

Understanding the U.S. Illicit Tobacco Market

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ISSUE BRIEF

For Policymakers

Although tobacco use has declined in recent decades, worldwide more than one billion people still regularly use tobacco, including many who purchase cigarettes outside legal markets. Illicit tobacco markets can deprive governments of tax revenue and undermine public health efforts to reduce tobacco use. To answer a number of questions about the illicit tobacco market, a committee of experts appointed by the National Research Council and Institute of Medicine conducted a study and released its findings in the report *Understanding the U.S. Illicit Tobacco Market*.



Among the topics discussed in the report are policy options for addressing the existing illicit market in the United States. The report also explores how any new regulations that affect the design, formulation, or marketing of cigarettes may affect the illicit market.

The Illicit Market in the United States

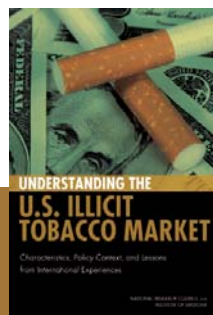
Currently the U.S. illicit tobacco market consists almost exclusively of bootlegging—buying cigarettes on Indian reservations or in low-tax states such as Virginia and selling them in high-tax states such as New York without paying taxes on the sale. The portion of the total U.S. tobacco market represented by illicit sales has grown in recent years and is now between 8.5 percent and 21 percent. This represents between 1.24 and 2.91 billion packs of cigarettes annually and between \$2.95 billion and \$6.92 billion in lost gross state and local tax revenues. Illicit tobacco consumption is distributed unevenly across states, accounting for as much as 45 percent of the tobacco market in high-tax states and a lesser role in other states.

Although tobacco companies have promoted the smuggling of legally manufactured cigarettes at the global level in the past, there is no evidence that the tobacco industry is currently involved in the illicit trade in the United States. In addition, there is no systematic evidence for a sustained link between the global illicit tobacco trade and terrorism.

Policy Options for Addressing the Illegal Trade

If federal or state governments want to undertake efforts to reduce the size of the illicit tobacco trade, there are a range of efforts that are likely to have at least some effect.

Licensing and regulatory requirements. Governments can require participants throughout the supply chain—tobacco growers, manufacturers, distributors, wholesalers, and retailers—to be licensed, imposing



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obligations or restrictions on them. Governments can mandate that failure to comply with such obligations or restrictions will result in administrative, civil, or criminal penalties, depending on the location and severity of the infraction. Other control measures, such as requirements for record-keeping and limits on quantities of tobacco products sold, can regulate the supply chain without explicitly requiring formal licensing. In the United States, supply-chain controls imposed at the production and in-transit phases seem to prevent certain forms of the illicit trade, such as the production of counterfeit cigarettes. Conversely, the absence of consistent state regulations and comprehensive federal controls may contribute to the increased diversion to the illicit market seen at the wholesale and retail phases of the supply chain.

Track and trace systems. These systems place encrypted tax stamps or other markings on cigarette packs in order to track tobacco products through each stage of the supply chain, from production to sale. These markings aid law enforcement efforts to investigate tobacco smuggling by helping to identify the points at which tobacco products are diverted into illicit markets. California and Massachusetts have already implemented such systems. A national system—one that is implemented across state borders—would be better able to track and trace cigarettes through the licit distribution system and identify points of diversion into illicit markets than would systems implemented at the state level.

Tax harmonization. Enacting a program that harmonizes tax rates across state boundaries, although politically challenging, would address one key cause of the U.S. illicit trade: very different tax rates across states. States might be willing to coordinate taxes in order to reduce disparities if there were a change in the conditions that led to different tax rates; for example, federal funds could subsidize or incentivize coordination. With respect to Native American tribes, some states have already entered into agreements with them in order to reduce the price disparities that make illegal sales profitable.

Public education campaigns. Aimed directly at those who participate in the illicit trade, public education campaigns show some promise as well. A few countries—such as the United Kingdom, Hong Kong, and Canada—and the city of Chicago have implemented such campaigns for the specific purpose of lowering demand for or raising public awareness of the illicit tobacco trade. Administered by governments, retailer organizations, or advocacy groups, such campaigns have for the most part targeted disadvantaged communities where the illicit trade is undermining strategies to control the use of tobacco in general. Most assessments and evaluations of campaigns find survey respondents who are able to identify or recall elements of the campaigns and report increased awareness of the illicit trade and its consequences, as well as positive attitudes toward the campaigns. More research and experimentation are needed.

