

Parallel Tobacco Trade during COVID-19: From Learnings to Expectations

Curtis Vaisse*

Founding Member, International Tax Stamp Association, Sunbury-on-Thames, UK

***Corresponding Author:** Curtis Vaisse, Founding Member, International Tax Stamp Association, Sunbury-on-Thames, UK.

Received: September 23, 2020; **Published:** October 07, 2020

Abstract

The lockdown measures during the COVID-19 pandemic created a unique situation where cross-border parallel trade was made impossible by border closures. This situation emphasized how tobacco parallel trade undermines public health policies that are grounded in tax hikes. In the EU for instance, where tax policies are essentially made at the national level - until such time as further European fiscal harmonization measures are put in place - the differences in retail prices and the oversupply of tobacco retailers located at borders, feed cross-border trade between member states with significant retail price differentials. Indeed, while EU tax harmonization is not foreseeable in the short term, even between neighbouring member states, measures are necessary to tackle what has become the most detrimental trade practice to the most efficient tobacco control policy: taxes.

But while EU tax harmonization is currently implausible due to differences in living standards between the member states, other regulatory measures - some of which are already in force, although not yet implemented - seem much more feasible. Indeed, the WHO Protocol to Eliminate Illicit Trade in Tobacco Products regulates national deliveries of tobacco and imposes deliveries that are commensurate with local consumption - in order to prevent illicit practices from occurring. The Protocol sets forth comprehensive requirements for a track and trace system to identify flows of tobacco and support the sanctioning of those responsible for illicit trade.

Overall, the WHO Protocol sets forth binding measures to tackle tobacco parallel trade. The International Tax Stamp Association, a non-profit association which excludes tobacco industry-related parties, has published a blueprint to support the elaboration of a robust and cost-effective track and trace system that is interoperable at international level. Indeed, while the requirements governing such systems appear quite technical and complex, the means to put these systems in place at national and regional levels are grounded in basic independence principles to ensure their effectiveness, which often necessitate judicial proceedings and the provision of related forensic evidence to discourage unscrupulous stakeholders from continuing with illicit practices.

Keywords: *Tobacco Trade; COVID-19; Tax*

“Tax and price policies are widely recognized to be one of the most effective means of influencing the demand for and thus the consumption of tobacco products”.

This statement from the guidelines for implementation of article 6 of the WHO FCTC shows the importance of tax policy and ultimately, of tobacco retail prices to tackle smoking prevalence.

All around the world, this statement has become an undisputable truth, which is why many countries have been regularly increasing taxes on tobacco, not only because they seek to maximize their revenue, but most importantly because most have grown aware of the health burden that tobacco consumption constitutes for society.

Citation: Curtis Vaisse. “Parallel Tobacco Trade during COVID-19: From Learnings to Expectations”. *EC Pulmonology and Respiratory Medicine* 9.11 (2020): 32-40.

Indeed, the direct and indirect cost of tobacco consumption for a country far outweighs the taxes that can be levied on the sale of tobacco products, thereby incentivizing public authorities to implement comprehensive tobacco consumption reduction strategies. In France for instance, the national court of auditors' evaluation published in 2012 [1] assessed the direct costs of tobacco at 45 billion euros per year, while mentioning that overall cost should be more systematically analysed (an economist reached a figure of 120 billion euros' worth of direct and indirect costs [2]). Meanwhile, VAT and excise collection amounted to about 15 billion euros per year for a pack of cigarettes costing on average a little less than 10 euros. Health related expenditure is therefore 3 to 7.5 times higher than generated revenue.

On the basis of this comparison, one could consider that the average price per pack in France should be somewhere around 30 euros (according to the court of auditors' evaluation) and 80 euros per pack (according to the second estimate) to compensate for the social cost of tobacco. Theoretically, this would allow for the health cost generated by smokers to be fully offset by the taxes levied on these products, without non-smokers having to bear the brunt of such costs. Of course, with such retail prices much fewer people would smoke, so that public revenue from tobacco would be decreased in similar proportions, requiring an even higher tobacco retail price. This absurd reasoning, although based on figures from a reputed institution and an economist, shows the difficulty of setting the right price policy for tobacco.

