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# **Causes and effects of the illegal import and circulation of tobacco products in Ukraine**

Research Report

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- involvement of all interested parties in conducting the research;
- representation and analysis of all viewpoints;
- independence of conclusions.

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## EXECUTIVE SUMMARY

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### **The illegal import and circulation of tobacco products is an extremely serious problem for Ukraine**

During the past two years, the illegal import and circulation of tobacco products has grown significantly in Ukraine. This has resulted in huge losses, due to reduced state budget revenues and decreased returns on investment for Ukraine's tobacco industry. The amount of illegal tobacco products available in the Ukrainian market demands the development of a strategy that would reduce this phenomenon.

### **Tobacco industry is important to Ukraine's economy**

The share of Ukraine's tobacco industry in the gross output of goods and services is less than 1%. However, the contribution of tobacco companies to state budgets at all levels makes up 3% of consolidated budget revenues; and foreign direct investment in the industry amounts to 5% of total FDI into Ukraine. Foreign investments have modernised the industry and established cigarette production based on modern technologies. However, the existence of a large black market of tobacco products has resulted in a significant under-utilisation of capacity and reduced the industry's investment attractiveness.

### **Illegal cigarettes account for over a quarter of consumption volumes**

According to our calculations, the illegal supply of tobacco products in Ukraine during 1999 amounted to approximately 18.6 billion sticks, or 27% of total consumption. The illegal supply of cigarettes consisted almost entirely of illegal imports, mostly cheap non-filter cigarettes (about 94% of the total amount).

### **Illegal import and sale of cigarettes results in huge losses**

Losses from the illegal import and sale of tobacco products in Ukraine are very large. Tobacco producers in Ukraine lose due to reduced profits and returns on investments, while consumers lose due to higher health hazards and a lack of quality guarantees. In general, society loses due to the underfunding of public services (lower budget revenues), inefficient state health care, and the criminalisation of society. Those who benefit represent a small group involved in the illegal import and sale of tobacco products.

### **The sale of illegal cigarettes is facilitated by differences in excise rates, and by other conditions**

We divide the causes of illegal tobacco circulation in Ukraine into incentives and conditions. Incentives give rise to activities associated with the illegal import or sale of tobacco products and entry of new participants in this sphere. The incentive is the opportunity to receive profits from illegal sales of tobacco products due to differences in excise rates. Conditions are factors that enable profit-making opportunities. Such conditions include ineffective existing mechanisms for disclosing and punishing illegal importers and distributors of tobacco products. The lack of a mechanism for destroying seized tobacco products also poses the threat of resumed legal sales of products which are harmful for human health.

### **Eliminating conditions for illegal tobacco import and circulation will have a long-term positive effect**

In our opinion, reducing the excise rates for non-filter cigarettes, aimed at eliminating the incentive for illegal imports, will result in a significant decrease in budget revenues and will have a negative effect on society as a whole. Hence, we propose to concentrate efforts on the following measures: (1) increase the effectiveness of law-enforcement agencies, (2) simplify conditions regulating the legal retail trade of tobacco products, (3) improve mechanisms for punishing illegal distributors of tobacco products, and (4) increase protection of state borders. These measures will have long-term positive effects, since they will enable both reducing the existing illegal inflow of imports and circulation of tobacco products, as well as ensure prevention of illegal operations in the future and facilitate resolving other societal problems.

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# 1. INTRODUCTION

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During the past two years, the illegal import and circulation of tobacco products has grown significantly in Ukraine. This has resulted in huge losses, due to reduced state budget revenues and decreased returns on investment for Ukraine's tobacco industry. The amount of illegal tobacco products available in the Ukrainian market demands the development of a strategy that would reduce this phenomenon.

## 1.1 Research objectives

The main objective of this research is to determine optimal methods for overcoming the problem of illegal import and circulation of tobacco products in Ukraine. In order to achieve the goal, the following objectives were set:

- determine the scope of the problem and volume of losses from the illegal import and circulation of tobacco products;
- determine the causes of this phenomenon;
- analyse alternatives and develop recommendations for amendments to state policy that would reduce or eliminate the illegal sale of tobacco products.

## 1.2 Information sources

Our research was based on official information provided by:

- the State Customs Service of Ukraine (SCS);
- the State Tax Administration of Ukraine (STA);
- the State Committee for Protection of the State Border of Ukraine;
- the State Department for Regulation of Production and Circulation of Alcohol and Tobacco Products;
- the Ukrtiutium (Tobacco) Association.

We also utilised calculations and surveys provided by the tobacco industry. To research the schemes of illegal import and distribution, we conducted a field study in Donetsk oblast and analysed mass media materials. Particular attention was paid to the comparative experience of reducing illegal cigarette imports in Great Britain, Ireland, Canada, and New Zealand.

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## 1.4 Supplementary information

Official exchange rates set by the National Bank of Ukraine on September 12, 2000:

- 1 dollar (\$ or USD) — 5.44 hryvnias (UAH)
- 1 Russian ruble (RUR) — 0.195 UAH

Average official exchange rates in 1999:

- 1 \$ or USD — 4.13 hryvnias (UAH)
- 1 EURO (*eur*) — 4.39 UAH
- 1 RUR — 0.167 UAH

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## 2. THE TOBACCO INDUSTRY IN UKRAINE'S ECONOMY

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The share of Ukraine's tobacco industry<sup>1</sup> in the gross output of goods and services is less than 1%. However, the contribution of tobacco companies to state budgets at all levels makes up 3% of consolidated budget revenues; and foreign direct investment in the industry amounts to 5% of total FDI into Ukraine. Foreign investments have modernised the industry and established cigarette production based on modern technologies. However, the existence of a large black market of tobacco products has resulted in a significant under-utilisation of capacity and reduced the industry's investment attractiveness.

### 2.1 Production

According to our calculations, the share of the tobacco industry in overall industrial production slightly exceeds 2.5%, while in the food industry the share is almost 17%<sup>2</sup>. Today, tobacco factories employ approximately 6,000 workers.

Ukraine's tobacco industry has attracted significant foreign direct investment. While during 1991–99 the cumulative volume of foreign direct investment (FDI) into Ukraine amounted to \$3.3 billion, four tobacco-producing multinational enterprises (MNEs) invested \$163.5 million, which constitutes 5% of the total volume of FDI.

**Table 1. MNE investment in Ukraine's tobacco industry**

| Company                  | Start of activities in Ukraine | Investment     |
|--------------------------|--------------------------------|----------------|
| British-American Tobacco | 1993                           | \$28 million   |
| J.T. International       | 1993                           | \$26 million   |
| Philip Morris            | 1994                           | \$37 million   |
| Reemtsma                 | 1993–94                        | \$72.5 million |

The multinational tobacco companies that entered Ukraine's market raised the efficiency of tobacco factories, increased quality, and extended the range of products mainly through introducing new filter brands. For example, while in 1996 Ukrainian tobacco factories produced 35 brands of filter cigarettes (production of "light" cigarettes was nonexistent), in 2000 the number of filter brands increased to 68, of which 16 brands are "lights".

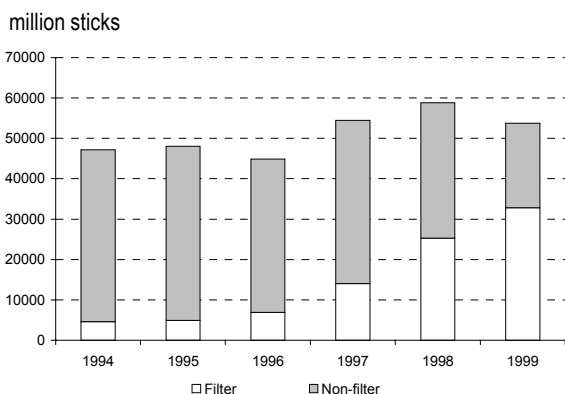
Thanks to foreign investment, during 1994–98, the following major trends were observed in the tobacco industry: (1) growth in the total volume of cigarette production, and (2) an increase in the share of filter cigarettes in the overall production structure (see Chart 1). During 1996–98, the level of production capacity utilisation at Ukrainian tobacco factories grew constantly, thanks to the crowding out of imported tobacco products. However, in 1999 this indicator dropped to 71% (see chart 2). In our opinion, reduced capacity utilisation was caused by the renewed expansion of illegal cigarette imports.

