing a high speed tracking system. Their system has 120+ markets with master case tracking and 50+ markets with carton aggregation and authentication (i.e. where carton information is reflected in the mastercase code) - among them Russia, Ukraine, Romania and other key diversion markets. Key diversion markets are those where products have typically been smuggled towards the EU and elsewhere. PMI is in the process of rolling out pack tracking in a number of markets and they have completed the first installation of pack tracking in their factory in Switzerland. Pack tracking currently exists for some key brands in select markets. On these packs, PMI has printed unique codes and information that contains information about the place of manufacture, the time and date of production and the brand.\(^\text{137}\) By mid-2016, PMI plans to have pack level tracking operational in all EU Member States.


\(^{137}\) Personal interview with Florian Müller, Senior Manager Government/Stakeholder Relations, Corporate Affairs, PMI. Lausanne, Switzerland. April 1, 2014.
Specifically, PMI marks master cases with unique, machine-scannable bar code labels before selling them to a first purchaser. The computer generated codes are printed onto labels that are applied to cartons as they pass along a manufacturing line. These cartons are linked to master cases. The barcode labels contain a human readable translation (spelled out in letters and numbers). The cost for the equipment to mark all cartons is not expensive at about 50-60,000 euro. The database is managed by PMI with access for authorized members of relevant agencies in Member States or the European Commission. This part of the system will ultimately have to change if the Protocol enters into force. The Protocol clarifies that obligations assigned to Parties shall not be performed by, or delegated to, the tobacco industry. This obligation has not yet been addressed.

The Brazilian control and monitoring system was updated and improved in 2011 pursuant to a new federal law. The federal law required every pack of cigarettes produced in Brazil for export has to be marked with a unique identification code at the production lines to determine the origin of the products and to control their movements. Some note that system has significantly improved Brazil’s ability to regulate its tobacco market\footnote{Hedley, D. (2012, December 19). Fighting Illicit Trade in Tobacco with Technology: Does it Work? Euromonitor International. http://blog.euromonitor.com/2012/12/fighting-illicit-trade-in-tobacco-with-technology-does-it-work.html, accessed on February 21, 2014.} while others claim that it does not provide any tracking and tracing functionality but it only marks packs for fiscal assessment.\footnote{Personal communication with Florian Müller, Senior Manager Government/Stakeholder Relations, Corporate Affairs, PMI. Lausanne, Switzerland. April 1, 2014.}

The crucial characteristic of effective tracking and tracing systems is that all tracking and authentication information is reflected in every code at every packaging level (i.e. mastercase, carton, and pack level).

**Automated Number Plate Recognition System (ANPRS)**

In August 2012, a new camera-based surveillance system was activated at Dutch national borders that allows the Netherlands to carry out stringent checks on who is coming into the country without breaking EU free movement rules. The new system, named @migoboras, recognizes suspect cars entering and leaving the Netherlands from a database which uses traffic flow analysis. Vehicles are picked out for inspection based on their being a certain type or color, or passing at certain times, possibly in combination with other vehicles.\footnote{DutchNews.nl (2012, August 24). New Border Surveillance System in Line with EU Rules, Says Minister. http://www.dutchnews.nl/news/archives/2012/08/new_border_surveillance_system.php, accessed on February 20, 2014.} @migoboras is an acronym standing for ‘Mobile Information-Driven Action – Better Operational Results and Advanced Security’. It supports the Royal Military and Border Police’s enforcement activities, makes it possible to target controls better, and cuts down on the inconvenience suffered by legitimate cross-border traffic. The cameras have been installed on the 15 largest cross-border
roads that the Netherlands shares with Belgium and Germany. As the location of the cameras is public information, the question is raised as to whether cigarette smugglers will just avoid these crossings. Often, Dutch Customs will wait until a suspected smuggler is 10-20 kilometres inside the Dutch border before they are stopped so as not to delay traffic at the border.

The ANPRS has gaps along the EU external borders, particularly along Eastern Europe (Kaliningrad, Russia, Bulgaria and Romania) where much of the illicit tobacco trade is believed to originate. According to an EU Commission report about smuggling on the Eastern border, funding was provided by the EU to fill the gaps, but a 50% co-financing condition is an obstacle to complete installation.141

**More customs officers and additional police powers**

On the enforcement side, OLAF, customs and tax authorities, FIOD, border guards, and the police are key players in the fight against illicit trade. They all face challenges related to data exchange, risk management and targeting, territorial issues, and the economic pressures of limited manpower. Further, cooperation measures do not always exist to allow effective collaboration. My meeting in Rotterdam with four members of illicit trade enforcement/policy staff occurred with staff from different departments whose offices were only a few blocks apart yet required layers of administrative approval before a joint meeting could be arranged.