Enforcement. Regulations and technologies to monitor and control the supply of tobacco products will have limited impact without enforcement efforts. So far, however, enforcement efforts against the illicit tobacco market have been a low priority in the United States at both the federal and state levels, and the limited available evidence suggests that tobacco smugglers currently face little risk of detection and prosecution. Because the illicit tobacco trade has been nonviolent, it is generally treated as an economic rather than a criminal problem. Law enforcement efforts to investigate the illicit trade tend to be weak and uneven, and criminal prosecution of those involved is a very low priority for prosecutors.

Some states and jurisdictions, such as New York City, have intensified efforts to combat illicit sales. However, because cigarette bootlegging by its nature crosses state boundaries, state efforts to enforce their own tax laws are weakened by the difficulty of coordinating efforts across state lines—a challenge that suggests a key role for federal action. The federal government could promote the coordination of enforcement efforts across states and jurisdictions in ways that it has done for other interstate crimes such as gun crimes and drug trafficking. The federal government could also support collaboration among various agencies and other stakeholders to address tobacco smuggling.

Possible Effects of Future Regulations

In the future, if regulations are placed on how cigarettes are designed, formulated, packaged, or marketed—for example, by lowering the allowed nicotine content or banning menthol flavoring—illicit markets could be very different from current markets in terms of what is driving demand. Very little research has directly examined the effects of modifying cigarettes on the illicit market.

However, in assessing the potential effects, it can be helpful to examine whether modifying cigarettes might affect how appealing they are for consumers. If the modifications reduce cigarettes' appeal, consumers might respond in any number of ways—by continuing to smoke the modified cigarettes, by quitting, by substituting similar legally available products, or by seeking illicit versions of cigarettes with the qualities they miss.

Studies in several countries have examined cigarette modifications and their impacts on smokers' preferences and behavior. Overall, although there is not enough evidence to draw strong conclusions, the limited available evidence suggests that if current cigarettes are modified through regulations, the demand for illicit versions of them is likely to be modest.

- Experimental studies have found that **reducing ignition capacity** (requiring that cigarettes extinguish when not actively puffed) and **decreasing filter ventilation** have only modest impact on cigarettes' appeal among U.S. smokers.
- **Reducing nicotine levels and mentholation** has been shown in experimental studies to have a stronger effect on reducing product appeal. Existing studies have shown mixed results on smokers' use and preferences: Some studies have found that most smokers intend to quit rather than seek alternative products. Other studies have found that smokers are able to tolerate substantial reductions in nicotine with little to no change in individual cigarette consumption. Several new research initiatives are under way on this issue, and more definitive findings are anticipated.
- **Cigarette packs with large graphic warning labels or in plain packaging** have also been shown to reduce cigarettes' appeal. In countries that have required these, it has promoted quitting behaviors.

It is also unclear whether and how quickly a large-scale illicit supply would emerge to meet any new demand that may arise for cigarettes with prohibited features.

Because aggressive policies to modify tobacco products are new in the countries that have issued them, there have been few studies of their effects on the illicit market. If the U.S. illicit market does change in response to regulations, policymakers could look for guidance to the experiences of other nations, such as Brazil, where a ban on menthol is pending. Broad-ranging interventions adopted by other countries show that it is possible to reduce the size of the illicit tobacco market by dedicating resources for enforcement, collaborating across jurisdictions, and implementing strategies that use a variety of regulatory, enforcement, and policy approaches.

A more in-depth discussion of policy options for addressing the illicit tobacco trade can be found in the report, *Understanding the U.S. Illicit Tobacco Market: Characteristics, Policy Context, and Lessons from International Experiences*, available from the National Academies Press (<http://www.nap.edu>). The study was sponsored by the U.S. Food and Drug Administration. Any findings, conclusions, or recommendations expressed in this publication are those of the study committee and do not necessarily reflect those of the sponsor.