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<sup>1</sup> Under tobacco industry we consider enterprises having licenses to produce tobacco products. Further in this report, we use data for 10 major tobacco factories being members of the Ukrutiutiu Association and producing over 99% of the total amount of cigarettes produced in the country. For detailed profile of the tobacco industry see appendix A.

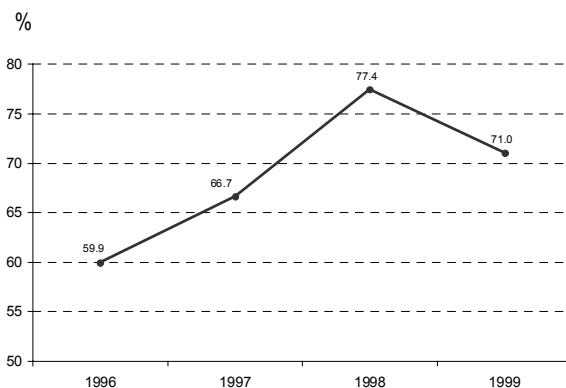
<sup>2</sup> In calculating the value of cigarettes produced, the following average prices were used: 0.6 UAH per pack of non-filter cigarettes and 1.5 UAH per pack of filter cigarettes.

**Chart 1. Cigarette production in Ukraine**



Source: Ukrtiutiun Association

**Chart 2. Production capacity utilisation**

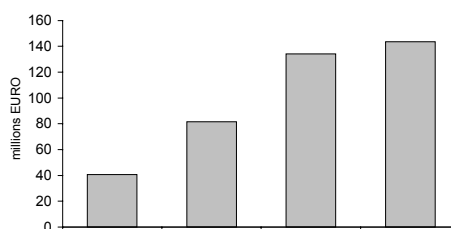


Source: Ukrtiutiun Association

## 2.2 Tobacco industry contribution to state budget revenues

Tobacco companies provide a significant share of Ukraine's state budget revenues. According to data from the STA, in 1999 budget revenues from excise tax imposed on cigarettes produced in Ukraine amounted to 522 million UAH, or almost one-third of the total revenues from excise in Ukraine. According to our calculations, in 1999 the total amounts contributed by tobacco companies to the consolidated budget was almost 1.2 billion UAH, or more than 3% of the total consolidated budget revenues last year.

**Chart 3. Excise revenues collected from cigarette production in Ukraine, 1996–1999**



|   | 1996 | 1997 | 1998  | 1999  |
|---|------|------|-------|-------|
| Collected excise revenues (millions EURO) | 40.7 | 81.7 | 134.2 | 143.6 |
| Excise on filter cigarettes (EURO)        | 2    | 2    | 2     | 2.5   |
| Excise on non-filter cigarettes (EURO)    | 0.5  | 1    | 2     | 2.5   |

We use EURO since during 1996–99 excise rates were set in this currency.

Source: Ukrtiutiun Association, ICPS estimates

### 3. ESTIMATING THE SIZE AND STRUCTURE OF ILLEGAL SALES OF TOBACCO PRODUCTS IN UKRAINE<sup>3</sup>

According to our calculations, the illegal supply of tobacco products in 1999 amounted to 18.6 billion sticks, or 27% of total consumption. Cheap non-filter brands prevail in the illegal supply structure (approximately 94% of the total amount, or about 17 billion sticks). The illegal supply of tobacco products in Ukraine consists almost entirely of illegal imports.

#### 3.1 Tobacco product consumption

Market estimates of cigarette consumption in Ukraine range from 65 to 78 billion sticks annually. According to our calculations, the size of Ukraine’s tobacco market is approximately 70 billion sticks per year, where non-filter cigarette consumption accounts for 53–54% of the total market (or approximately 38 billion sticks). For a detailed methodology of the consumption estimate, see appendix B.

#### 3.2 Illegal supply

Cigarette consumption in Ukraine equals total supply; hence:

- illegal supply = domestic consumption — legal supply<sup>4</sup>;
- legal supply = legal domestic production — legal exports + legal imports.

Based on the market size of 70 billion sticks annually, we estimate that the illegal supply in 1999 amounted to 18.6 billion sticks (see table 2). This makes up 27% of total consumption (see table 3). Cheap non-filter cigarettes prevail in the structure of illegal supply (approximately 94%, or about 17 billion sticks).

| billion sticks |            |        |       |
|----------------|------------|--------|-------|
|                | Non-filter | Filter | Total |
| Consumption    | 38.0       | 32.0   | 70.0  |
| Legal supply   | 20.6       | 30.8   | 51.4  |
| Production     | 20.9       | 32.8   | 53.7  |
| Imports (+)    | 0.0        | 3.7    | 3.7   |
| Exports (—)    | 0.3        | 5.7    | 6.0   |
| Illegal supply | 17.4       | 1.2    | 18.6  |

Source: ICPS estimates

| Price segment (in brackets— % of Marlboro price, which is assumed to be 100) | Average price, UAH (\$) | Market share, % |
|--|-------------------------|-----------------|
| <b>Filter cigarettes</b>   |                         | <b>46</b>       |
| Prestige (106+)  | 4.6 (0.84)              | 2               |
| Premium (81–105)   | 3.7 (0.67)              | 10              |
| Mid-price (41–80)  | 2.1 (0.38)              | 14              |
| Popular (25–40)  | 1.12 (0.20)             | 18              |
| Illegal supply   | —                       | 2               |
| <b>Non-filter cigarettes</b>   |                         | <b>54</b>       |
| Legal supply (<25)   | 0.77 (0.14)             | 29              |
| Illegal supply   | 0.55 (0.10)             | 25              |

Source: ICPS estimates.

<sup>3</sup> In this research, we analyse only the problem of import and distribution of illegal cigarettes in Ukraine, i.e., non-Ukraine duty paid cigarettes. Despite the existence of such a problem as illegal cigarette exports from Ukraine, its analysis is beyond the scope of our research. Also, we do not consider the problem of illegal distribution of legally produced tobacco products; however, we believe that the expansion of illegal trade activities facilitates the distribution of illegal products.

<sup>4</sup> In our opinion, the volume of illegal exports is relatively small, given the closed Western border of Ukraine (illegal exports are more often undertaken to Eastern and Western European countries due to excise differentials).

### 3.2.1 Illegal production

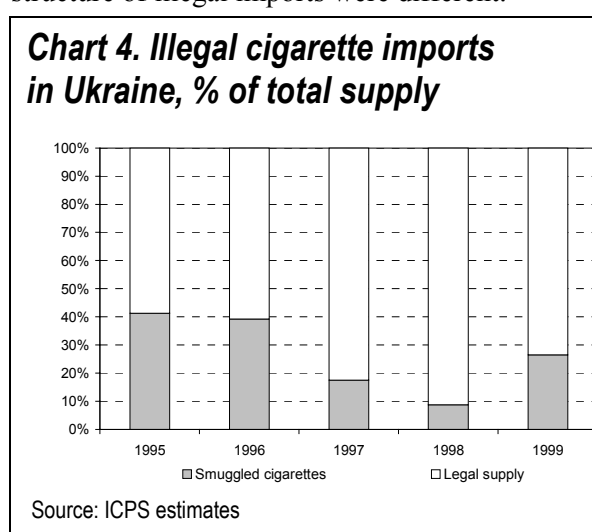
We conclude that the volume of illegal production is small. The main factor that complicates illegal cigarette production in Ukraine is the significant initial investment needed, as well as a permanent location for an illegal production unit, which ultimately increases the risk of disclosure. Illegal production also includes unreported (and, hence, untaxed) cigarette production at legally operating factories. In our opinion, this phenomenon is not widespread, due to sufficient government control and market dominance of MNEs operating under international standards of conducting business.

Thus, in the further analysis we assume that the illegal cigarette supply in Ukraine consists almost entirely of illegal imports.

### 3.2.2 Illegal imports

#### a) History and structure of illegal cigarette imports in Ukraine

Analysis of Ukrainian production data and consumption estimates indicate that the problem of illegal cigarette imports to Ukraine has existed since the early 1990s; however, the volumes (see chart 4) and structure of illegal imports were different.



Until 1997, illegal imports consisted mainly of filter cigarettes. This was due to the lack of domestic production of high-quality filter cigarettes, high import tariffs and excise, and the inability of the government to combat illegal imports.

