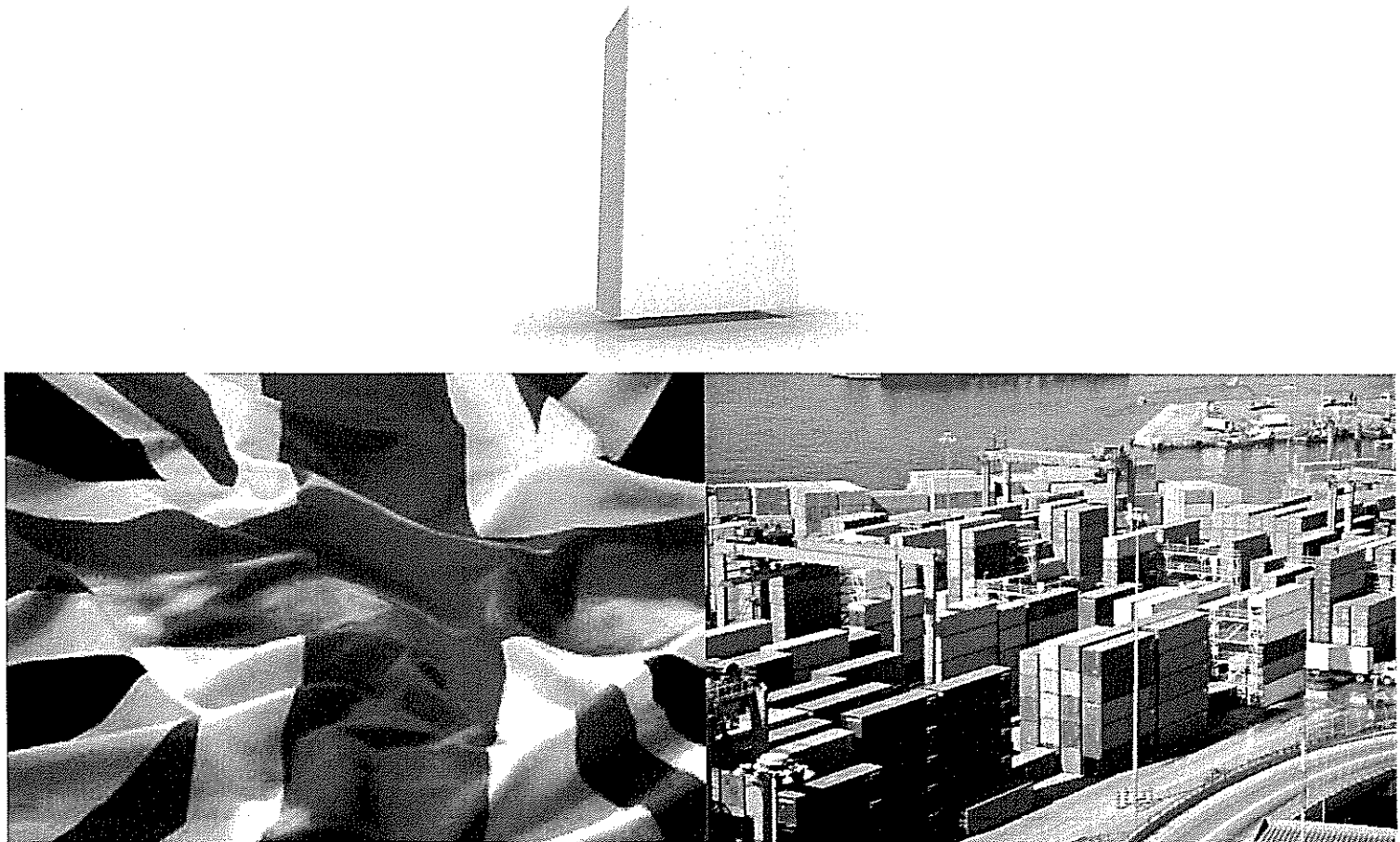


## PLAIN PACKAGING AND ILLICIT TRADE IN THE UK



STUDY ON THE RISKS OF ILLICIT TRADE IN TOBACCO PRODUCTS AS UNINTENDED  
CONSEQUENCES OF THE INTRODUCTION OF PLAIN PACKAGING IN THE UK

## PLAIN PACKAGING AND ILLICIT TRADE IN THE UK

Study on the risks of illicit trade in tobacco products as unintended consequences of the introduction of plain packaging in the UK

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# Executive Summary

This study analyses the risks of the illicit trade in tobacco products (ITTP) which may arise as the unintended consequences of the introduction of plain packaging of tobacco products in the UK.

**The tobacco market is a dual market.** It consists of a legitimate and an illegal part, which implies that **changes to the legal market may affect the illicit market as well.** The ITTP is a threat to the effectiveness of tobacco control policies aimed at curbing smoking and its dangerous effects on human health.

The plain (also known as generic or standardised) packaging of tobacco products is a tobacco control policy which forbids any form of branding or any other distinguishing feature on the packaging of tobacco products. The main assumption behind the requirement of plain packaging is that logos, colours and other features of tobacco packaging are important means of promotion. At present, plain packaging has not yet been implemented in any country in the world. Australia is the only country to have approved plain packaging legislation, which will be implemented in December 2012. The past few years have seen lively debate on plain packaging in the UK. Recently, the Department of Health launched a public *Consultation on standardised packaging of tobacco products* on 16 April 2012.

## *The ITTP in the UK*

**The ITTP became an important concern in the UK during the 1990s.** In 1999-2000, HM Treasury estimated that the market share of illicit tobacco amounted to nearly 18% for cigarettes and 80% for hand-rolling tobacco (HRT). In 2000, the UK Government launched a strategy to tackle the trade in illicit tobacco, with an investment of £209m over three years from 2000 (deployment of

approximately 1000 extra customs staff and the purchase of x-ray scanners) and the allocation of a further 200 operational staff in 2006 specifically to tackle HRT smuggling. Although the Government's action has been quite successful in reducing the market share of illicit products, **the UK illegal market still remains above the average of EU Member States.**

**The structure and functioning of the UK illicit market have significantly changed in reaction to intensified enforcement efforts.** Other forms of ITTP have gradually emerged, with large-scale smuggling being replaced by a significant growth of counterfeit cigarettes. Furthermore, illicit whites have gradually gained an important share of the illicit market. **This evolution shows that ITTP is a highly flexible phenomenon: it is sensitive to the regulation of the legal market and also to law enforcement efforts.** The introduction of new tobacco control measures should consider their impacts on the illicit trade.

## *Limited assessment of the impacts of plain packaging on the ITTP*

**Despite the importance of the ITTP in the UK, the policy documents prepared for the public consultation have not considered the impacts on the ITTP.** In particular, the systematic review of evidence commissioned by the Department of Health has overlooked the impacts on the illicit trade (Moodie, Stead, et al., 2012, pp. 5-6). Furthermore, the Impact Assessment on plain packaging prepared by the Department of Health remarked that "any risk that standardised packaging could increase illicit trade of tobacco will be explored through consultation as there is insufficient evidence on which to include analysis in this IA" (Department of Health, 2012a, p. 3). The report explicitly recognized the importance

of the ITTP, arguing that “the main uncertainties associated with the policy explored herein [...] relate to impacts upon price and the illicit tobacco trade” (2012a, p. 13), that “the illicit and cross-border trade are declining but there is the risk that standardised tobacco packaging may lead to some reversal of this trend” (2012a, p. 19) and that “any adverse impact of standardised tobacco packaging (increase) in the non duty paid segment of the market could involve significant costs” (2012a, p. 23).

**Notwithstanding the acknowledged importance of the risks relative to the ITTP, the documents cited have not conducted a detailed analysis of the likely impacts of the introduction of plain packaging.** This is remarkable because plain packaging may produce a variety of effects which ultimately undermine its main purpose, i.e. to reduce smoking initiation and prevalence. **This lack of knowledge is important, and more specific studies should be conducted on this issue by the UK authorities.**