Since official border controls were eliminated between Schengen zone countries, Dutch police have carried out spot checks on cars crossing from Germany and Belgium into the Netherlands.

Freedom of movement is one of the founding principles of the EU. EU member states are required to insure that control procedures at external borders do not constitute a major barrier to trade and interchange. There are limits on the police who monitor the borders in order not to overly restrict free movement. As such, the border police are only allowed to monitor borders for a maximum number of hours per month and to stop a certain number of cars. Although the EU opposes any further controls of the border areas, some members of parliament have suggested that the police be given additional powers in this area. This action should be considered based on the propensity for smuggling in certain areas and times.

As previously stated, China is the principle source of counterfeit cigarettes yet OLAF has eliminated the EU liaison officer in China. Salvatore Catania cites budget cuts as the reason for this elimination.142 An office in China could prevent substantial financial losses in the EU, particularly as China


142 Personal interview with Salvatore Catania, Head of the Tobacco and Counterfeit Goods Unit, OLAF. Brussels, Belgium. February 27, 2014.
is willing to cooperate and was one of the first countries to sign the FCTC Illicit Trade Protocol in January 2013.

Dutch Customs Officers suggest that rotating assignments of customs officers announced at the last minute may be a good policy option. In that manner, if there were any collusion among customs officers and smugglers, the smugglers would not know in advance which routes to take. According to representatives of the Dutch Customs there is no suspicion of collusion between smugglers and customs officers at this time.

Hungary used an interesting approach to controlling smuggling in 2005 when their share of the illicit tobacco market reached 27%. Among other actions to reduce smuggling, they deployed stationary X-Ray at railway stations from the Ukraine and for trucks and containers, created mobile teams to affect controls anywhere in the country, and changed the compensation method of their customs and police officers. In order to motivate police and customs, they paid direct and automatic premiums to customs and police officers who detected illegal shipments of cigarettes. They reduced their share of illicit trade by ten percentage points in one year.\footnote{Nagy, J. (2012). Tackling cigarette smuggling with enforcement: Case studies reviewing the experience in Hungary, Romania and the United Kingdom. World Customs Journal, 6, 29-38.}

**Transparency**

Public transparency in all dealings between government and quasi-government employees and tobacco companies is basic. It is important for public officials to “hear all sides” when it comes to policy formation, but in order to avoid even a whiff of impropriety, these meetings should be publicly noted with minutes available for public review. The recent allegations of the contacts and relationship between the Dutch Health minister Edith Schippers and the tobacco industry is a matter of concern.\footnote{Sheldon, T. (2011). Dutch Health Minister is quizzed about “intensive” contact with tobacco industry. BMJ, 343, d7137.} Policies on accepting gifts of any sort during publicly held office should be in place. The issue of revolving door appointments (the movement of public sector staff to industry and/or lobby jobs or vice versa) at the EU level has been a concern. Dutch politicians should be prohibited from going to work in any industry for which they have potential regulatory authority for 3 years after leaving office.

A recent report by Fooks et al (2014) questions a strategy by PMI of funding academic reports from a University in Milan that lend academic capital to the industry’s stance that taxation and standardized packaging are drivers of illicit trade.\footnote{Fooks, G., Peeters, S., & Evans-Reeves, K. (2014). Illicit Trade, tobacco industry-funded studies and policy influence in the EU and UK. Tobacco Control, 23, 81-83.} TTCs have the complete right and perhaps even obligation to commission studies about illicit trade. However, in the interest of complete disclosure and
transparency, tobacco company funded work by academic bodies should be so noted when the tobacco companies use the academics work in policy debates.

A further effort to increase transparency would be to require monthly shipment reports by brand from manufacturers, importers and exporters and require public disclosure of these reports. Government officials and tobacco control organizations need to know what is happening in the marketplace. A sudden change in shipment patterns or shipments in excess of consumption may be a warning that intervention is required.
7. Areas for Future Research

More data about illicit cigarette trade in the Netherlands is needed before definitive public health policy recommendations can be made. For example, it is important to know the socio-demographic and socio-economic characteristics of smokers of illicit tobacco. If the smokers are indeed primarily older men, from a public health viewpoint this is less serious than if the smokers are young people who are initiating the smoking habit because of the low price of illicit tobacco. In other words, how many first time smokers started with genuine product or illicit trade? A cross-sectional face-to-face survey using standardized methods like those of Gallus et al (2012) may be appropriate for this kind of research.\textsuperscript{146} This type of research includes a “show your pack” section to cross validate direct questions on smuggling. Another study that illustrates a fairly good methodology for evaluating illicit trade at the consumer level is that by Joossens et al (2012), in which they describe a comprehensive measure called an Identification of an Illicit Pack.\textsuperscript{147}