In 1998–99, domestic production squeezed illegal imports out of the market, since illegally imported cigarettes became non-competitive after Ukraine’s manufacturers introduced a wide spectrum of filter cigarettes in various price segments. Ukrainian consumers switched to domestically produced filter cigarettes, due to their sufficiently high quality and relatively low price.

Today, illegal imports of filter cigarettes are negligible and are represented mainly by the least expensive brands (mainly Russian brands) and the most expensive brands that are not produced in Ukraine. According to our calculations, the volume of such illegal imports does not exceed 2% of total cigarette consumption in Ukraine.

Instead, in 1998–2000, for the first time Ukraine faced the phenomenon of illegal imports of non-filter cigarettes. This is evidenced by consumption of non-filter cigarettes that significantly exceeds their legal supply.

#### b) Geography of illegal imports

In the geographic profile, the main share of illegal imports comes from Russia and Moldova; mainly non-filter and inexpensive filter cigarettes are imported illegally from both countries. This fact is also indirectly proved by data from the State Customs Service that indicates increased numbers of detained individuals attempting to bring cigarettes illegally into Ukraine across its borders with Russia and Moldova. While in all of 1999 1,054 attempts of illegal cigarette imports from Russia and Moldova were disclosed (the value of tobacco products detained on borders with Russia and Moldova accounted for

34.5% of the total value of all detained cigarettes), in H1'00 alone the number amounted to 887 (or 72% of the value of all detained cigarettes). The increased number of detentions, together with the decreased absolute value of detained products indicates the activation of illegal imports into small consignments.

| Border        | 1999                |                      |  | H1'2000             |                     |  |
|---------------|---------------------|----------------------|--|---------------------|---------------------|--|
|               | Number of incidents | Value, thousands UAH | % of the value of tobacco products detained on all borders | Number of incidents | Value thousands UAH | % of the value of tobacco products detained on all borders |
| Russia        | 501                 | 529.6                | 7.6  | 620                 | 585.0               | 39.4   |
| Moldova       | 553                 | 1,866.4              | 26.9   | 267                 | 485.1               | 32.6   |
| <b>Total:</b> | <b>1,054</b>        | <b>2,395.9</b>       | <b>34.5</b>  | <b>887</b>          | <b>1,070.1</b>      | <b>72.0</b>  |

Source: State Customs Service of Ukraine

According to our surveys, the greatest extent of black market activity is observed in the eastern Ukrainian oblasts bordering the Russian Federation. This is caused by a number of factors:

- the most beneficial strategy is quick sale of illicit tobacco products immediately after crossing the border;
- transportation costs are minimised;
- probability of illegal import disclosure (and hence, corresponding losses) is reduced;
- population density (and hence, consumption of tobacco products) in eastern oblasts is one of the highest in Ukraine.

However, tobacco products illegally imported from Russia have already reached central and even western oblasts of Ukraine.

### **c) Ways of illegal importing and distribution**

The following scheme of illegal cigarette import and distribution is the most common. Individuals ship cigarettes legally purchased in Russia on the demand of small illegal groupings or legal firms. After the illegally imported cigarettes are in Ukraine, small wholesale firms sell them through open markets or street vendors. Usually, the activities of such firms (groups) within a particular region (city) are well established and co-ordinated, which gives us grounds to consider that they are organised crime activities.

Cross-border transportation of illicit tobacco products is undertaken either through avoiding customs controls or concealing products from controls. The transparency of the Ukrainian-Russian border enables the undertaking of such activities, even unto using cross-border local trains, which are usually not subject to thorough customs controls or inspections. Data from the State Customs Service for 1999 and 2000 indicate almost a twofold increase in the number of disclosed attempts of cigarette smuggling into Ukraine. This year alone, data indicate an almost threefold drop in the average value of detained illegal tobacco products as compared to the previous year. This fact also supports the hypothesis of a growing number of private cigarette smugglers transporting small consignments. Detention of large illegal cigarette lots has become a rare phenomenon.

Taking into account that numerous wholesale cigarette markets are located in Russia nearby the Ukrainian border, about 1,500 individuals would be able to generate the existing inflow of illegal cigarettes in Ukraine if they made two trips to Russia per day and transported two master cases (1,000 packs) of cigarettes each time.

### **d) Proceeds from illegal operations with cigarettes**

According to our calculations, in 1999, the size of the Ukrainian black market in tobacco products exceeded 700 million UAH in monetary equivalent<sup>5</sup>. Given the average prices of non-filter cigarettes in

<sup>5</sup> In estimating the size of the black market, we used the following average retail prices of illegal tobacco products sold in Ukraine: 0.6 UAH for a pack of non-filter cigarettes and 3.5 UAH for filter cigarettes. Hence, the size of the black market in

Russia and average retail prices of those cigarettes illegally sold in the Ukrainian market, we can estimate approximate net profits from illegal imports and sales of non-filter cigarettes. In 1999, the net profits of individuals involved in the illegal distribution of tobacco products exceeded 200 million UAH. According to our calculations, the profits of individuals undertaking cross-border transportation accounted for about 50% of total profits; small wholesale firms (groups) received approximately 40%, while retailers typically earned 10%.

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monetary equivalent is calculated as the number of cigarette packs illegally imported to Ukraine multiplied by the corresponding prices.

## 4. LOSSES FROM THE ILLEGAL IMPORT AND CIRCULATION OF TOBACCO PRODUCTS

In our opinion, Ukrainian society faces huge losses from the illegal import and circulation of tobacco products in Ukraine. Tobacco producing companies in Ukraine face losses due to decreased profits and returns on investment; while consumers lose due to the absence of quality guarantees and the higher probability of health hazards. In general, society loses due to the underfunding of public services (lower budget revenues), inefficient state health care, and the criminalisation of society. Those who benefit represent a small group involved in the illegal import and sale of tobacco products.

### 4.1 Losses to society

The illegal sale of tobacco products hampers the implementation of effective state policy aimed at protecting public interests. First, the government is incapable of providing sufficient public services, due to budget revenue losses. Second, due to the lack of quality controls over illegal tobacco products, the government is unable to ensure compliance with standards regarding cigarette tar and nicotine contents, and hence, the fulfilment of declared health care policy is jeopardised. Third, profitability of illegal trade in tobacco products induces people to participate, which promotes disrespect for the law and the criminalisation of society. Thus, all law-abiding citizens lose due to the abovementioned factors.

#### 4.1.1 Underfunding of public services

Funds raised through taxation represent government financial resources spent on production and provision of public services (education, health care, social security, etc). Sales of tobacco products are subject to excise, VAT, and import duty taxation (in case products are imported). Convenience of excise taxation lies in the possibility to predict budget revenues quite accurately, due to the existence of a stable demand for tobacco products.

According to our calculations, in 1999 the consolidated state budget and the Pension Fund lost approximately 660 million UAH in revenues due to the illegal import of tobacco products.

| Tax/Duty                                     | Method of charging and the amount of tax/duty     | Estimated budget revenue losses (millions UAH) |
|--|---|--|
| Excise tax                                   | 2.5 EURO per 1,000 sticks                         | 203.369  |
| VAT  | 20% * (customs value* + excise tax + import duty) | 196.783  |
| Import duty                                  | 3 EURO per 1,000 sticks                           | 244.043  |
| Allocations to the Pension Fund <sup>6</sup> | 5% * (customs value* + excise tax)                | 15.414   |
| <b>Total</b>                                 |   | <b>659.609</b>                                 |

\* the following average customs values were used: 0.45 UAH for non-filter cigarettes and 2.5 UAH for filter cigarettes.  
Source: ICPS estimates

However, if all taxes were paid, the price of a non-filter pack of “Prima” cigarettes produced in Russia would exceed 1 hryvnia, making the cigarettes non-competitive compared to domestically produced analogues (see Table 3). Hence, the above-given estimate is likely to be a theoretical one. More

<sup>6</sup> 5% allocation to the Pension Fund from sales of tobacco products was introduced by a law dated July 15, 1999 that came into effect on August 19, 1999.

accurately, budget revenue losses may be estimated under the assumptions of zero illegal imports and legal domestic production of the same quantity of cigarettes.