*The risks of ITTP as unintended consequences of plain packaging*

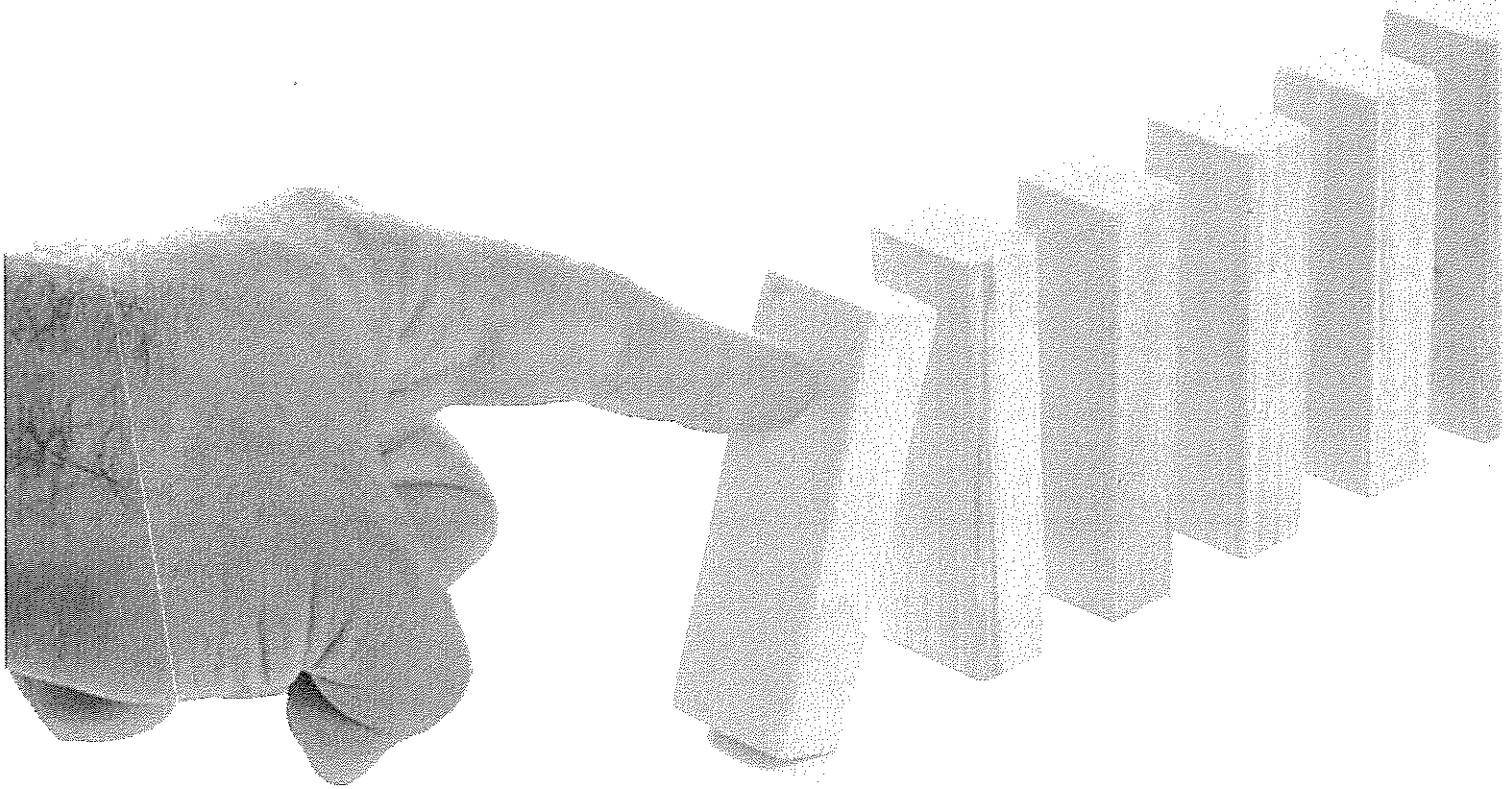
**This study identifies three main risks associated with the introduction of plain packaging**

1. **An increased risk of counterfeiting of tobacco products.** Plain packaging will facilitate the business of counterfeiters in two ways: it will make it easier for them to reproduce

genuine products, and it will significantly reduce the production costs of counterfeits. The counterarguments advanced in relation to the risk of counterfeiting are weak. Firstly, the presence of pictorial health warnings has not to date discouraged counterfeiting, and health warnings are easier to counterfeit than specific brands and features. Secondly, the presence of covert marking and other identification devices does not help consumers to spot counterfeits.

2. **A risk of decreased differentiation between legitimate and illicit tobacco products.** The implementation of plain packaging may gradually decrease consumers' perception of the differences between legitimate and illicit tobacco products. Market data suggest that a downtrading trend is already in progress, with consumers switching to cheaper products. Given this scenario, there is the risk that unbranded genuine products may lose most of their appeal compared with cheaper illicit cigarettes.
3. **A risk of increased ITTP as a result of increased potential profits.** Many studies suggest that plain packaging may induce price-competition among brands. This may lead to price reduction, with possible risks of increased consumption. The increasing of taxes to counterbalance price reductions will increase the potential profits for the ITTP.

# 1. Introduction



This study analyses the risks of illicit trade in tobacco products (ITTP) which may be created as unintended consequences of the introduction of plain packaging of tobacco products in the UK.

Transcrime has been studying the impact of legislation on crime for years, beginning with projects funded by the European Commission (Savona, 2006a; Savona, Maggioni, Calderoni, & Martocchia, 2006). The main assumption has been that, in intensely regulated markets, regulation may unwittingly create opportunities for illicit and criminal activities (Albrecht & Kilchling, 2002; Morgan & Clarke, 2006; Savona, 2006a, 2006b; Savona, Calderoni, Martocchia, & Montrasio, 2006; Savona, Maggioni, et al., 2006). Assessment of the unwanted crime

risks may contribute to better regulation, enabling the more effective and efficient achievement of policy goals.

In regard to tobacco markets, Transcrime has already analysed the impact of the current and forthcoming regulation of the tobacco market on the ITTP. In particular, a first paper assessed the crime risks associated with the current European Union regulation (Transcrime, 2011); a second study conducted a crime proofing exercise on the proposed policy options for the revision of the EU Tobacco Products Directive (Calderoni, Savona, & Solmi, 2012);<sup>1</sup> a third

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<sup>1</sup> Directive 2001/37/EC of the European Parliament and of the Council of 5 June 2001 on the approximation of the

report analysed the likely impact of the Draft Protocol on Eliminating Illicit Trade in Tobacco Products, under negotiation within the context of the World Health Organization Framework Convention on Tobacco Control (Transcrime, 2012).

Transcrime's report on the EU Tobacco Products Directive analysed the likely impact of a number of possible policy options, including the introduction of plain packaging in the EU. The results of the study pointed out that "generic packaging is likely to impact on consumers' capacity to distinguish legitimate products from counterfeit ones. In particular, the envisaged measures do not adequately address the risks associated with a possible increase in counterfeiting" (Calderoni et al., 2012, p. 40). It also argued that "the lack of any study on generic packaging and the ITTP suggests that any policy considering its introduction should carefully ponder the possible risks relating to the criminal opportunities" (Calderoni et al., 2012, p. 14).

The debate of recent years on the introduction of plain packaging in the UK and the recent launch of the public consultation on the plain packaging of tobacco products represent an interesting opportunity for more detailed study of the risks of this policy for the illicit trade (Department of Health, 2012b).

**The aim of this study is to focus exclusively on the impact of plain packaging on the illicit trade in the UK.** While other impacts (e.g. smoking habits, health, and the legitimate tobacco market) have been more thoroughly studied, there is a lack of sound analyses on the effects of plain packaging on the illicit trade.<sup>2</sup> This

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laws, regulations and administrative provisions of the Member States concerning the manufacture, presentation and sale of tobacco products, *OJ L* 194, 18.7.2001, p. 26–35.

<sup>2</sup> The literature review conducted for this paper identified only one study in this specific field which concluded that plain packaging may not affect consumers' behaviours towards illicit tobacco (Moodie, Hastings, & Joossens, 2012). However, closer assessment of the approach and methodology adopted suggests that they may not adequately support the conclusions (for further discussion, see section 3 below).

study tackles this specific issue and is not specifically concerned with the impact on other fields, however important. Tobacco consumption is indubitably a danger for human health, and the tobacco market should be carefully regulated by governments. However, as already observed in many other fields, regulation may create unintended opportunities for illicit or criminal activities which, while encouraging illegal behaviour, may ultimately jeopardize achievement of the policy goals.

**The tobacco market is a dual market, i.e. it is composed of a legitimate and an illegal part.** A number of factors may influence the extent of both parts. Since tobacco markets are generally closely regulated, regulation may play an important role in determining the relationship between the legal market and illicit tobacco. While some studies have already considered the impact of different pricing and taxation policies on smuggling (Abedian, van der Merwe, Wilkins, & Jha, 1998; Chaloupka & Warner, 2000; Joossens, Chaloupka, Merriman, & Yurekli, 2000; Reidy & Walsh, 2011), scholars acknowledge that "the impact of non-price smoking regulations on cigarette smuggling has not been considered in the literature" (Goel & Nelson, 2008, p. 55). **The dual nature of the tobacco markets implies that the ITTP is a threat to the effectiveness of tobacco control policies aimed at curbing smoking and its dangerous effects on human health.** Illicit tobacco products are supplied with no controls and to consumers of any kind, including minors; the ITTP provides cheap tobacco which in turn may increase smoking prevalence and initiation (Joossens, Merriman, Ross, & Raw, 2009; West, Townsend, Joossens, Arnott, & Lewis, 2008). Counterfeit tobacco products have very low quality standards and have been proved to cause even more serious damage to human health (HMRC, 2006, pp. 13–14; von Lampe, 2006, p. 240). Finally, the ITTP decreases government revenues from taxation, affecting public budgets and damaging the legitimate market, which in its turn generates employment and tax revenues for the national economy.

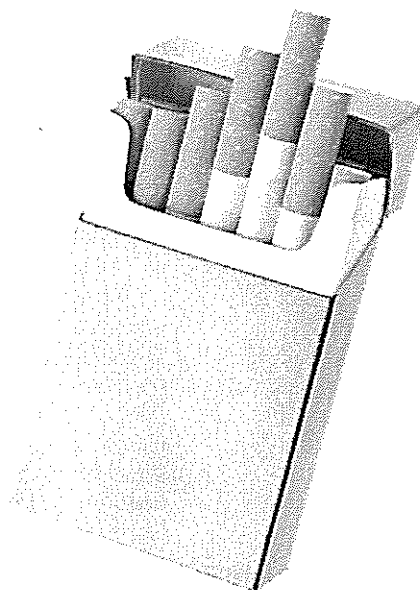
This report is organized as follows. The following subsections discuss the history of plain packaging and the debate on its introduction in the UK. Section 2 analyses the

illicit trade in tobacco products with a particular focus on the UK market. The third section considers the likely impacts of the introduction of plain packaging in the UK on the illicit trade. Section 4 concludes.