It may also be important to know what motivates these smokers have (price only? Image? The allure of risky behavior?), what is important to them, and what their knowledge base is about the composition (noxious elements) of counterfeit tobacco products and illicit whites. Geographic location of these smokers may also provide some data about the locus of distribution of illicit cigarettes and distance from borders.

Incentives for consumers to purchase illicit cigarettes need to decrease. In order to discourage the population from buying illicit tobacco products, the negative impact of illicit trade should be communicated to the wider public. In particular, the impact on national finances, the involvement of organized crime, and the fact that illicit products do not comply with EU legislation regarding the ingredients and health warnings. More detail on the consumer who purchases illicit products and the knowledge base of the general public is required before a social marketing message can be formulated. Baseline data in these areas is primordial to measuring the impact of any public health efforts.

Further, as cigarette taxes increase consumption falls and illicit trade increases, there must be an optimal point at which taxation decreases consumption yet the low price point of illicit trade does not stimulate new smokers. This may be a complex study but worthy of exploration.

It has been noted that the Netherlands has a low corruption index. It may be useful to tease out the influence of corruption in a society and the extent of illicit trade. A simple study could test the correlation between a country’s corruption index and the extent of illicit trade. Based on further review,

\begin{flushleft}
\end{flushleft}
if corruption is indeed a strong explanatory variable for illicit trade, then this mitigates somewhat the tobacco company stand that taxation increases illicit cigarettes.

Studies have looked at cross-border shopping of cigarettes but it has not been determined precisely whether these transactions were legal or illegal and whether they were incidental to the trip or done for the purpose of purchasing cigarettes. This would be an important fact to know.
8. Conclusion

The problem of illicit trade in tobacco products is global, complex and extremely difficult to measure. The most commonly used measures to assess the extent of the problem are EPS, quantitative consumer surveys and seizure data. All of these measures have inherent flaws and methodological challenges. The most robust methodology should combine several methods. Regardless of the method used to assess illicit tobacco trade and compared to other countries in the EU and the world, the extent of the problem of illicit trade in the Netherlands is relatively low. As previously noted, the 2012 KPMG report, which is believed to be exaggerated, calculates counterfeit and contraband in the Netherlands at about 11% of total consumption. The report shows that the more specific problem seems to be “illicit whites”, which are increasing in the Netherlands as well as throughout the EU. The 2013 Dutch Customs report of seizure data indicates the major share of seized cigarettes in the Netherlands were illicit whites. According to the 2012 KPMG report, non-domestic inflows or product that has been brought into the Netherlands legally by consumers (such as during a cross-border trip) has also increased. Smuggling of genuine product in the Netherlands does not appear to be an extremely large problem.

As primarily a transit country, certain vulnerabilities exist in the ports (primarily Rotterdam) and in the Free Trade Zones. Some concern exists among officials that the Netherlands is also becoming an inland transit country as the Eastern EU border areas are sources for illicit trade. Due to limited manpower and EU requirements to maintain fluid borders, Dutch Customs uses risk assessment to determine what to inspect. As cigarette taxes increase particularly in relationship to its neighbors, the Netherlands may become more of a destination country.

In addition to the need for a standardized method of data collection, this paper sets forth a few policy suggestions including: track and trace measures operated by the government, higher trafficking penalties, greater transparency between government employees and the TTCs, and enhanced tax stamps.

Any policy change has to recognize the highly political nature of tobacco control in general, and illicit trade in particular, as well as the complex vested interests concerned. The Protocol will effectuate change in the level of illicit trade but it cannot be completely effective until all Parties have implemented it across all participants in the supply chain. Further, illicit trade is not a local problem and inter-jurisdictional efforts are needed to solve it. Combating illicit trade in tobacco products requires both political will to place public health priorities above revenue enhancement and the sway of tobacco companies and concrete actions to fight cross-border crime. A central theme of all successful programs to combat illicit trade is cross-border cooperation as well as the cooperation of the tobacco companies.
Appendix A: Interviews Conducted

2. Florian Müller, Senior Manager Government/Stakeholder Relations, Corporate Affairs, PMI. Lausanne, Switzerland. March 22, 2014.