Based on data from 1999 on the production and total contributions of tobacco companies to the state budgets at all levels, we calculated that the average tax content in each cigarette produced in Ukraine was approximately 2.2 kopeks<sup>7</sup>. Hence, according to our calculations, if illegally imported cigarettes had been legally produced in Ukraine, the budget would have received an additional 400 million UAH in the form of taxes and duties<sup>8</sup>.

Thus, the government receives less financial resources due to the illegal import and circulation of tobacco products, which leads to its decreased ability to provide public services.

#### 4.1.2 Ineffective state health care

State health care policy is aimed at preserving human potential and decreasing the level of public morbidity. One of the tools for achieving these goals is to protect consumers from inferior-quality and dangerous goods. Illegal circulation of tobacco products results in the increased availability of cheap cigarettes to wider societal groups, and the impossibility to control the quality of tobacco products and adherence to standards regarding the content of harmful substances.

##### a) Expansion of teenager smoking

The existence of a large-scale black market in tobacco products causes increased levels of smoking amongst teenagers. Low prices of illegal cigarettes promote uninformed cigarette consumption by teenagers. Teenagers tend to be more sensitive to changes in tobacco prices, since they have limited financial resources and have not yet acquired the habit of smoking a particular cigarette brand<sup>9</sup>. Illegal cigarette sellers do not obey state requirements on conducting retail trade in tobacco products, which leads to increased availability of cigarettes to teenagers being not able to make an informed decision on smoking.

##### b) Non-compliance with standards regarding harmful substance content

Taking into account the negative effects of smoking on human health, the government is interested in reducing smoking in the country. In order to fulfil this objective, restrictions on harmful substances (namely, tar and nicotine) content are set. Tobacco products imported to Ukraine are subject to state hygiene and sanitary expertise, which is aimed at verifying the quality of the products and compliance of harmful substance content to the maximum permitted levels set by the Ministry of Health Care of Ukraine. However, massive illegal cigarette inflows undermine the implementation of the state health care policy.

**Table 6. Content of harmful substances in cigarettes produced in Ukraine and Russia**

| Cigarette brand, country of origin   | Tar content, mg/sticks | Nicotine content, mg/stick |
|--|------------------------|----------------------------|
| <i>Filter cigarettes (low price segment)</i>   |                        |                            |
| Prima silver, Reemtsma (Ukraine)   | 14                     | 0.9                        |
| Novost, Liggett-Ducat (Russia)*  | 16–20                  | 1.3                        |
| <i>Non-filter cigarettes</i>   |                        |                            |
| Prima classical, Reemtsma (Ukraine)  | 15                     | 1.0                        |
| Prima Classic, Liggett-Ducat (Russia)*   | 24                     | 1.3                        |
| Notice: Data on harmful substance content are printed on cigarette packs produced in Ukraine. Prices of cigarettes were obtained through a field study conducted in August 2000 in Kyiv. |                        |                            |
| *Since information about harmful substance content is not given on cigarette packs produced in Russia, the data given in the table represent normative requirements set in Russia.       |                        |                            |

<sup>7</sup> 1.2 billion UAH of state budget revenues from taxes and duties / 53.727 billion cigarettes = 2.2 kopeks.

<sup>8</sup> 18.6 billion sticks of illegal cigarettes \* 0.022 UAH = 409 million UAH.

<sup>9</sup> Chaloupka, Frank. Macro-Social Influences: The effects of prices and tobacco control policies on the demand for tobacco products. Nicotine & Tobacco Research forthcoming <http://www.uic.edu/~fjc/publications/>

Since illegal tobacco products are mainly represented by Russian cigarettes from the low-price segment, standards of the Ukrainian health ministry regarding harmful substance content are not met; hence, consumers expose their health to additional danger. Moreover, consumers are not aware of this danger, since Russian legislation (as opposed to Ukrainian legislation) does not require producers to indicate harmful substance content on cigarette packs.

### **4.1.3 Criminalisation of society**

Existing illegal circulation of tobacco products results in reduced respect for the law, since an increasing number of individuals is involved in the transportation, storage, and sales of illicit tobacco products. Illegal employment leads to social uncertainty: individuals occupied in the illegal business are not guaranteed adherence to the terms of labour agreements between employees and employers, and such individuals cannot rely on social assistance in case of their disablement.

From the economic point of view, illegal cigarette distribution is socially inefficient. Black market activities are less productive in the utilisation of attracted resources compared to the legal sector, since such activities always involve costs associated with concealment of the business.

An expanded sphere of activities by individuals engaged in the organisation of illegal tobacco circulation creates grounds for forming organised criminal networks, financing other criminal activities, and/or bribing public servants. European parliamentary experts determined the existence of a strong correlation between cigarette and alcohol smuggling on the one hand, and trade in arms and drugs on the other, since very often the same individuals, ways, and methods are involved<sup>10</sup>. Owing to high profits, individuals involved in illegal sales of tobacco products are able to bribe public servants in order to avoid financial sanctions and goods seizure. Consequently, corruption in law enforcement agencies promotes further criminalisation of social relations<sup>11</sup>.

## **4.2 Losses to producers**

Since excise and other duties are not paid from cigarettes imported illegally to Ukraine, the price of illicit cigarettes is much lower compared to the price of legally produced or imported cigarettes. Under this setup, legal producers (importers) and suppliers of illicit tobacco products find themselves in disparate competitive positions. Consequently, legal producers receive lower returns on their investments and will be reluctant to invest in the Ukrainian tobacco industry in the future.

### **4.2.1 Decreased return on investment**

In 1999, given the large volumes of illegal imports, legal tobacco producers had to reduce production and review their investment plans. Production of cigarettes in Ukraine declined by 8.6% compared to 1998, although initially tobacco companies projected an 8% increase in production for 1999.

Establishment of complete-cycle cigarette production, particularly the launch of a section for primary tobacco processing, requires tens of millions of dollars in investments. Meanwhile, profit losses caused by illegal imports of tobacco products lead to reduced returns on investment. Hence, investors reject new investment projects, and this has negative consequences for the Ukrainian economy as a whole.

### **4.2.2 Violation of intellectual property rights**

The existence of organised networks for illegal tobacco sales establishes conditions for the sale of counterfeit tobacco products. Sales of counterfeit tobacco products violate intellectual property rights. In the short run, violation of intellectual property rights leads to real producers losing their market share, hence, returns on investment decline. Owners of trademarks lose consumer confidence in their products; consequently, profits from product sales shrink.

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<sup>10</sup> *Committee Enquiry into the Community Transit System*, European Parliament, February 1997. <http://www.europarl.eu.int>

<sup>11</sup> Ganuza J.J., E. Hank *Economic Integration and Corruption: The Corrupt Soul of the EU*. Economics Working Paper Series, Universitat Pompeu Fabra, June 2000. <http://www.econ.upf.edu/deehome/what/wpapers/postscripts/482.pdf>

In the long run, violation of intellectual property rights reduces new investment inflows. Due to poor protection of intellectual property rights, researchers lose motivation for conducting innovative activities since they are not guaranteed that their inventions will not be counterfeited.

### **4.3 Losses to consumers**

In our opinion, consumer losses associated with the lack of quality guarantees and higher probability of harming health due to the consumption of illicit tobacco products outweigh the benefit represented by a lower price on such cigarettes.

In buying illegal cigarettes, consumers are not provided quality guarantees. Tobacco products are very sensitive to storage and transportation conditions. Tobacco loses its quality and taste due to the absorption of moisture and smells, which inevitably happens if cigarettes are not transported in special packaging. On the contrary, legal producers ensure compliance with all requirements regarding transportation and storage of products, and guarantee quality to consumers.

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## 5. CAUSES OF THE ILLEGAL IMPORT AND CIRCULATION OF TOBACCO PRODUCTS IN UKRAINE

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We propose to divide the causes of illegal tobacco circulation in Ukraine into incentives and conditions. Incentives give rise to activities associated with the illegal import or trade in tobacco products and entry of new participants in this sphere. The incentive is the opportunity to receive profits from illegal trade in tobacco products, due to excise differentials with Russia. Conditions are factors that enable profit-making opportunities. Such conditions include ineffective existing mechanisms for disclosure and punishment of illegal import and distribution of tobacco products. The lack of a mechanism for destroying seized cigarettes poses the threat of resumed legal sales of products which are harmful for human health.