*As a concerned stakeholder in the fight against the illicit trade in tobacco products, Philip Morris International (PMI) welcomed*

*Transcrime's initiative to conduct research on the possible impact of plain packaging in the UK, with financial support and the provision of relevant information on the UK tobacco market. However, Transcrime retained full control and stands guarantor for the independence of the research and its results.*

## 1.1. Plain packaging of tobacco products



The plain packaging of tobacco products is a tobacco control policy prohibiting any form of branding or any other distinguishing feature on the packaging of tobacco products. The only exception is the name of the brand and the name of the product, which should be written in a standard font and size for all products (Deloitte, 2011; Department of Health, 2012a, 2012b; Europe Economics, 2008; London Economics, 2012; Moodie, Stead, et al., 2012; Standing Committee on Health, 1994).

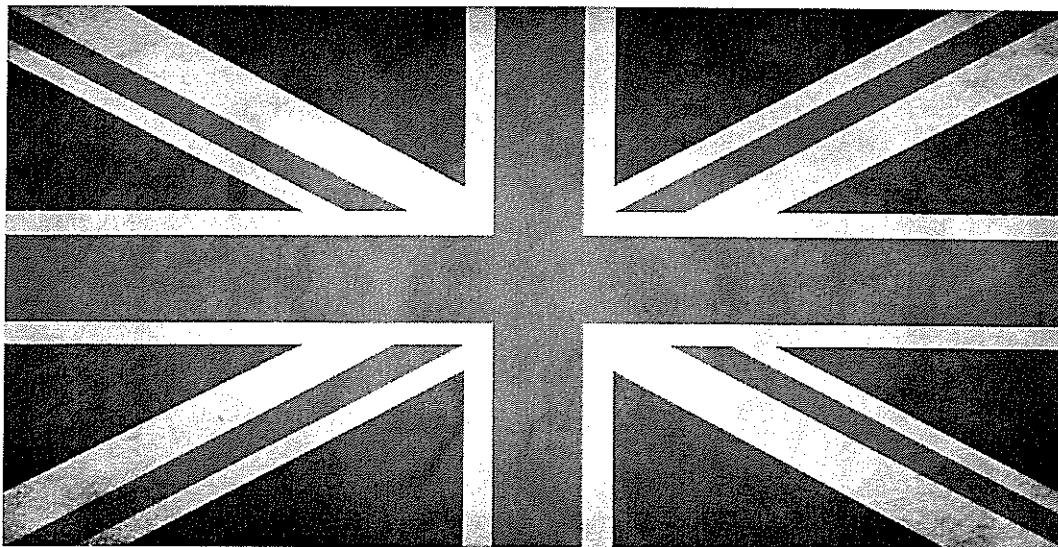
The main assumption behind the obligation of plain packaging is that logos, colours and any other feature of tobacco

packaging are important means of promotion. In particular, it is argued that some specific forms of packaging may stimulate smoking initiation, particularly among young people (Moodie, Stead, et al., 2012).

The first arguments in favour of plain packaging were advanced at the end of the 1980s by New Zealand's Department of Health (Laugesen, 1989). At present, plain packaging has not yet been implemented in any country in the world. Australia is the only country to have approved plain packaging legislation (the Tobacco Plain Packaging Act 2011), which will be implemented in December 2012.



## 1.2. Plain packaging in the UK



Recent years have seen lively debate on plain packaging in the UK. In 2008, the Department of health opened a public consultation on the future of the UK's tobacco control strategy. The consultation document solicited the opinions of stakeholders and the general public about the introduction and likely impact of plain packaging of tobacco products (Department of Health, 2008, pp. 39–42).

In 2010, the Department of Health's Tobacco control strategy argued in regard to plain packaging that

the Government believes that the evidence base regarding 'plain packaging' needs to be carefully examined. Therefore, the Government will encourage research to further our understanding of the links between packaging and consumption, especially by young people. The Government will also seek views on, and give weight to, the legal implications of restrictions on packaging for intellectual property rights and freedom of trade (Department of Health, 2010, p. 39)

In 2011, the Coalition Government adopted a new tobacco control strategy. This also addressed the issue of plain packaging. In

particular the Government undertook to hold a specific public consultation for the purpose of exploring how to reduce the promotional impact of tobacco packaging (including plain packaging) within the end of 2011 (Department of Health, 2009, p. 22). The consultation was subsequently postponed owing to the need for its coordination with the Governments of Scotland, Wales and Northern Ireland, as well as to complete a comprehensive review of available evidence on the topic (Lansley, 2011). The public *Consultation on standardised packaging of tobacco products* was launched on 16 April 2012. It is clear from its title that the Government had shifted its focus from the reduction of the promotional impact of tobacco packaging to the specific measure of obliging the use of plain packaging (Department of Health, 2012b).<sup>3</sup> The Consultation document was accompanied by an impact assessment exercise on the introduction of plain packaging obligations in the UK (Department of Health, 2012a) and a systematic review of evidence on plain packaging commissioned by the Department of Health (Moodie, Stead, et al., 2012).

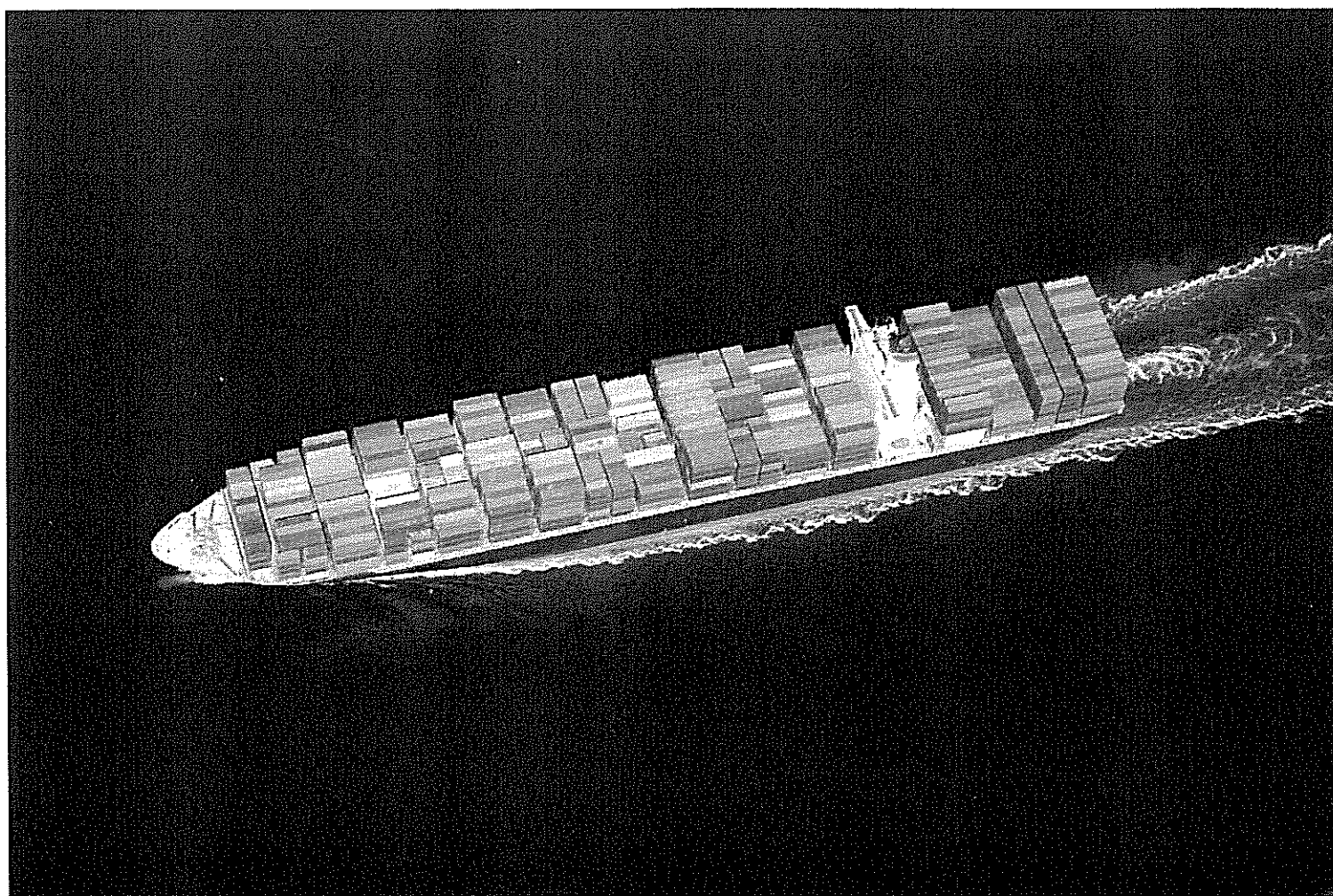
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<sup>3</sup> The consultation preferred to use the expression 'standardised packaging' rather than 'plain packaging' or 'generic packaging' (Department of Health, 2012b, p. 3).

**The Department of Health's consultation document and the Impact Assessment, as well as the systematic review on plain packaging, did not consider the latter's implications for the ITTP, and particularly for the counterfeiting of tobacco products.** In particular, the systematic review of evidence commissioned by the Department of Health completely overlooked the impacts on the illicit trade (Moodie, Stead, et al., 2012, pp. 5–6). Furthermore, the Impact Assessment on plain packaging by the Department of Health remarked that “any risk that standardised packaging could increase illicit trade of tobacco will be explored through consultation as there is insufficient evidence on which to include analysis in this IA” (2012a, p. 3). At the same time, the report explicitly acknowledged the importance of the ITTP, arguing that “the main uncertainties associated with the policy

explored herein [...] relate to impacts upon price and the illicit tobacco trade” (2012a, p. 13), that “the illicit and cross-border trade are declining but there is the risk that standardised tobacco packaging may lead to some reversal of this trend” (2012a, p. 19) and that “any adverse impact of standardised tobacco packaging (increase) in the non duty paid segment of the market could involve significant costs” (2012a, p. 23). Notwithstanding the acknowledged importance of the illicit trade, these statements were not followed by detailed analysis of the risk of increased ITTP as an unintended consequence of the introduction of plain packaging. This is remarkable because several studies have argued that plain packaging may have a variety of effects which ultimately undermine its main purpose, i.e. reduce smoking initiation and prevalence (Bloomquist, 2011; Deloitte, 2011; Europe Economics, 2008, p. 29).