Taxes are the most efficient way to curb the tobacco epidemic

Tobacco price policy is the most efficient tool to combat smoking prevalence, but even taxes as high as 80% of the retail price of tobacco products are far from compensating the direct losses caused by their consumption. For price policy to be fully effective, it is paramount that all tobacco products generate their related revenue and are not affected by external factors.

Unfortunately, in France, where at least one quarter of tobacco consumption comes from parallel trade, the effects of price policy are made inefficient by the huge proportion of products coming from the parallel trade. Parallel trade encompasses both products that are purchased legally and brought back legally on a given territory, but also products purchased legally and brought back illegally (such as when tobacco is purchased in duty free shops or in neighbouring member states and brought back in quantities exceeding the franchise/limits), as well as products that are purchased illegally and sold illegally (more commonly called contraband products). But the line is thin, and one must already consider that products sold legally in a jurisdiction and brought back illegally could qualify as contraband products.

Now that these preliminary remarks on price policy have been exposed, let's consider how tobacco parallel trade has manifested during the COVID-19 crisis in the European Union (EU). This will enable us to precisely qualify the problem and propose the most obvious solution to it, which, remarkably, is not rocket science: it is simply the strict and comprehensive enforcement of existing compulsory regulation.

How lockdown measures contributed to learnings about the magnitude of tobacco parallel trade in the EU

Tobacco parallel trade is the subject of many studies by experts, academics and tobacco control specialists. But the lockdown measures have provided the most unique circumstances in history to allow for a specific analysis of its magnitude and provenance, notably in the EU.

Indeed, the COVID-19 health crisis created a situation where many countries had to close their borders to avoid an unmanageable spike in hospital admittance and potentially high death rates considering the limited availability of respiratory apparatus to cope with the virus' worse symptoms.

This led to a - somewhat foreseeable - spike in internal tobacco consumption where tobacco products were still on sale, considered as essential supplies by public authorities. In some countries like France, consumption in local retail shops soared on average by one fifth compared to the same period without lockdown measures, notably in the eastern and southern parts of France. From March 2020 to April

2020, near the borders of Germany for instance, cigarette purchases on the French side soared by 71% and that of roll-your-own products by 235.2%, while tobacconists on the Belgian border saw a 47.1% peak in cigarette sales and 188.4% peak in roll-your-own sales [3].

Considering the high level of cross-border trade in the EU, this did not come as a surprise: a very high percentage of tobacco products are purchased in neighbouring countries with much cheaper retail prices. France has five neighbouring member states with much cheaper tobacco retail prices (with price differentials ranging from 35% with Germany and Belgium, 45% with Luxembourg and up to 50% with Spain), thereby spurring significant levels of cross-border trade.

Yet, measures exist to ensure such practices are addressed, or at least diminished so that they do not substantially undermine the effectiveness of tobacco control policies - which they currently do.

Excise policy devoid of its rationale

It is interesting to compare the maps of tobacco retail prices in the EU for the past 20 years. The differences in retail prices between member states have remained similar, thereby reproducing the same type of price differentials that attract millions of smokers from one member state to cross the border (or more precisely enter a neighbouring member state, since borders physically no longer exist) and buy tobacco in the neighbouring member state. While such practices undermine public health policies, they have other unintended consequences: from environmental ones created by the pollution caused by vehicles used to purchase tobacco, to the undermining of the credibility of EU policies - with tobacconists on the affected border resenting this union for policies they consider are slowly killing their business. From a strictly fiscal standpoint, this leads to excise taxes being perceived in a territory which does not suffer the negative externalities of consuming the related products (i.e. their public health cost), thereby nullifying one of the fundamental effects of such consumption taxes. Of course, the same situation happens throughout the EU where significant price differentials exist between member states.

Indeed excise duties are meant both to discourage the consumption of the targeted product, but also to collect the needed revenue to refund the health cost of tobacco to social security systems. In France, where the highest retail price is applied throughout continental Europe, more than a quarter of French taxes are thus perceived elsewhere than where their public health aftermath is borne.

Some might consider this to be one of the few logical negative consequences of a common market. However, although not wanting to put into question the principle of the free circulation of goods, one would certainly have a hard time justifying that a product that kills 75,000 of its consumers per year (in France alone) should be subject to the same rules as other products such as foodstuffs or other consumer products. Moreover, a specific European legal framework (Directive 2008/118/EU) already limits the number of cigarettes transported by individuals to 800 cigarettes (four cartons), which is an admission that tobacco is such a specific product that it requires specific limitations with regard to the free movement of goods.