### 5.1 Incentives for the illegal import and distribution of tobacco products

The opportunity to receive profits from the illegal import and sale of tobacco products in Ukraine exists due to differentials in cigarette prices between Ukraine and Russia, caused by differentials in excise rates. The gap between excise rates in the two countries appeared in 1998–99, after the significant depreciation of the Russian ruble and the Ukrainian hryvnia with respect to leading currencies. Till the end of 1999, Ukrainian excise rates for tobacco products were set in EUROS, while in Russia excise rates were set in rubles during the whole period. Depreciation of the hryvnia with respect to the EURO de facto led to higher excise rates in Ukraine and the appearance of a gap in excise rates between the two countries. Then, during 1999 illegal cigarette imports expanded rapidly.

Since December 1999<sup>12</sup>, excise rates for tobacco products in Ukraine have been set in hryvnias. On July 1, 2000, a uniform excise rate was introduced, i.e., 10 hryvnias per 1,000 sticks. This excise rate is significantly lower than the rates in other Eastern European countries; in particular, Poland's uniform excise rate of 42 zloty (51 UAH) per 1,000 sticks was set on October 1, 2000. At the same time, the excise rate in Ukraine exceeds the excise rates introduced in Russia for the cheapest cigarettes.

As opposed to the Ukrainian legislation, which envisages a uniform excise rate for non-filter and filter cigarettes, Russian legislation envisages different excise rates for various categories of tobacco products. Compared to non-filter cigarettes, different categories of filter cigarettes in Russia are subject to 3.5–7.5 times higher excise rates<sup>13</sup>; hence, the largest gap between excise rates in Ukraine and Russia appears in the segment of non-filter cigarettes. Currently, Ukrainian excise on non-filter cigarettes is over 7 times higher than that introduced in Russia; starting at the beginning of 2001, Ukrainian excise will be 5 times higher. Regarding filter cigarettes, the gap between the excise rates is either insufficient to promote massive illegal imports (old Soviet filter brands), or absent (international brands). Consequently, non-filter cigarettes account for the majority of illegal imports to Ukraine.

| UAH per 1,000 sticks                     |                               |
|--|-------------------------------|
| Ukraine                                  | Russia                        |
| 10 (since July 1, 2000)                  | 1.35 (till January 1, 2001)   |
|  | 1.93* (after January 1, 2001) |
| * according to the present exchange rate |                               |

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<sup>12</sup> According to the Law dated November 19, 1999.

<sup>13</sup> According to the Tax Code of the Russian Federation. The norm on new excise rates for tobacco products will come into force on January 1, 2001.

At the same time, international experience indicates that under fair administration of tobacco markets and given the effective work of customs and law enforcement agencies, tobacco excise differentials do not lead to the appearance of large-scale black markets in tobacco products<sup>14</sup>.

## 5.2 Conditions for illegal import and distribution of tobacco products

Activities associated with illegal imports and trade in tobacco products in Ukraine de facto remain unpunished, due to the low probability of illegal import disclosure, lack of proper controls within the country, and ineffectiveness of the punishment procedure. This is due to:

- transparent borders with neighbouring countries;
- ineffectiveness of law enforcement agencies' work, which impedes the disclosure of illegal imports and distribution of tobacco products;
- inefficient mechanisms for punishing involvement in the illegal import and distribution of tobacco products.

Illegal distribution of tobacco products is also promoted by the low incomes of Ukrainian consumers and flawed government regulation of trade in tobacco products.

### 5.2.1 Transparent borders with neighbouring countries

Poor control over the Russian-Ukrainian border facilitates the illegal import of tobacco products to Ukraine:

- numerous uncontrolled side-roads exist near the officially established checkpoints controlled by frontier troops and customs agencies. According to the State Customs Service, there are 41 official checkpoints and 1,100 uncontrolled side-roads over the 2,500 kilometres of the Russian-Ukrainian border;
- stops of local trains running from Russia to Ukraine last 2–5 minutes, which makes it impossible to conduct customs control.

Such transparency of the border enables unhindered illegal cross-border transportation of tobacco products in small lots, using local trains or side-roads.

### 5.2.2 Inadequate law enforcement

The illegal chain for the import and sale of tobacco products includes (1) cross-border transporters, (2) firms that store and distribute illegal products, (3) retail dealers. Transporter activity should be disclosed and punished by the State Customs Service, and wholesale firms' and retailers' activities by the State Tax Administration or internal affairs agencies. However, none of these organisations is interested in conducting complete investigations or disclosing the whole chain of illegal imports and distribution of tobacco products. Such disinterestedness results from the fact that for each agency such investigation entails additional expenditures; in addition, the SCS has no right to conduct intelligence.

According to the Ukrainian legislation in force, complete investigations can only be performed by the National Security Service of Ukraine. According to Article 112 of the Criminal-Procedural Code, primary investigation of contraband cases is the prerogative of the National Security Service of Ukraine. Contraband is defined as the transportation of commodities, currency, valuables, and other goods in large amounts across the customs border of Ukraine, avoiding or concealing them from customs controls<sup>15</sup>. In case signs of contraband are discovered<sup>16</sup>, the customs service or another law enforcement agency has to

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<sup>14</sup> See appendix C and also Luc Joossens, Martin Raw: "Cigarette smuggling in Europe: Who really benefits?", *Tobacco Control*, 1998; 7:66–71.

<sup>15</sup> According to Article 70 of the Criminal Code of Ukraine, "large amounts" should be understood as contraband when the total value of involved goods amounts to 200 or more official minimum [monthly] wages (since July 1, 2000 — 118 UAH; hence, the value of illegally imported goods should exceed 23,600 UAH).

<sup>16</sup> The State Customs Service of Ukraine is only authorised to conduct inquests on cases of contraband.

deliver the case to the National Security Service for investigation. However, since illegal imports of tobacco products are conducted in small lots, the National Security Service does not perform investigations in these cases.

Within its authority, the State Customs Service conducts administrative cases on the violation of customs rules (imposes administrative penalties, delivers cases on property seizure to the court). The State Customs Service is able to disclose methods and individuals involved in illegal tobacco imports, but given its lack of the right to conduct intelligence, it has no right to proceed with investigation of the distribution chain. Moreover, the State Customs Service's authority extends only over customs control zones established at state border checkpoints, but not over the whole state border.

The tax police are authorised to conduct intelligence concerning violations of tax legislation, which include the sale of products without excise stamps. However, the tax police do not have a special subdivision for conducting investigations regarding the illegal circulation of tobacco and alcohol. After establishing the subdivision, which is envisaged in the Law of Ukraine dated April 20, 2000, we can expect better co-ordination of activities among the law enforcement agencies regarding the disclosure and punishment of firms and individuals involved in the illegal circulation of tobacco products.

Since illegally imported cigarettes are sold by numerous street vendors, tax administration agencies can efficiently disclose activities associated with illegal tobacco sales only with the co-operation of internal affair agencies. However, such co-operation between agencies would require a priority directive from the government and the President.

The effectiveness of each law enforcement agency and their co-operation could be higher if criteria for evaluating the effectiveness of their work are set. In countries where much attention was paid to the performance of law enforcement agencies (particularly USA and New Zealand), evaluating performance of an agency determines its budget financing. While submitting a request for budget financing, law enforcement agencies define their agenda priorities and determine criteria for evaluating their work on each item in the agenda. Owing to the lack of such a procedure in Ukraine, expenditures of law enforcement agencies increase due to the implementation of non-priority programs. Moreover, the lack of procedures for planning and evaluating performance of law enforcement agencies reduces incentives to establish co-operation among agencies in order to fulfil common priority objectives.

### **5.2.3 Poor punishment mechanisms**

Punishment mechanisms are ineffective due to the following factors:

- complexity of the procedure for seizure of illegal tobacco products;
- lack of mechanisms for the destruction of seized tobacco products;
- lack of a negative public attitude towards the illegal import and circulation of tobacco products.

#### ***a) Complexity of seizure procedure***

Article 164-5 of the Code of Ukraine on Administrative Offences envisages the seizure of goods involved in the offence. However, according to Article 41 of the Constitution of Ukraine, the seizure of private property can only be executed by court decision.

Consequently, if violations of customs rules, illegal trade, transportation or storing of tobacco products without excise stamps are revealed, authorities from the State Customs Service and Tax Administration impose a fine and have to bring the case into court in order to seize illegal tobacco products.