## 2. The illicit trade in tobacco products in the UK



## 2.1. The Illicit Trade in Tobacco Products and its size



The illicit market for tobacco products comprises a number of different activities which vary significantly as to their causes, drivers, actors, *modi operandi* and output. It is important to distinguish the different types of ITP, namely:

- **Smuggling (or contraband):** the unlawful movement or transportation (including online sale) of tobacco products (genuine or counterfeit) from one tax jurisdiction to another without the payment of applicable taxes or in breach of laws prohibiting their import or export (Joossens & Raw, 2008).
- **Counterfeiting:** the illegal manufacturing of a product bearing or imitating a trademark without the owner's consent. Illegally manufactured products can be sold in the source country or smuggled into another country (Joossens & Raw, 2008).
- **Cheap Whites or Illicit Whites:** this more recent type of ITP relates to cigarettes being produced legally in one country but normally intended for smuggling into countries where there is no prior legal market for them. Taxes in production countries are normally paid, while they are avoided/evaded in destination countries (Allen, 2011).
- **Unbranded tobaccos:** these are manufactured, semi-manufactured and even loose leaves of tobacco (also known as "chop-chop" (Geis, 2005)) being illegally sold by weight (e.g. in large plastic bags, also known as "baggies"), carrying no labelling nor health warnings and consumed in roll-your-own cigarettes or in empty cigarette tubes (Walsh, Paul, & Stojanovski, 2006).

- **Bootlegging:** this consists in legally buying tobacco in a low-tax country and illegally reselling it in a high-tax country. This crime concerns individuals or small groups who smuggle smaller quantities of cigarettes, taking advantage of tax differentials, with the aim of making extra income (Hornsby & Hobbs, 2007).
- **Illegal manufacturing:** this concerns cigarettes manufactured for consumption, which are not declared to the tax authorities. These cigarettes are sold without tax and may be manufactured in approved factories or illegal covert operations (Joossens, Merriman, Ross, & Raw, 2010).

**The ITTP is very profitable for a number of reasons.** The first reason is that the potential demand for illicit tobacco in any market may be extremely high. Indeed, the tobacco market has a dual nature in that it is composed of a legitimate and an illegitimate part (Reidy & Walsh, 2011, p. 9). The licit and illicit markets vary across countries and regions according to the cultural, social and economic factors affecting the structure of the tobacco market. This implies that the illicit market has significant room for expansion, potentially addressing the entire demand for tobacco products of a specific market, if favourable conditions are met and no countermeasures are adopted.

A second reason is that tobacco products are heavily taxed in most countries. The difference between retail price and production costs is very wide and accounts for the greater share of the former (Joossens, 1998, p. 149; Levinson, 2011, p. 21). In particular, cigarettes are the commodity with the highest fiscal value per weight (Joossens, 1998, pp. 149–150). These mechanisms make the ITTP a business yielding high profits, since the different types of ITTP illegally avoid or significantly reduce the taxation of tobacco products.<sup>4</sup> Although heavy taxation

on tobacco products serves to reduce and compensate for the societal costs of tobacco consumption, the price difference makes all forms of ITTP very profitable activities (Reidy & Walsh, 2011; van Duyne, 2003; von Lampe, 2005a, 2005b). Indeed, taxation levels are only the first driver of the ITTP. Other elements are crucial in the development and flourishing of illicit tobacco markets (e.g. socio-economic factors, smoking prevalence and habits, supply and demand for illicit products, law enforcement, penalties and sanctions) (Blecher, 2010; Joossens et al., 2009; Joossens & Raw, 1998).<sup>5</sup>

Several studies have attempted to estimate the size of the ITTP by means of different methodologies. The world share of the ITTP on total tobacco consumption was reported to be 6% in 1993, 8.5% in 1995, 10.7% in 2006, 11.7% in 2007 (Merriman, Yurekli, & Chaloupka, 2000; Shafey, Eriksen, Ross, & Mackay, 2009).<sup>6</sup> As for the EU market, recent studies have estimated the EU ITTP at approximately 8.5% of total consumption in 2007 (Joossens et al., 2009, p. 10) and 9.9% in 2010 (KPMG, 2011, p. 39).

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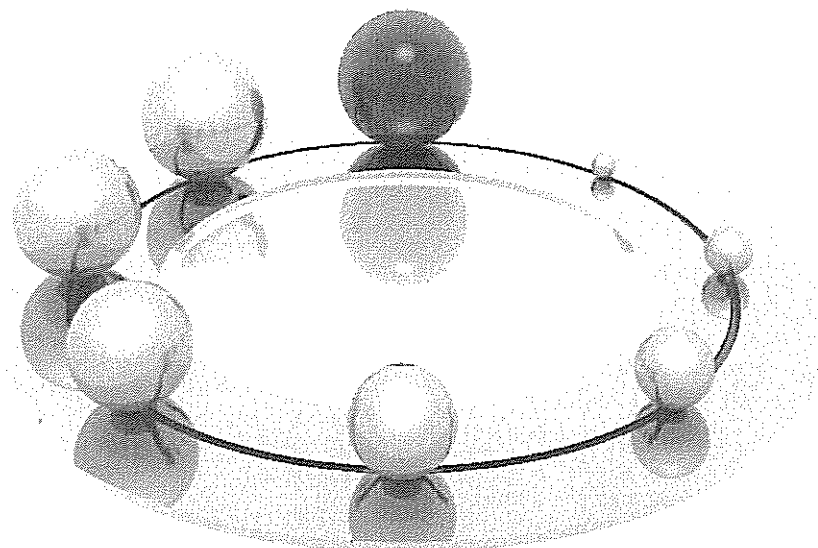
the invested capital (van Heuckelom, 2010) and over (Gutauskas, 2011, p. 72).

<sup>5</sup> Specifically, “a high tax margin can provide the initial incentive to smuggle; however the data show that it is not the most important factor” (Joossens, Merriman, Ross, & Raw, 2009, p. 9).

<sup>6</sup> There is evidence to suggest that the worldwide retail value of the ITTP may be comparable to the cocaine market. Estimates by a recent UN report on the cocaine market highlighted that the global retail value of consumed cocaine was 85 billion US\$ in 2009 (UNODC, 2011). A recent study estimated the worldwide government revenue losses from the ITTP at 40.5 billion US\$ in 2007 (Joossens et al., 2009, p. 2). Considering that the mean of taxes in percentage of retail price is approximately 50%, the global retail value of the ITTP for the same year equalled 81 billion US\$ on the legitimate market. This is the market value that the currently illicit share of the market would have on the legal market (the mean tax proportion of final retail price was calculated on data from the Tobacco Atlas 2009 (Shafey, Eriksen, Ross, & Mackay, 2009, pp. 105–113). The mean share is not weighted for the population, but the mean tax share for the first five countries in the world by population (China, India, USA, Indonesia and Brazil) is 49.75%, suggesting that the weighted mean share should not vary significantly. However, some world regions have significantly higher mean tax proportions. For example, in the European Union it amounts to 79.6% (European Commission, 2011, p. 6)).

<sup>4</sup> According to experts, cigarette counterfeiting may grant a return on investment of more than forty times

## 2.2. The evolution of the ITTP in the UK



The ITTP became an important concern in the UK during the 1990s, when it grew rapidly because of the increased relative prices of tobacco products in the UK, the creation of the European Single Market, and the associated profitability of the illegal trade (Hornsby & Hobbs, 2007, p. 551; von Lampe, 2006, p. 236). In 1999-2000, HM Treasury estimated that the market share of illicit tobacco amounted to nearly 18% for cigarettes and 80% for hand-rolling tobacco

(HRT) (HM Customs and Excise, 2000, p. 5). In particular, the bulk of the illicit tobacco consisted of genuine UK brands which were initially exported and subsequently smuggled back to the UK. In particular, exports were directed to relatively small countries with low controls (e.g. Andorra, Latvia, Moldova). This made it possible to evade taxation (e.g. exploiting VAT exemptions for exports), making it a profitable illegal scheme.

**Table 1. Estimates of the size of the UK illicit cigarette market. Percentage of the total market.**

Source	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
HMRC (HMRC, 2011)	21	20	16	18	17	16	15	14	13	10	
Euromonitor (2011a)						17.5	17	16.7	16.5	15.9	15.1
KPMG (2011)							13	15.8	15.6	12.6	10.5
TMA (N.d.-a)(N.d.)	31	30	26	28	28	28	27	27	24	21	

Source: Transcrime elaboration on HMRC, Euromonitor, KPMG and TMA data.