Existing regulatory tools to efficiently tackle tobacco parallel trade are not applied

While tax policy is considered one of the most efficient tools to reduce smoking prevalence, the legal measures that exist to ensure its effectiveness but are not fully implemented, if at all.

Indeed, the World Health Organization adopted a whole set of legal provisions setting forth public policy instruments to ensure a higher level of protection on a common basis, including the protection of such policies from vested interests of the tobacco industry. The basic instrument is the Framework Convention for Tobacco Control (FCTC) which entered into force on 27 February 2005 and laid the foundations of an international tobacco control regulatory framework which is now in force in the 182 parties that have ratified it to date. Following this ground-breaking achievement, more detailed rules needed to be adopted to specifically address parallel tobacco trade.

On the grounds of article 15 of the FCTC, the Protocol to Eliminate Illicit Trade in Tobacco Products was adopted in 2012. It now has 62 parties and is intended to provide the means to tackle illicit trade in tobacco products through the implementation of preventive and repressive measures. Among the former, know-your-customer policies and due diligence obligations oblige tobacco trade stakeholders to keep detailed records of the persons they conduct business with. These obligations combined with those that oblige states to implement track and trace systems in strict independence from the tobacco industry are meant to identify securely and unambiguously the rogue actors that do not trade tobacco legally... and to ensure that the means exist to sanction their practices.

On the repressive side, the Protocol organizes penal cooperation on an international scale, ensuring that infringements can be sanctioned regardless of where the infringement has taken place and regardless of the complexities that the globalization of world trade creates. Indeed, in an internationally open world, where products are often produced far away from where they are consumed, the ability of states to sanction illicit behaviour relies on the legal frameworks of other countries - this is typically an area where public policy must be adopted at international level to produce expected results through the use of harmonized tools.

WHO Protocol provisions to rule out oversupply of tobacco products

As regards parallel trade and more specifically cross-border trade in the EU, control of supplies is made compulsory by two provisions of the Protocol: article 7 and 10 impose that tobacco deliveries be commensurate with local demand for tobacco products. At member state borders where significant price differentials exist, one can easily understand the justification behind such provisions. Indeed, tobacco retailers on the side of the member state applying cheaper excise taxes are flourishing, often selling products in packaging that seem tailored to cross-border trade.

Tobacco products in such states are sold packaged in master packaging with multiple cartons, or much bigger quantities of roll-your-own tobacco (sometimes up to one kilogram), so as to satisfy the demand of consumers who are willing to transport big quantities of tobacco products. This seems to be knowingly organized to fuel cross-border trade (it can be compared to duty free shops where five-carton wrappings or bulk roll-your-own tobacco products are offered, while franchises are usually limited to one or two cartons per country).

In fact, the result of such actions is easily noticeable: most tobacconists from the expensive member state's side of such borders are shutting down or struggling with plummeting turnovers and just a few products on their shelves. Meanwhile, a few kilometres away on the other side of the border, in the member state applying cheaper prices, sales are much higher than local demand, with tobacconists offering hundreds of different references in gigantic stores and back shops to stock the necessary quantities of tobacco that will be sold to foreign consumers commuting to satisfy their need for cheap products. These tobacco shops are thriving businesses - except during the COVID-19 lockdown measures of course - which benefit tobacco manufacturers while seriously jeopardizing public health policies.

This is clearly a breach to the Protocol's provisions, which undermines public policies based on tax hikes. But considering the regularity of deliveries and the granularity of the supply network, the limitations provided for in the Protocol could easily be implemented through the establishment of a delivery schedule commensurate with national demand and controlled through a mechanism under government control, without affecting the EU's fundamental principles relating to the free circulation of goods. A secure traceability system under the control of member state governments could also provide technical functionalities for ensuring that retail shop activities abide by these protocol provisions.

Why is tobacco parallel trade so pervasive

The tobacco industry has argued for decades that tobacco parallel trade is caused by high retail prices, caused by taxes levied by state authorities. This statement fails to address the number one reason why tobacco parallel trade affects most countries applying tax-based

tobacco control policies: the facilitation of tobacco purchases by the tobacco industry and more precisely the feeding of tobacco parallel trade markets in tremendous proportions.