However, since Ukraine's general courts are overburdened with civil and criminal cases, consideration and decision making concerning cases on the seizure of illegal tobacco products are postponed. Insufficient immediacy of considering such cases in courts delays punishment for offenders, increases expenditures on storing impounded goods, as well as increases the risks of selling said goods in the market, due to officials' abuses of the law.

### **b) Lack of mechanisms for the destruction of seized tobacco products**

According to the new edition of the Law “On the state regulation of production and trade in ethanol, cognac, and fruit alcohol, alcoholic beverages, and tobacco products”, which came into force on July 10, 2000, seized tobacco products are subject to mandatory destruction. Previously, as an alternative to destruction, seized tobacco products could be resold to consumers in the army, prisons, and old people’s homes. However, reselling of illegal tobacco products led to the following negative results:

- according to the Cabinet of Ministers Decree dated October 24, 1996<sup>17</sup>, officials from state tax administrations had the right to make a decision on the inexpediency of testing seized tobacco products to be resold if the expenditures on such testing exceeded the value of the seized products. Consequently, consumers may receive low-quality products or products that do not meet the standards of harmful substance content;
- the opportunity to receive illegal profits from reselling seized tobacco products creates grounds for abuse by the officials involved in reselling.

Experience of other countries proves that the obligatory destruction of seized cigarettes, together with coverage of the destruction procedure in the mass media, is an effective mechanism for the formation of a negative public attitude towards the illegal circulation of tobacco products. However, Ukraine still lacks a clear mechanism for the destruction of seized tobacco products. According to the existing procedure for the resale or destruction of seized alcoholic beverages and tobacco products, destruction (utilisation) is executed by a commission that includes representatives of the State Tax Administration which registered the products, agencies where testing was conducted, and corresponding local state administrations. At the same time, the procedure does not define which agencies are to physically destroy the seized tobacco products, as well as the sources of financing for expenditures associated with the transportation, storage, and destruction of the products. According to the Law dated April 20, 2000, the Cabinet of Ministers had to approve a new destruction procedure by July 10, 2000; however, this requirement of the Law has not been fulfilled yet.

The lack of a clear destruction mechanism leads to non-fulfilment of the Law. Moreover, the STA has initiated cancellation of the norm on obligatory destruction, using the argument that large amounts of accumulated seized tobacco products have not been destroyed yet. Rescindment of the provision on mandatory destruction will enable the legal sale of hazardous products in Ukraine and promote abuse by officials.

### **c) Lack of a negative public attitude towards the illegal circulation of tobacco products**

People are rarely aware of the social losses from illegal trade in tobacco products; hence, they do not consider it to be a serious offence<sup>18</sup>. In reality, though, all law-abiding citizens lose from the illegal circulation of tobacco products (see section 5). The lack of a negative attitude towards the illegal circulation of tobacco products promotes the impunity of offenders. Successful combating of this negative phenomenon requires public awareness of the harmful effects, and their support of measures implemented by the government in order to overcome the phenomenon.

The experience of other countries (for example, Canada) indicates that informing the public on the negative effects of illegal tobacco circulation, and forming unattractive image of offenders through the mass media, is one method to overcome the phenomenon. In Ukraine, such measures are not implemented by the government or interested public organisations. Hence, for most people, the purchase of an illegal cigarette pack from a street vendor is acceptable and not associated with contributing to organised crime.

Moreover, due to the lack of information, consumers do not know how to distinguish legally produced cigarettes from smuggled cigarettes. Usually, illegally imported cigarette packs lack Ukrainian excise stamps; instead, Russian excise stamps are attached.

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<sup>17</sup> Cabinet of Ministers Decree “On approving the Regulations on the production, storage, and sales of excise stamps and labelling of alcoholic beverages and tobacco products and the Procedure for reselling or destroying seized alcoholic beverages and tobacco products” dated October 24, 1996.

<sup>18</sup> *The Black Market in Tobacco Products*, DTZ Pieda Consulting, May 2000.

## How to distinguish a legally produced cigarette pack from a smuggled one

In Ukraine, each legally produced pack of cigarettes should contain the following information in Ukrainian<sup>19</sup>:

- name of the producer or tobacco company;
- general and specific names;
- filter or non-filter indicated;
- number of cigarettes in the pack;
- tar and nicotine content in each stick;
- “Smoking is harmful to your health” warning;
- indication of the normative document (for cigarettes produced in Ukraine);
- bar code.

The excise stamp should be attached to the pack under the polyethylene wrapper in such a manner that it tears when the pack is opened<sup>20</sup>.

### 5.2.4 Low Ukrainian consumer income

Demand for cheap cigarettes illegally imported to Ukraine is determined by the low incomes of Ukrainian consumers. This factor makes Ukrainian consumers choose products by the price criterion (as opposed to quality criterion)<sup>21</sup>. A survey conducted by the AC Nielsen company (see table 8) indicates that the overwhelming majority of Ukrainian smokers buy cigarettes in the places where the price is usually lower, though tobacco quality guarantees are minimal. Illegally imported products are sold through street vendors, wholesale, or in the open markets.

|                      | Kiosks | Street vendors | Open markets | Stores and supermarkets | Wholesale markets |
|----------------------|--------|----------------|--------------|-------------------------|-------------------|
| % of respondents     | 30     | 27             | 20           | 13                      | 10                |
| Source: “AC Nielsen” |        |                |              |                         |                   |

### 5.2.5 Inadequate state regulation of tobacco product trade

According to the Ukrainian legislation in force, in order to undertake legal retail trade in tobacco products, retailers need to obtain a license for each trade outlet. The annual cost of the license is too high, while the procedure for obtaining the license requires much time and effort. These factors promote illegal retail trade in tobacco products, particularly through street vendors and open markets (see table 8). Since unlicensed retail trade in tobacco products is de facto not controlled, the majority of illegal tobacco products is sold through a network of illegal retailers.

<sup>19</sup> The Law of Ukraine “On the state regulation of production and trade in ethanol, cognac, and fruit alcohol, alcoholic beverages, and tobacco products” dated December 19, 1995.

<sup>20</sup> The Law of Ukraine “On excise taxation of alcoholic beverages and tobacco products” dated September 15, 1995.

<sup>21</sup> According to a survey conducted by the GfK-USM company, Ukrainian consumers consider price to be the dominant motive in choosing consumer goods. The survey indicates that 50% of consumers assume that well-known brands differ only in price but not in quality; hence, they are always seeking for the lowest price. (For comparison, in Hungary 25% of respondents support this opinion.)

### **a) High administrative costs associated with legal trade activities**

Administrative costs associated with legal tobacco trade activities exceed the expenditures on concealing and risk of punishment, due to the following factors:

- the necessity to submit five documents to obtain a license for retail trade, where the greatest effort is needed to receive permission for trade in tobacco products at the indicated address;
- mandatory requirement to use electronic cash registers;
- requirement to keep special records on excisable products.

The abovementioned factors lead to the expansion of the network for illegal trade and, hence, uncontrolled trade in tobacco products.

### **Documents that need to be submitted in order to obtain a license for retail trade in tobacco products**

In order to receive a license for retail trade, businesses must submit the following documents<sup>22</sup>:

- application for the license, according to the established procedure;
- copy of the certificate on the state registration of an individual as a business entity;
- State Tax Inspection's certificate on the registration of the legal entity or certificate on the state registration of an individual as a business entity;
- permission for trade in tobacco products in outlets at the indicated addresses;
- copy of the document on the registration of electronic cash registers, or a certificate from the corresponding financial agency on the registration of a commodity and cash book; or upon presentation of accounting records.

### **b) High cost of the license for retail trade**

According to the Law “On the state regulation of production and trade in ethanol, cognac, and fruit alcohol, alcoholic beverages, and tobacco products”, the cost of an annual license for retail trade amounts to 50 non-taxable minimum [monthly] wages (UAH 850)<sup>23</sup> per each trade outlet. Hence, an entrepreneur having three outlets needs to pay UAH 2,550 annually, which exceeds the cost of one license for wholesale trade in tobacco products (UAH 1,700).

Under such circumstances, entry into legal retail trade becomes too expensive for small retailers, while wholesale firms sell tobacco products both to legal and illegal traders.

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<sup>22</sup> According to the Cabinet of Ministers Decree “On the temporary procedure for issuing exim licenses on ethanol, cognac, and fruit alcohol, alcoholic beverages, and tobacco products, and retail trade in alcoholic beverages and tobacco products” dated May 13, 1996.