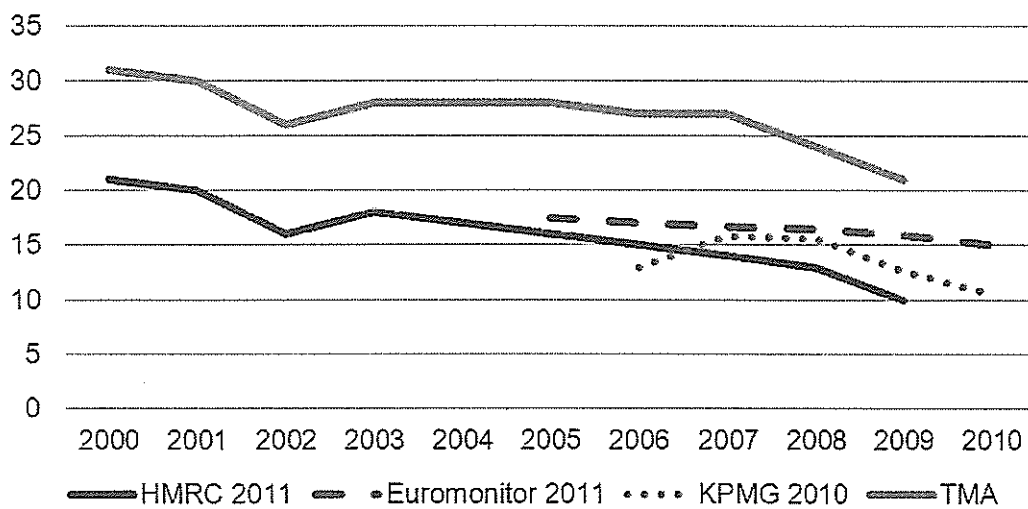
In 2000, the UK Government launched a strategy to reduce the ITTP, including a variety of measures ranging from increased resources for law enforcement agencies to

the signature of memoranda of understanding with the tobacco manufacturers (HM Customs and Excise, 2000). The strategy invested a significant

amount of resources, with a financial effort of £209m over three years from 2000, with the deployment of approximately 1000 extra Customs staff and the purchase of x-ray scanners (HM Customs and Excise, 2000, p. 11). In 2006, a further 200 operational staff were deployed specifically to tackle HRT smuggling (HMRC, 2006, p. 20). These efforts were the first strategic action plan

against the ITTP in the world (Joossens & Raw, 2008). Overall, the Government strategy has been quite successful in reducing the market share of the illicit trade. According to various estimates, the decline has been particularly noticeable for both illicit cigarettes and HRT (See Table 1 and Figure 1 for cigarettes, Table 2 and Figure 2 for HRT).

**Figure 1. Estimates of the size of the UK illicit cigarette market in percentage of the total market.**



Source: Transcrime elaboration on HMRC, Euromonitor, KPMG and DH data.

Notwithstanding these important efforts and results, **the market share of illicit tobacco in the UK remains above the average of EU Member States** (KPMG, 2011, p. 40). Furthermore, the illicit share for HRT is extremely large, hovering around 50% of the market. This is particularly remarkable considering that the sales of HRT have

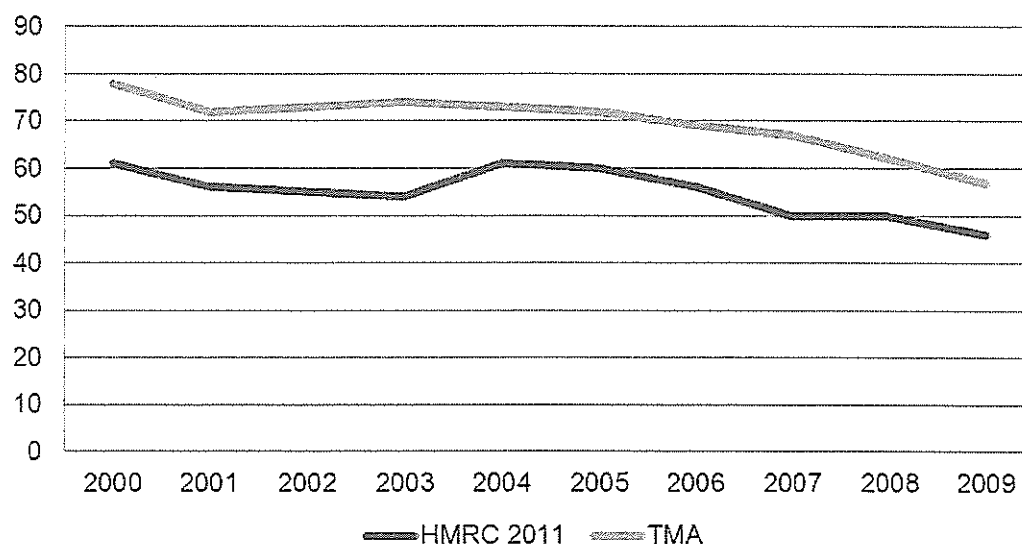
significantly increased because a number of consumers have switched from cigarettes to HRT in recent years (Euromonitor, 2011b, p. 18; KPMG, 2011, p. 260; TMA, n.d.-b). As reported by the Department of Health, the share of consumers mainly smoking HRT has increased to nearly 30% (Department of Health, 2012a, p. 17).

**Table 2. Estimates of the size of the UK illicit HRT market. Percentage of the total market.**

Source	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
HMRC (HMRC, 2011)	61	56	55	54	61	60	56	50	50	46
TMA (N.d.-b)(N.d.)	78	72	73	74	73	72	69	67	62	57

Source: Transcrime elaborations on HMRC and TMA data.

Figure 2. Estimates of the size of the UK illicit HRT market. Percentage of the total market.



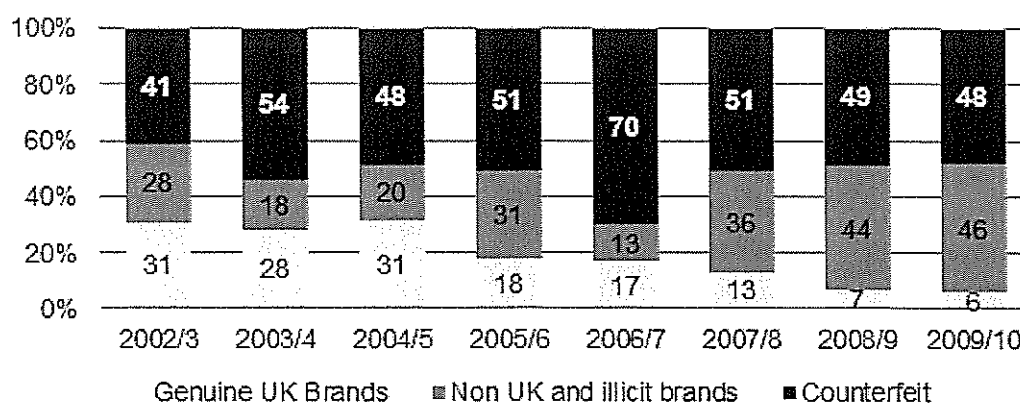
Source: Transcrime elaboration on HMRC and TMA data.

In the years following the adoption of the new strategy, as a reaction to increased enforcement resources and efforts, **the structure and functioning of the UK illicit market significantly changed** (HMRC & UKBA, 2011, p. 6). The share of the illicit cigarette market due to the large scale smuggling of UK genuine products dramatically diminished. This was due to stronger action by the Government, but also to a change of behaviour by some manufacturers, which, under pressure by the authorities and the public opinion, discontinued their exports to the above

mentioned countries (von Lampe, 2006). As a result, seizures of UK genuine brands dropped from 31% to 6% of all large seizures made by UK law enforcement agencies (Figure 3).

Similarly, the share of non-UK duty paid cigarettes (a figure calculated by the Tobacco Manufacturers' Association and which includes smuggling, counterfeiting, duty free and cross-border purchases of cigarettes) from extra-EU countries fell from 46% in 2001 to 15% in 2010 (Figure 4).

Figure 3. HMRC and UKBA seizures of cigarettes (over 100,000 sticks) by type of cigarettes.



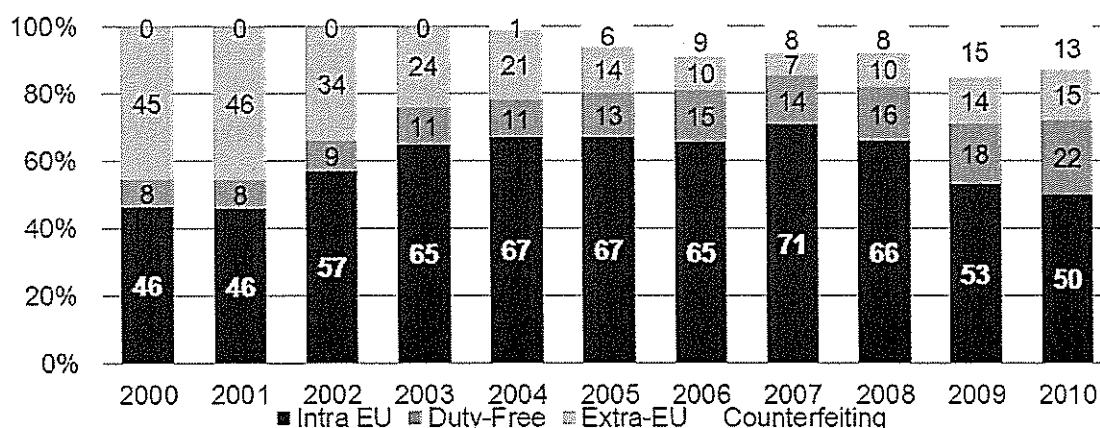
Source: Transcrime elaboration on HMRC and UKBA (2011, p. 6) data.