Canada is an illustrative and well-known example of how a tax-based public health policy can be turned down by a tobacco company opposed to the negative consequences it would have on its turnover. In an attempt to curb the health damages caused by tobacco consumption, Canadian authorities decided to significantly raise the taxes levied on tobacco. Rapidly the Canadian market was overwhelmed by illicit products, the trafficking of which was enabled by a tobacco industry actor, pushing the consumption of contraband products to 30% on average and up to 75% in some areas of Quebec. To cope with the soaring contraband, Canadian authorities had to reverse their policy and reduce tobacco taxes, so that the retail price of tobacco products was lowered to put an end to trafficking. This created a worrying precedent where the creation of a contraband market led a government to reverse its tax-based public health policy in consideration of the surge in contraband that was being fed by a legitimate tobacco actor.

All around the world, as soon as a government proposes, tries to implement, or enforces a tax hike, a tobacco industry actor raises the red flag of illicit trade - as was already the case in Canada, as described above, when the government publicised its upcoming tax increase - to discourage such a move on the grounds that it would cause a surge in illicit trade. But this alleged automatic reaction is actually one of pure creation, as no mention is made of why illicit trade exists in the first place: because some tobacco industry actors take measures to ensure that the parallel trade exists, and most illicit products actually originate from the tobacco majors' factories themselves [4].

It is also important to mention that, in spite of manipulation by the tobacco industry, positive actions can be effective to counter parallel trade practices: because robust, comprehensive and fully independent track and trace systems are not currently implemented worldwide. Should such measures be put in place and implemented, should enforcement and judicial authorities be empowered to convict the culprits, should judicial actions be conducted until those guilty are convicted, the levels of illicit trade would probably be far less important. Or course, security systems are only a part of the overall policy that must be implemented, since a system is only a tool that requires enforcement to be effective. But they are an essential component insofar as they enable correct and reliable information to be obtained by enforcement and judicial authorities, thereby bestowing authorities with the capacity to conduct their mission.

Despite the tobacco industry presenting itself as a victim - often citing counterfeits as the biggest threat to public policies - most evidence shows that the industry and its network fail to give a correct picture of reality.

Recently, a European parliament member published a report showing how parallel trade is diverse in nature but most often led by tobacco industry actors [5]. His findings lead to the conclusion that if one entrusts tobacco industry actors to solve an issue which they are the cause of, it will inevitably end in failure.

These findings cannot, however, be considered ground-breaking, and neither can the solution to this issue, which already exists: it consists in the obligation to implement comprehensively and stringently the Protocol provisions, notably with a robust track and trace system that is independent from the tobacco industry.

The expectations for a thorough protocol implementation

Given the many drivers of the parallel trade in tobacco products (including high demand, wide price differentials between legal and parallel markets creating significant margins, low risk of sanctions - or, more precisely, low enforcement of sanctions), the dynamics of tobacco parallel trade require strong counter-measures.

If unscrupulous actors think they can get away with an illegal practice, either because it is mildly punished, or not punished at all because of the lack of compelling evidence, such practice is bound to keep happening, particularly if it is very lucrative.

The system provided for in the Protocol is the very basis upon which customs, enforcement and judicial authorities can optimize their efficiency in tackling parallel trade. Should such a system be uncertain in its ability to define the status of a product, as well as be fragmented with regard to responsibilities, and reliant on persons having a direct or indirect interest in the practice that is being regulated, this will affect the system's effectiveness and make it impossible to identify with certainty - notably before judicial authorities - those responsible for the organization of parallel trade. Therefore, the practice will go unpunished, and its repetition will not be discouraged. On the other hand, should the system be certain in its ability to determine the provenance of a product and the person responsible, should it allocate responsibilities enabling the constitution of the necessary evidence for judicial proceedings and should it be fully independent from vested interests in the products' parallel trade, then it will enable the necessary sanctioning.

The implementation of a comprehensive system should be combined with other provisions of the Protocol, notably know-your-customer policies and due diligence processes which oblige manufacturers to ensure they scrutinize and keep detailed records of the downstream stakeholders in the supply chain of their products, so that when a parallel trade product is seized, its provenance can be readily identified, as well as the chain of custody that led the product to its illicit location.