<sup>23</sup> Except for villages and towns, where costs of licenses amounts to 10 and 20 non-taxable minimum [monthly] wages (UAH 170 and 340), respectively.

## 6. POLICY ALTERNATIVES FOR ELIMINATING THE ILLEGAL IMPORT AND CIRCULATION OF CIGARETTES

State policy for combating the illegal import and circulation of tobacco products can be aimed at either eliminating incentives (for example, reducing the excise rate for non-filter cigarettes), or eliminating conditions for conducting illegal operations. These alternatives should be evaluated on the basis of the total effect on society. In our opinion, reducing in excise rates will lead to a significant decrease in state budget revenues and will have a negative effect on society as a whole. Hence, we propose to concentrate efforts on eliminating conditions for the illegal import and sale of tobacco products. Such measures will have long-term positive effects, since they will enable both the reduction of existing volumes of illegal imports and sales, and ensure the prevention of illegal operations in the future, as well as promote the resolution of other societal problems.

### 6.1 Excise rate reduction

Although reduction of the excise rate for non-filter cigarettes will enable temporary elimination of illegal imports, it will lead to decreased budget revenues and will have negative effects for society as a whole. Social costs and benefits from the reduction in the excise rate for non-filter cigarettes downward, to the rate in Russia, are summarised in the following table.

| <b>Table 9. Social costs and benefits from a reduced excise rate for non-filter cigarettes</b>  |  |
|---|--|
| <b>Costs</b>  | <b>Benefits</b>  |
| <ul style="list-style-type: none"> <li>• underfunding of public services due to reduced budget revenues</li> <li>• stability of Ukrainian taxation policy will be reduced, since it will be dependent upon decisions made by Russian authorities</li> <li>• contradicts intentions to harmonise Ukrainian and European legislation</li> <li>• does not change conditions enabling the illegal import and distribution of products</li> <li>• return on investment in production and development of tobacco market will decline</li> </ul> | <ul style="list-style-type: none"> <li>• quick effect – producer losses from unequal competition with illegal imports will be eliminated</li> <li>• consumers will have more quality guarantees</li> <li>• the level of criminalisation in society will decline</li> </ul> |
| Source: ICPS evaluations.   |  |

#### 6.1.1 Reduction in budget revenues

If excise rates for non-filter cigarettes in Ukraine and Russia had been equalised, in 1999 the Ukrainian excise rate would have to be reduced to approximately UAH 1.2 per 1,000 sticks. We assume that under such circumstances, legal production in Ukraine would grow and completely crowd smuggled cigarettes out of the market. Under this scenario, our estimates show that in 1999, budget revenues from excise on non-filter cigarettes would have dropped from UAH 230 million de facto collected to approximately UAH 45 million. In general, budget revenues from the production of non-filter cigarettes (including excise tax, VAT, and obligatory 5% deducted to the Pension Fund) would drop from UAH 438 million down to UAH 332 million, or by approximately 25%.

### **6.1.2 Inconsistency with social goals**

Excise reduction would contradict the objective of harmonisation of Ukrainian and European legislation. For example, Eastern European countries aiming at entering the EU are forced to increase excise rates significantly in order to match them to those in the EU. Moving in the opposite direction will have negative consequences for Ukraine in the future.

Such changes in taxation will reduce the stability of Ukrainian taxation policy, because they contradict the strategic directions of its development and make the policy dependent upon decisions made by Russian authorities.

## **6.2 Eliminating conditions for illegal operations**

Eliminating conditions for the illegal import and sale of tobacco products (i.e., transparency of borders, low performance of law enforcement agencies, poor punishment mechanisms, overregulation of legal tobacco trade) will enable a permanent reduction in the scale of this phenomenon. Moreover, these measures will also help to resolve other social problems such as contraband in arms, drugs and alcoholic beverages, illegal migration, and illegal import of other products.

At the same time, it should be understood that such a strategy requires a significant number of organisational measures and amendments to legislation. Hence, in order to minimise social losses from the illegal import and circulation of goods in Ukraine, the government should develop an action plan envisaging rapid implementation of these measures and amendments.

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## 7. RECOMMENDATIONS

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In our opinion, the action plan for combating the illegal import and circulation of tobacco products in Ukraine should embrace the following steps: (1) increase the effectiveness of law enforcement agencies, (2) simplify conditions for legal retail trade in tobacco products, (3) improve mechanisms for the punishment of illegal distribution of tobacco products, and (4) increase the protection of state borders.

### 7.1 Increasing law enforcement effectiveness<sup>24</sup>

If the effectiveness of law enforcement agencies is raised, we should expect an increase in the probability of disclosure and punishment of individuals involved in the illegal import and circulation of tobacco products. We propose to concentrate effort on disclosing criminal groups involved in the organisation of illegal import and distribution of tobacco products. Hence, there is a crucial need for increasing the performance of the State Customs Service<sup>25</sup> and State Tax Administration.

The State Customs Service will be more capable of disclosing groups involved in the organisation of illegal imports if case it is granted the authorities envisaged in the draft of the new Customs Code of Ukraine:

- the right to conduct intelligence—the State Customs Service, together with State Tax Administration, is responsible for collecting obligatory payments to the budget. Hence, analogously to the tax police, which has the right to conduct intelligence, the same right should be granted to the SCS;
- the right to conduct customs controls not only at cross-border checkpoints, but around border zones as a whole. This will increase the probability of detecting illegal cross-border transportation of products.

According to the Law of Ukraine dated April 20, 2000, the structure of the tax police should be expanded to include a special department for combating the illegal circulation of alcoholic beverages and tobacco products. The establishment and operation of this department will reinforce controls over the illegal circulation of tobacco products within the country. Moreover, this department can be made responsible for co-ordinating the activities of law enforcement agencies combating the illegal import and circulation of tobacco products.

At the same time, extending the authorities of State Customs Service and State Tax Administration will require higher quality planning of their work, since additional mandates can result in increased expenditures. Such planning includes definition of programs, their prioritisation, and setting criteria for evaluating performance. Moreover, the experience of OECD countries proves the expediency of subordinating the State Customs Service and State Tax Administration to the Finance Ministry, since both agencies are in charge of collection of payments to the budget. If this is implemented, distribution of authorities and co-ordination of the agencies' activities will be improved. The international customs organisation also indicates a trend towards merging the authorities responsible for collecting indirect taxes.

Expanding authorities should be accompanied by measures for preventing corruption in law enforcement agencies. International experience indicates that effective methods for preventing corruption include clear instructions regarding activities at each level of decision making, and conducting a personnel policy envisaging unprejudiced competitive selection of staff and staff rotation<sup>26</sup>.

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<sup>24</sup> Law enforcement agencies include all agencies conducting controls over the implementation of legislation. They include internal affair agencies, the National Security Service, the State Committee for Protection of the State Border of Ukraine, the State Customs Service, the State Tax Administration, prosecution agencies, etc.

<sup>25</sup> Appendix C contains a description of the successful experience of New Zealand in reforming its customs service.

<sup>26</sup> Kaufmann, Daniel. *Challenges in the Next Stage of Anti-Corruption*, World Bank, 1998, 28 pp.

## 7.2 Simplifying conditions for the legal trade of tobacco products

We expect simplification of conditions for legal trade in tobacco products in Ukraine after the implementation of the Law “On the licensing of some economic activities” approved by the Verkhovna Rada on June 1, 2000. According to the Law, licensing rules for retail trade in tobacco products will not differ from analogous rules set up for other economic activities which are subject to licensing according to the Law. Hence:

- the requirement to obtain a license for each outlet will be revoked. After the Law comes into effect, businesses pay for a general license permitting trade in tobacco products. According to the application, the licensing authority issues a copy of the license for each outlet;
- in order to obtain a license, businesses submit applications containing personal information and the type of activity subject to licensing.

If the law on licensing is implemented and cost of the license is set at the level of administrative expenditures<sup>27</sup>, risks and expenses associated with illegal trade will exceed payments for conducting legal activities. Consequently, more entrepreneurs will prefer legal activities. Entrepreneurs will create workplaces and employ individuals who were otherwise induced to earn their living in illegal retail trade.