**Other forms of ITTP gradually emerged.** Firstly, large scale smuggling was replaced by a significant **growth of counterfeit cigarettes**. Remarkably, in 2001/2002 counterfeits accounted for only 15% of the large seizures made by HMRC (HMRC, 2006, p. 12). This figure grew to 70% in 2006/7 (HMRC & UKBA, 2011, p. 6). In the three following years, it stabilised at approximately 50% of the total seizures (HMRC & UKBA, 2011, p. 6). These figures show that some changes occurred in the UK illicit cigarette market. However, the estimates should be treated with particular caution because they rely exclusively on data from large seizures (i.e. > 100.000 sticks) and may be biased in favour of large scale ITTP. It is likely that seizure data overestimate the presence of counterfeits, since these are frequently shipped in large loads. Indeed, data from the Tobacco Manufacturers Association indicate

a significantly lower market share for counterfeits, although they confirm a growing trend from 2004 to 2009 (Figure 4). At the same time, a number of specific counterfeit 'hotspots' were identified, accounting for more than 85% of street seizures (HMRC, 2006, p. 13). This confirms the local nature of most forms of the ITTP, which may affect only relatively specific areas and regions (von Lampe, 2006). In any case, this growing trend corresponds to the explosion of counterfeit cigarettes produced in China (von Lampe, Kurti, Shen, & Antonopoulos, 2012). Indeed, the UK authorities confirmed that counterfeit cigarettes originated from the Far East and Eastern Europe and quickly became the major concern of UK law enforcement action against the ITTP (HMRC, 2006, pp. 12–14; Shen, Antonopoulos, & Von Lampe, 2010).

**Figure 4. Non-UK duty paid by source. Percentage of the total**



Source: Transcrime elaboration on Fenton (2011, p. 5) data.

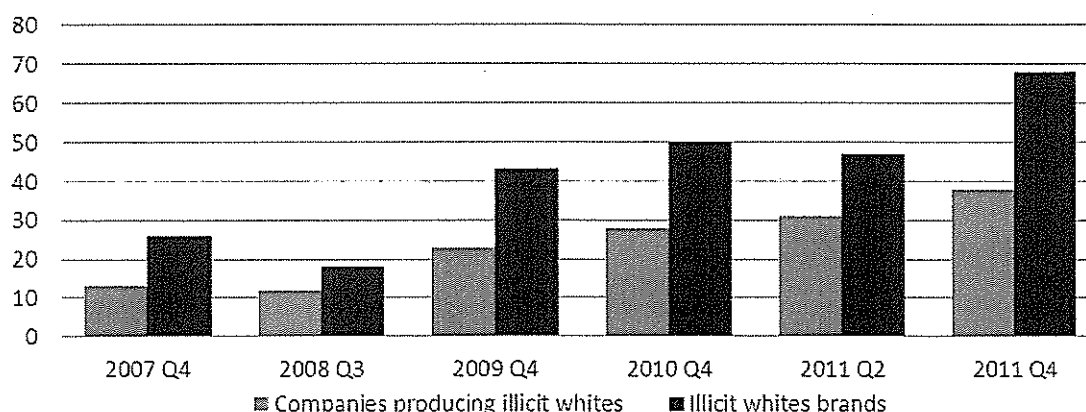
A second evolution was due to **illicit whites**, which gained an increasingly large share of the illicit market. As already mentioned, illicit whites are cigarettes produced by manufacturers which do not normally supply the legal market in a given country. In the UK the most frequently found brands are Raquel, Richman and Jin Ling (HMRC & UKBA, 2008, p. 8, 2011, p. 7). The threat associated with these products was discussed for the first time by HMRC and UKBA in their joint report of 2008 (HMRC

& UKBA, 2008, p. 8). Indeed, official seizure data show that from 2006/7 to 2009/10 the share of non-UK and illicit brands (i.e. illicit whites) rose from 13% to 46% of the total amount seized (HMRC & UKBA, 2011, p. 6). The analysis of two brands of illicit whites (Classic, produced in Ukraine and Jin Ling, produced in the Russian enclave of Kaliningrad on the Baltic Sea) showed the gradual diffusion of illicit whites in EU Member States. For both 2009 and 2010, the UK reported several local Jin Ling 'hotspots', i.e. places where more than 1% of

the collected packs were Jin Lings (KPMG, 2011, pp. 78–79). The most recent empty pack survey conducted by tobacco manufacturers highlighted that the number

of companies producing illicit whites and the number of illicit whites brands increased from 2007 to 2011 (MSIntelligence, 2012, p. 25) (Figure 5).

Figure 5. Number of companies producing illicit whites and illicit whites brands 2007–2011.



Source: Transcrime elaboration on MSIntelligence (2012, p. 25) data.

The HRT market exhibits a different evolution. It has remained largely dominated by smuggled genuine UK brands, which are exported to countries with lower taxation and then smuggled back to the UK (HMRC & UKBA, 2008, p. 8). More recently, official sources have reported an increasing share of counterfeit products (HMRC & UKBA, 2008, pp. 8–9).

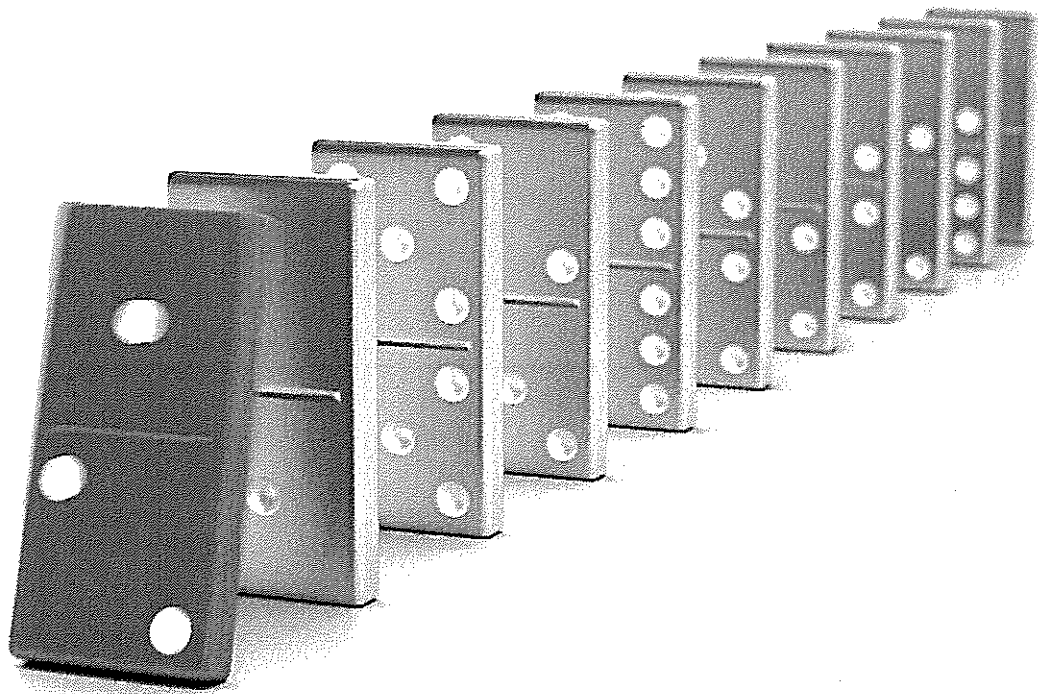
Except for the attempts to assess the size and trend of the illegal market, there has been a limited amount of research on other aspects of the ITTP in the UK. In particular, only a few studies have analysed the social organization and *modi operandi* of the illegal activities (Hornsby & Hobbs, 2007; von Lampe, 2006). This implies that the actual dynamics of the illicit market and its structure have to date gone largely uninvestigated.

In conclusion, the foregoing analysis has shown that ITTP is a flexible phenomenon. Indeed, since the launch of the Government action plan and the consequent decrease in the exports of UK products to small countries (where these products were subsequently smuggled back

into the UK), cigarette counterfeiting and illicit whites have rapidly emerged as new forms of ITTP. This signals that the illicit market is highly sensitive to the regulation of the legal market and also to law enforcement efforts. In regard to the impact of law enforcement and strategic action plans, some sectors of the illicit market have shown particular resilience to law enforcement action. For example, notwithstanding important investments in human, technological and financial resources, the market share for illicit HRT is still very large. It is unlikely that the investment of further resources in enforcement efforts will provide additional benefits, given that in 2006 the UK Government deployed an additional 200 operational staff to tackle illicit HRT.

The evolution of the issue in the UK confirms the dual nature of tobacco markets. The implementation of new policies and strategies should be carefully evaluated by considering how the ITTP may adapt and which new trends may emerge as a consequence of the introduction of new measures (Sweeting, Johnson, & Schwartz, 2009, p. 112).

### 3. The impacts of plain packaging on the ITTP



In the policy debate on the introduction of plain packaging, in the UK as well as in other countries, most arguments concern the impact on smoking habits and initiation of plain packs compared to branded packs, and the further impact that this may have on the legitimate tobacco market, particularly on manufacturers and retailers (ASH, 2011; Bloomquist, 2011; Deloitte, 2011; Department of Health, 2008, 2012a, 2012b; Europe Economics, 2008; Moodie, Stead, et al., 2012).

**Whilst the possible risks of increased ITTP are frequently evoked, they are addressed in relatively superficial terms. When the point is made that plain packaging**

may stimulate the illicit trade in tobacco products and particularly counterfeiting, the counterarguments have remained constant throughout the years. Examples follow:

A way to counteract this potential problem would be to require other sophisticated markings on the plain packages that would make the packages more difficult to reproduce. In addition, the colour picture warnings, which must appear on all tobacco products manufactured from October 2008, would remain complicated to reproduce (Department of Health, 2008, p. 42).

There is no evidence that plain packaging will lead to an increase in the illicit trade in tobacco. Tobacco packs are already easily counterfeited which is why the industry is required to put covert markings on all tobacco packs to distinguish between authentic and counterfeit packs. Plain packs may not have tobacco branding but they will have all the health warnings and other markings required on current packs – so they will be no easier to counterfeit than current branded packs (ASH, 2011, p. 6).