Polemics about the EU tobacco traceability system's in compliance to the protocol

Different types of systems have been proposed to tackle tobacco parallel trade.

On the one hand, one of the latest examples is the system deployed in the EU on the basis of Directive 2014/40/EU. The European Commission conceived a system to detail the application of the general provisions contained in the Directive. To put it simply, among the three policy options proposed - a tobacco industry operated solution, a fully independent one and a mixed governance one - it selected the latter.

On these grounds, only generators of the unique codes to be printed on tobacco packaging would be selected through an open, transparent and competitive public tender. As for data processing and storage, as well as for the anti-tampering device installation on tobacco production lines (the device that verifies that the tobacco product is correctly marked), the providers are appointed and remunerated directly by the tobacco manufacturers, from a list of European Commission approved suppliers. It appears particularly odd to allow those that have been barred from taking part in tobacco supply chain control because of their involvement in tobacco parallel trade to be the ones to choose the data storage providers that conduct one of the most important parts of the system. In fact, such a situation resulted in the appointment of the information technology companies that had conceived, implemented and promoted the tobacco industry proprietary system (formerly known as Codentify) that the WHO had qualified as unfit for purpose [6].

Indeed, while the Protocol sets forth that its parties shall establish "a tracking and tracing system controlled by the Party for all tobacco products", that "obligations assigned to a Party shall not be performed by or delegated to the tobacco industry" and more importantly that "each Party shall ensure that its competent authorities, in participating in the tracking and tracing regime interact with the tobacco industry and those representing the interests of the tobacco industry only to the extent strictly necessary" [7] for the implementation of track and trace, one fails to understand how such a comprehensive and stringent set of provisions allowed former Codentify partners [8] to be in charge of the EU system's core components.

At the time of conception of the EU system, it was not yet obvious for the layman that the system was conceived in a way that would impede the security industry providers that had most experience in providing anti-illicit trade systems to governments for their traditional markets. But now that the providers of the EU system have been appointed among tobacco industry preferred suppliers, the system's ability to solve tobacco parallel trade appears doubtful, even before one considers already identified system failures on the part of some of the data storage providers for reporting logistical events [9].

International tax stamp association raison d'être

On the other hand, traditional security solution providers have concurrently continued to respond to national tenders imposing anti-illicit trade programs, which are based on a more cohesive set of requirements under the responsibility of a single supplier, providing unique identifiers, a multiple set of security features analogous to those used to print banknotes and centralised databases to provide governmental authorities with the required supply chain information.

Some of these providers constituted the International Tax Stamp Association (ITSA), a non-profit association bringing together 23 members from the security printing and authentication industry. Its first mission was to adopt, under the International Standardization Office (ISO), a consensual set of requirements governing content, security, issuance and examination of excise tax stamps [10]. After five years of work and meetings by security experts from all around the world, under the ISO security and resilience technical committee, ISO 22382:2018 was adopted in October 2018 in order to create a high-level benchmark supporting states seeking to implement excise tax stamps and traceability programs to efficiently tackle illicit trade.

Such a benchmark was created on the basis of the best practices implemented by ITSA members through their decades-long experience in implementing anti-illicit trade systems throughout the world. These experiences seem to have been a source of inspiration for the Protocol drafters (which explicitly mention tax stamps in article 8 - 3) between 2008 and the Protocol's final adoption in November 2012.

The detailed requirements for a Protocol compliant system remain to be finalized and adopted by the Protocol parties.

Recently, following the entry into force of the Protocol, and the obligation to Parties to implement Protocol compliant systems as of 2023, ITSA published an FCTC Protocol compliant blueprint [11], which laid out a proposal for systems to be implemented at national level, as well as ways to connect such systems to ensure cost-effectiveness, security and interoperability on an international scale.

The ITSA blueprint for a WHO protocol compliant system

The purpose of the present paper is not to give explicit details of the technical requirements in the ITSA blueprint (which are publicly accessible on the association's website), but to briefly explain the major principles that have been followed for its drafting.

Indeed, in order to come up with an efficient proposal, ITSA kept in mind the necessity to abide by Protocol provisions while entrusting a minimum of tasks to tobacco manufacturers. Indeed, the tasks entrusted to manufacturers do not jeopardize the system's security.