Standardised tobacco packs would still need to carry coloured picture warnings, as well as covert markings. Counterfeiters are already able to produce sophisticated replica goods (Department of Health, 2012a, p. 20).

The above considerations are the only evaluations in relation to the possible impact of plain packaging on the ITTP. Given the past and present levels of ITTP in the UK (discussed in the previous section), this lack of attention to the possible unintended consequences of new tobacco control measures is surprising. Furthermore, the action plans specifically designed to tackle illicit tobacco have never assessed the risk that may be unwittingly created by the implementation of plain packaging (HM Customs and Excise, 2000; HMRC, 2006; HMRC & UKBA, 2008, 2011). In general, it seems that analyses of the impact of plain packaging have not considered the implications for the ITTP, and particularly for the counterfeiting of tobacco products (see above, section 1). The only study identified in this area (Moodie, Hastings, & Joossens, 2012) argued that the participants in the study (n=54 in eight focus groups) were “easily able to distinguish smuggled and counterfeit products from each other—and both from legitimate product” (2012, p. 252). The study claimed that “packaging, whether

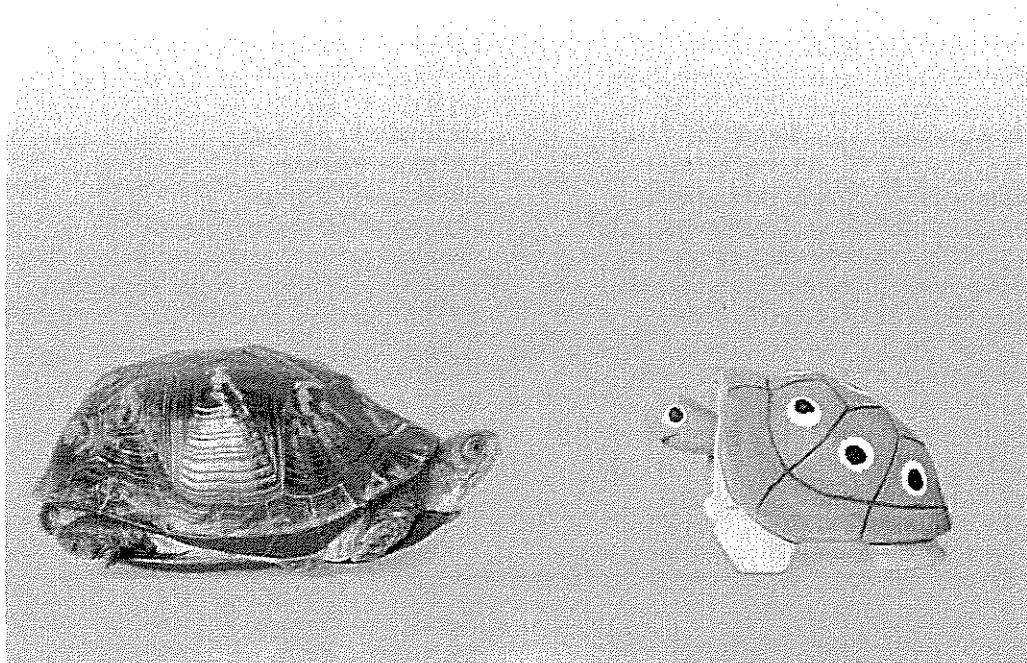
branded or plain, has no impact on the decision to consume counterfeit tobacco. Smokers indicated that counterfeit product was immediately recognizable, not least by the poor quality of all aspects of the packaging” (2012, p. 253). However, the methodology was not specifically designed to test smokers’ ability to spot illicit products, since the participants were generally asked “about their experiences, if any, of using illicit (including counterfeit) tobacco...” (2012, p. 252). Notwithstanding the evidence from other studies, suggesting that counterfeits are frequently of excellent quality (HMRC, 2006, p. 13; von Lampe et al., 2012, p. 56), participants were not asked to identify illicit products between genuine and counterfeit products packs. The limited size of the sample and the weakness of the methods suggest that the evidence collected hardly supported the conclusions.

Although the assessment of the evolution of the illicit market is made difficult by the inherently hidden nature of the ITTP, it seems that the Impact Assessment has overlooked evidence and information indicating three main risks in relation to the impact of plain packaging on the illicit trade in the UK, namely:

1. An increased risk of counterfeiting of tobacco products
2. A risk of decreased differentiation between legitimate and illicit tobacco products
3. A risk of increased ITTP as a result of increased potential profits

The following subsections analyse these three risks.

### 3.1. Risk of increased counterfeiting of tobacco products



**The introduction of plain packaging is likely to increase the risk of counterfeiting of tobacco products.**

Counterfeiting is a type of ITTP which relies on the imitation of genuine products, particularly premium brands, so as to benefit illegally from their higher prices. At the same time, the production costs are low because of poorer quality, lower safety standards, and fewer controls (HMRC, 2006, p. 13). This makes counterfeiting particularly profitable, provided that the imitations of genuine premium brands are sufficiently credible to be mistaken for the latter. Hence, a key factor for a successful counterfeiting business is its capacity to produce good imitations of genuine premium cigarettes or HRT, thereby inducing consumers to pay a price lower than that of the legal retail market (approximate 50% of it) but still significantly lower than actual costs.<sup>7</sup>

<sup>7</sup> According to HMRC, "counterfeit cigarettes can cost smugglers only one quarter of the price of genuine product" (HMRC, 2006, p. 13).

Evidence from illicit markets suggests that counterfeiters have acquired advanced skills with which to make counterfeits nearly indistinguishable from genuine products (HMRC, 2006, p. 13; von Lampe, 2006; von Lampe et al., 2012).

**Plain packaging will facilitate the business of counterfeiters in two ways. Firstly, it will make it easier for them to reproduce genuine products**, since most of the brand recognition features will be prohibited (all the packs will have to be identically rectangular, with orthogonal edges, nor rounded nor bevelled nor of any other shape); a standard size and colour for all brands will greatly facilitate the production of counterfeits of any brand; the start-up of a successful counterfeiting business will only require the decent reproduction of the plain pack, which is easier than the reproduction of the traditional branded packs. (Blaschke, 2012). **Secondly, plain packaging will significantly decrease the production costs of counterfeits**, since all the effort required to reproduce the various features

of each brand (e.g. logos, relief drawings, images or any other embellishments) will no longer be necessary. It is probable that these two effects (lower skills required, lower costs incurred) will increase the likelihood of counterfeiting because this business will most probably become more accessible and less costly than under the current conditions, yielding higher profits.

**The counterarguments advanced in relation to the risk of counterfeiting are weak. Firstly, the presence of pictorial health warnings has not discouraged counterfeiting so far, and health warnings are easier to counterfeit than specific brand and features.** The idea that, after the introduction of plain packaging, pictorial health warnings would maintain the difficulty of counterfeiting at the same level does not seem sound. Indeed, successful counterfeiters already need to reproduce branded packs featuring health warnings with pictures, and counterfeits were found in the UK after the introduction of pictorial warnings in 2008. The UK authorities have repeatedly stressed that counterfeiting has increased in recent years, and that it is gaining significant shares of the illicit market (HMRC, 2006, p. 12; HMRC & UKBA, 2011, p. 6). Experts from the carton-making industry recently declared that “pictorial health warnings pose no real barrier to counterfeiters: they can be produced (and reproduced) using low -cost printing techniques from equipment readily available in the market and four basic print colours” (Blaschke, 2012). For these reasons, “pictorial health warnings cannot be relied upon as an effective anti-counterfeiting measure” (Blaschke, 2012) and the already-mentioned effects of the introduction of plain packaging (lower skills required, lower costs incurred) will facilitate counterfeiting notwithstanding pictorial warnings.<sup>8</sup> **Secondly, the**

**presence of covert marking and other identification devices does not help consumers to spot counterfeits.** The most advanced identification instruments will not be available to consumers, but only to specialized personnel from the industry, the law enforcement agencies, and the tax authorities. Indeed, plain packaging will make it more difficult for consumers to distinguish genuine from counterfeit products and therefore to avoid the increased health damage caused by counterfeit tobaccos (Bloomquist, 2011, p. 17; HMRC, 2006, pp. 13–14; von Lampe, 2006). Thus plain packaging will foster the counterfeiting of tobacco products, reducing the capacity of consumers to detect illicit products. As a result, consumers will be more easily deceived by counterfeit packs, as well as less able to report illicit behaviour to the police and local authorities.

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<sup>8</sup> For example, it is possible to assume that the resources (e.g. skills and costs) for the successful production of counterfeits are the sum of:

a) the resources necessary to counterfeit brand features, and

b) the resources necessary to counterfeit health warnings.

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Currently, a) is likely to be higher than b), since each brand and product has a different logo, colour and features requiring specific additional efforts to replicate. By contrast, the resources required to counterfeit health warnings are likely to be less, since once this capacity has been acquired, it allows reproduction on multiple brands and is relatively less subject to change in time. Plain packaging is likely to decrease a) significantly because the imitation of genuine brands and products will no longer be necessary. Consequently, the largest component of the total resources needed successfully to produce counterfeit products will be greatly reduced. These considerations suggest that the health warnings alone will not be effective in preventing the easier counterfeiting of tobacco products.

### 3.2. Risk of decreased differentiation between legitimate and illicit products



**The implementation of plain packaging may gradually decrease consumers' perception of the differences between legitimate and illicit tobacco products.** This impact should not be expected to occur immediately; rather, it may develop over time. In particular, it is more likely to affect consumers of cheaper legitimate products, who may be tempted to switch to the illicit market. The perception of the difference between genuine plain products and illicit tobacco may gradually fade as the manufacturers of the legitimate brand are deprived of any means with which to promote brand identity (Bloomquist, 2011, p. 17; Sweeting et al., 2009, p. 113).

**Evidence from market data provides support for this scenario.** The Impact Assessment by the Department of Health reported that, from 2001 to 2009, the market share of mid-price and premium brands

decreased, while the share of economy and ultra-low price cigarettes increased (Gilmore, forthcoming, in Department of Health, 2012a, p. 16). This is most probably due to the high prices reached by tobacco products and the gradual switch to cheaper brands. This trend is already ongoing, and it is independent of the introduction of plain packaging. It has also affected HRT, whose share of consumption has increased to nearly 30% of the entire tobacco market (Department of Health, 2012a, p. 17). The Department of Health's Impact Assessment argues that "the extent of downtrading which we might expect to result from standardised packs is currently unknown and is a variable on which evidence needs to be collected as part of the consultation. We hypothesise that any impact will be gradual". The introduction of plain packaging will further reduce the promotion capacity of mid-price and premium brands. The Department of Health's

Impact Assessment acknowledges this outcome, arguing that plain packaging “would reinforce the trend towards downtrading to lower priced cigarette brands, a process that has, for a variety of reasons, been a notable feature of the market over the past decade” (Department of Health, 2012a, p. 23). A study on a variety of experience foods, including cigarettes, has demonstrated that, with plain packaging, consumers’ preferences are further shifted towards cheaper products (London Economics, 2012, p. 3). Consequently, the proportion of the consumers of economy and ultra-low price cigarettes, and of HRT, will probably increase. Just as an increasing number of consumers have downgraded

among legitimate brands, so there is the risk that, with the introduction of plain packaging, the switch to cheaper illicit tobacco will be facilitated. **Unbranded genuine products may lose most of their appeal compared with illicit cigarettes** (Sweeting et al., 2009, p. 113). This risk may be particularly serious in the case of the switch to HRT, where the illicit market still accounts for nearly 50% of the market.

Another risk is that specific demand for branded illicit products (e.g. famous brands smuggled from other countries or illicit whites) may gradually develop. This may be stimulated by consumers’ preference for branded packs.



### 3.3. Risk of increased ITTP as a result of increased potential profits



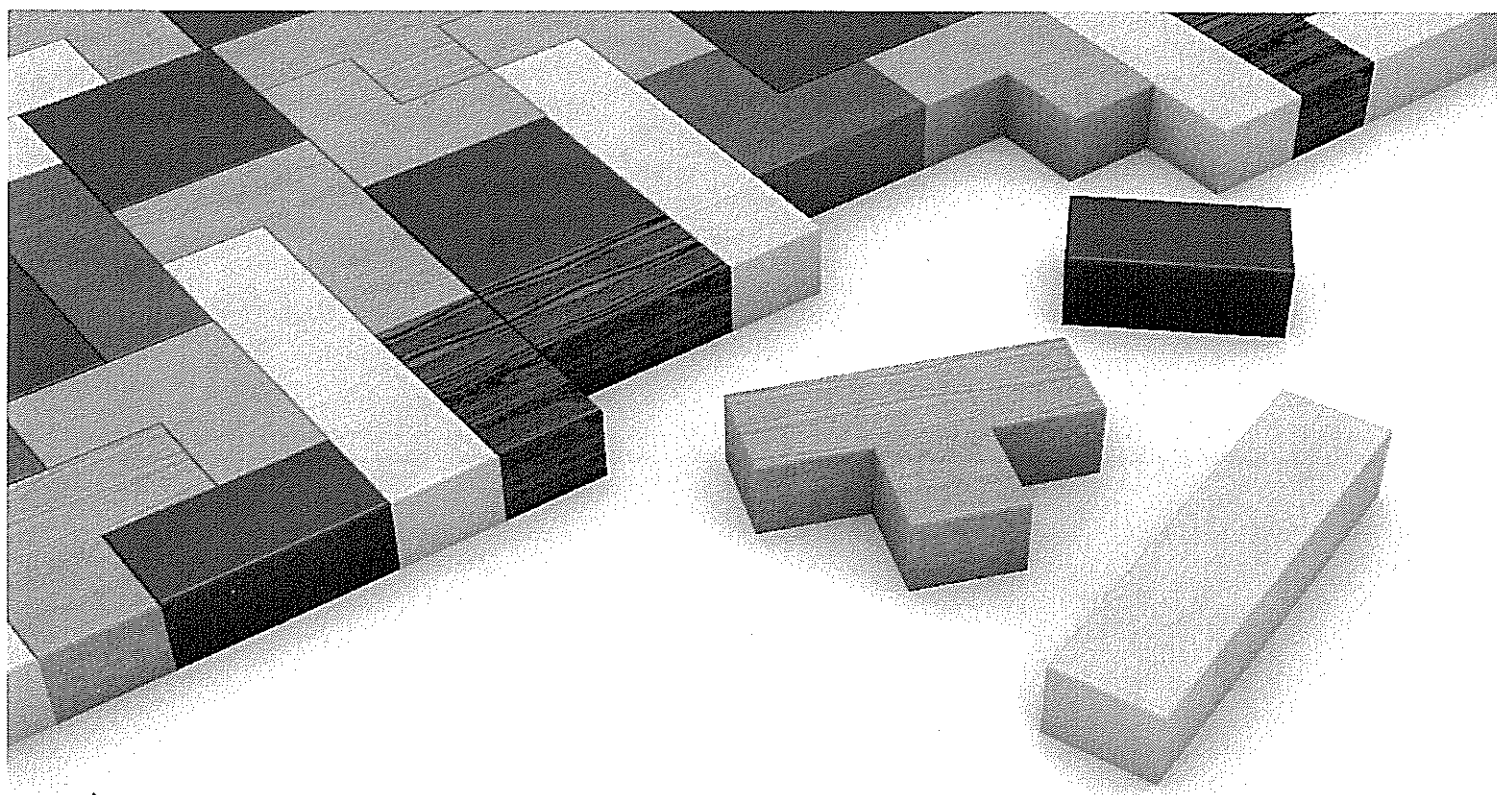
**The need to increase taxes to counterbalance price drops due to increased competition among unbranded products will increase the potential profits for the ITTP.** Most commentators have argued that the introduction of plain packaging will ultimately lead to price-based competition and price decreases (Deloitte, 2011; Department of Health, 2012a; Thomas, 2011; Tiessen et al., 2011, p. 152).<sup>9</sup> Plain packaging would deprive the tobacco industry of any instrument with which to promote the different products. This would make it difficult to signal the different types and qualities of tobacco products to consumers. Thus, plain packaging may ultimately lead to a commoditization of tobacco products whereby consumers perceive no significant difference among brands and products except for the price. As a consequence, manufacturers may be forced

to compete solely on price, with a general trend to lower prices and the associated undesired result of cheaper tobacco and a likely increase in smoking prevalence.

A possible measure to counter this effect of plain packaging would be an increase in tobacco taxation, or any other measure to maintain retail prices. Without any measure to off-set this effect, the risk may arise that a fall in retail prices ultimately leads to cheaper tobacco products and possible incentives to increase consumption (Department of Health, 2008, p. 41). However, **sudden increases in taxes to counterbalance rapid price falls due to competition among brands may create opportunities for further growth of the ITTP** (Bloomquist, 2011, p. 17). Given that all forms of the illicit trade are mainly driven by the high levels of taxation on tobacco products (although retail prices and taxation should never be considered as the only factors determining the levels of illicit trade), taxation shocks to compensate price drops will likely make the ITTP an even more profitable business. This will concern not only counterfeiting, but also other types of ITTP, such as smuggling and illicit whites.

<sup>9</sup> Only one study provides a slightly different scenario. Indeed, after an initial decline in prices, plain packaging may ultimately result in lower levels of innovation and market dynamism. This would strengthen existing market positions, ultimately leading to quasi-monopolistic competition which may result in higher prices and decreased consumption (Europe Economics, 2008, pp. 27–29).

## 4. Conclusions



This report has analysed the risks of an illicit trade in tobacco products which may be unwittingly created by the introduction of plain packaging in the UK. Whilst most of the impacts of plain packaging have already been analysed by different sources, the risks associated with the ITTP have frequently been overlooked, or they have been discussed in rather superficial terms.

Although intensified efforts by the UK Government and the law enforcement agencies have achieved some success in curbing the market share of the ITTP, **illicit tobacco products, particularly HRT, still retain a large market share in the UK,**

with a penetration above the average for EU Member States.

**The ITTP has shown a remarkable capacity to respond to increased law enforcement activity and the introduction of new policies.** This suggests that the supply of illicit tobacco can successfully adapt to a new policy environment and exploit unintended opportunities created by the introduction of new measures. The introduction of plain packaging should be carefully considered by policy-makers, not only in regard to its impact on smoking habits, Government revenues and the legal tobacco market, but also in regard to its likelihood of increasing

ITTP, and to the capacity of the law enforcement agencies to counter that risk.

The report has analysed evidence and information concerning the UK tobacco market in order to assess the likely impact of the introduction of plain packaging on the ITTP. **The analysis suggests that three risks may occur and should be carefully evaluated, namely:**

- 1. An increased risk of counterfeiting of tobacco products**
- 2. A risk of decreased differentiation between legitimate and illicit tobacco products**
- 3. A risk of increased ITTP as a result of increased potential profits**

These conclusions are based on evidence about the UK tobacco market, both legal and illegal. They suggest that plain packaging may have major impacts on the ITTP, and particularly on the counterfeiting of tobacco products. These impacts should be carefully studied and considered in the future debate on the introduction of plain packaging in the UK.

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