The blueprint therefore creates a level playing field between the providers of secure track and trace systems so that in response to national tenders based on these requirements, the competition between stakeholders will lead to cost-effective solutions without ever compromising the overall security and functionality of the system. While the system's cost could be seen as secondary considering the ability of parties to charge it to the tobacco industry (on the basis of article 8 - 14), it appeared necessary to ITSA to foresee cases where national authorities would be prevented from doing so, and thus propose the most cost efficient system.

The blueprint proposes detailed processes for each of the stakeholders of the system, from the national competent authorities, to the WHO governing bodies at the Framework Convention for Tobacco Control Secretariat, where a Global Information Sharing Focal Point is to be located. ITSA has taken into account all the main components - including tobacco industry responsibilities and the potential involvement of consumers to maximize the effectiveness of the system.

Lastly, in addition to other flaws of the EU system, ITSA also addressed the question of system operation, while strongly encouraging parties to identify conditions for control and enforcement at system inception so that the track and trace system delivers results during the first year of implementation.

Conclusion

While tax rises are one of the most efficient policies to curb the tobacco epidemic, tobacco parallel trade is the biggest obstacle to the effectiveness of tax policies. From cross-border trade - which is a lawful practice provided it remains within certain limits - to illicit trade, tobacco parallel trade requires comprehensive and robust means to ensure tax policies pursue their intended goal of limiting consumption and perceiving taxes where the health burden is borne. But some private stakeholders have an interest in undermining public policies to optimize their revenue, at the expense of national budgets, citizens' health and well-being and sometimes to the benefit of criminal organizations.

The most comprehensive and strongest measures need to be put in place to ensure such practices are stamped out. The legal basis exists in the form of the WHO Protocol to Eliminate Illicit Trade in Tobacco Products. But the details and technicalities of the system to be implemented in line with the Protocol are yet to be determined. Fully independent systems have been implemented around the world to enable governments to efficiently tackle tobacco parallel trade. Against these proven track records, the tobacco industry majors promote diverse types of alternative systems, such as the tobacco industry conceived Codentify platform, or the EU system for track and trace, in a bid to weaken effective tobacco control policies.

The International Tax Stamp Association, a non-profit organization that brings together the historical providers to governments of anti-illicit trade and traceability systems published a blueprint to support the definition of the most comprehensive, secure, efficient, yet cost-effective system, at national, regional and international levels. Indeed, while the pervasiveness of tobacco illicit trade requires the establishment of the most robust system at national and international levels, the experience of the security industry illustrates the proven benefits of anti-illicit trade programs.

The main requirement that must be kept in mind for the system to be efficient is governance. Only a fully independent track and trace system, from conception to industrialization, from data creation to data processing, and from the national layer to the international layer, can empower the revenue authorities of Protocol parties and the WHO with systems that are strictly independent from the tobacco industry and based on public, transparent and competitive tenders, so as to tackle illicit trade in the most efficient and cost effective way possible.

Bibliography

1. Rapport d'évaluation Les politiques de lutte contre le tabagisme.
2. Le coût social des drogues en France.
3. <http://www.lemondedutabac.com/marche-du-tabac-une-augmentation-de-237-directement-liee-a-la-fermeture-des-frontieres-seita/#more-128864>
4. <https://tobaccoatlas.org/topic/illicit-trade/>
5. MEP Younous Omarjee. "The black book of the tobacco lobby".
6. Anna B Gilmore., *et al.* "Tobacco industry's elaborate attempts to control a global track and trace system and fundamentally undermine the Illicit Trade Protocol". *Tobacco Control* 28.2 (2017): e127.
7. Article 8-2, 8-12 and 8-13 of the Protocol.
8. Allen William Andrew Gallagher., *et al.* "Tracking and tracing the tobacco industry: potential tobacco industry influence over the EU's system for tobacco traceability and security features". *Tobacco Control* (2019).

9. First operational year of the EU system of tobacco traceability.
10. ISO 22382:2018. Security and resilience - Authenticity, integrity and trust for products and documents - Guidelines for the content, security, issuance and examination of excise tax stamps.
11. Proposal for an FCTC protocol-compliant tobacco control system blueprint.

Volume 9 Issue 11 November 2020

©All rights reserved by Curtis Vaisse.