Expansion of legal trade will facilitate better controls by licensing and tax authorities over the circulation of tobacco products. Hence, retailers and wholesalers will be more reluctant to distribute illegal products, given the threat of losing their license and being punished by tax authorities. Moreover, legal traders will become a significant force interested in eliminating illegal tobacco circulation, and will actively assist law enforcement agencies in this field.

## 7.3 Improving mechanisms for punishing the illegal import and circulation of tobacco products

Higher penalties will reduce the profits, and increase risks and cost of concealing, for individuals involved in the illegal import and circulation of tobacco products. Methods for making penalties more severe include:

- choosing optimal penalties (fines);
- hastening court trials on the seizure of illegal tobacco products;
- obligatory destruction of seized tobacco products;
- formation of a negative public attitude towards the illegal import and circulation of tobacco products.

### 7.3.1 Choosing optimal penalties (fines)

The optimal fine for illegal operations with tobacco products should be sufficiently high to affect offender activity and deprive individuals of operating funds for continuing illegal activities. On the other hand, the fine should be realistic.

After making amendments to the Administrative Code that came into force on July 10, 2000<sup>28</sup>, fines for illegal circulation were regulated and optimised. The fine for retail or wholesale trade without the necessary license or excise stamps was set at 20–100 non-taxable minimum [monthly] wages (UAH 340–1,700).

The same fine was set for the storing or transportation of tobacco products without excise stamps. Moreover, for offences committed repeatedly or in large amounts (over 100 non-taxable minimum [monthly] wages—UAH 1,700) the fine increases to 100–300 non-taxable minimum [monthly] wages (UAH 1,700–5,100), which is a considerable penalty for wholesale distributors being key agents in the illegal circulation of tobacco products.

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<sup>27</sup> i.e., costs associated with printing license forms and keeping the General License Register.

<sup>28</sup> According to the Law “On amending some legislative acts of Ukraine on intensification of fighting the illegal production and circulation of ethanol, cognac, and fruit alcohol, alcoholic beverages, and tobacco products” dated April 20, 2000.

The Law also specifies liability for illegal vendor trade in tobacco products (undertaken by individuals): the fine varies from 1 to 7 non-taxable minimum [monthly] wages (UAH 17–119).

### 7.3.2 Improving court trial procedures regarding cases of illegal imports and distribution

Effectiveness of punishment for illegal operations with tobacco products substantially depends on the effectiveness of the judicial system, since cases on administrative offences are considered by the courts making decisions on imposing fines<sup>29</sup> and seizure of illegal tobacco products.

Activation of law enforcement agencies' work regarding the disclosure of illegal imports and circulation of tobacco products will bring an increased number of cases on administrative offences. Consequently, in order to reduce expenditures on court trials, we propose to establish specialised administrative courts for considering cases on administrative offences only<sup>30</sup>. If this is implemented, the duration of court trials on illegal imports and circulation of tobacco products will shrink, promoting more effective punishment.

The State Customs Service developed a draft Law “On amending some legislative acts of Ukraine on combating contraband and violations of customs rules”. The SCS suggests excluding illegal cross-border transportation of consumer goods (including tobacco products) from the definition of contraband, and hence, assigning administrative (not criminal) liability for such activities. Consequently, if these amendments are adopted, prompt punishment can be ensured for illegal cross-border transportation of tobacco products in large amounts, since the procedure for court trials on administrative offences is simpler compared to cases on criminal offences.

#### **Amendments increase the effectiveness of fighting the illegal circulation of tobacco products**

On July 10, 2000, the Law of Ukraine “On amending some legislative acts of Ukraine on the intensification of fighting the illegal production and circulation of ethanol, cognac, and fruit alcohol, alcoholic beverages, and tobacco products” came into force. Implementation of the Law will promote more effective counteraction against the illegal circulation of tobacco products. The Law envisages the following measures:

- the establishment of a department for combating illegal circulation of alcoholic beverages and tobacco products within the structure of the tax police. According to Ukrainian law, the State Tax Administration of Ukraine is made responsible for combating the illegal circulation of alcoholic beverages and tobacco products. It is specified that the State Tax Administration will maintain registers of importers, exporters, wholesale and retail traders, and places where alcoholic beverages and tobacco products are stored;
- obligatory destruction of seized tobacco products;
- introduction of administrative liability for officials who violate the procedure for destruction of tobacco products, and criminal liability for committing this crime repeatedly;
- regulation of administrative liability for retail and wholesale trade in tobacco products without a license or excise stamps (the fine is set at 20–100 non-taxable minimum [monthly] wages);
- setting the fine for illegal vendor trade at the level of 1–7 non-taxable minimum wages;
- specification of liability for storage or transportation of tobacco products without excise stamps (the fine equals 20–100 non-taxable minimum [monthly] wages, and 100–300 non-taxable minimum [monthly] wages for committing the crime repeatedly or in large amounts<sup>31</sup>).

<sup>29</sup> Except for fines for the violation of customs rules: according to the Customs Code and Administrative Code, customs agencies are authorised to impose corresponding administrative penalties.

<sup>30</sup> According to the Government Action Plan approved by the Verkhovna Rada of Ukraine on April 6, 2000, the Ministry of Justice of Ukraine was entrusted with the establishment of administrative courts.

<sup>31</sup> “Large amounts” means values exceeding 100 non-taxable minimum [monthly] wages.

### 7.3.3 Developing mechanisms for destroying seized tobacco products

On July 10, 2000, the norm on obligatory destruction of seized tobacco products envisaged by the Law “On excise taxation of alcoholic beverages and tobacco products” came into force. International experience indicates that the destruction of seized tobacco products increases the effectiveness of the struggle against illegal tobacco circulation. Nowadays, seized tobacco products are destroyed in many countries of the world, including Belgium, Great Britain, New Zealand, Portugal, Finland, and Sweden.

However, the Cabinet of Ministers of Ukraine has not yet approved the procedure for destroying seized tobacco products. Development of such a procedure involves the following difficulties: (1) choosing the proper destruction method, and (2) determining sources of financing. A proper destruction method should require minimum expenditures (for example, using the already existing capacity of disposal plants) and cause minimum damage to the environment.

Alternatives for financing the destruction of seized tobacco products include: (1) destruction at the expense of the offender and (2) destruction financed from fine proceeds. Destruction at the expense of the offender will increase the size of penalties. If offenders have no funds, destruction can be financed from fine proceeds. The first events of seized tobacco destruction should be given publicity.

### 7.3.4 Promoting a negative public attitude towards the illegal circulation of tobacco products

An important method for fighting crime in democratic societies is public involvement. International experience indicates that holding broad public campaigns aimed at explaining the criminal nature and negative consequences of illegal circulation of tobacco products has a positive effect on the formation of implacable attitudes towards this phenomenon<sup>32</sup>. Usually, such campaigns are organised by government and public organisations and tobacco companies, in co-operation with the mass media.

In order to propagandise a negative attitude towards illegal tobacco circulation, it is necessary to distribute information on:

- the social consequences of illegal tobacco circulation;
- examples of disclosed illegal activities in the tobacco market and punishment of offenders;
- the destruction of seized tobacco products.

In countries where measures for fighting the illegal import and circulation of tobacco products have been implemented, special rewards were introduced for individuals assisting law enforcement agencies in locating illegal tobacco products. Such measures were financed both from government funds and funds of public organisations representing tobacco producers and consumers. For example, in Great Britain such campaigns were conducted by the Tobacco Manufacturer’s Association, while the government established free phone lines for the public to call in about cases of distributing illegal tobacco products<sup>33</sup>.

## 7.4 Increasing the protection of state borders

Increasing the protection of Ukrainian borders with Russia, Moldova, and Belarus is a long-term objective which emerges given Ukraine’s policy of European integration, and its need to ensure the security and health of people and the protection of Ukrainian producers from unfair competition.

In the short run, in order to increase the protection of the Ukrainian border and establish conditions for detecting the illegal import of tobacco products, we propose to implement the following measures:

- concentrate the efforts of the customs service and frontier troops on the borders with Russia and Moldova, while reducing resources channelled to defence of the western border;

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<sup>32</sup> *Tackling Tobacco Smuggling*. HM Customs and Excise, HM Treasury, United Kingdom March 2000. <http://www.hmce.gov.uk>

<sup>33</sup> Nicholson, Marjorie. *Smuggler’s Charter: A Study of How High Tobacco Taxation around the World Increases Crime*. November 1994.

- change the timetables of cross-border trains. In order to ensure thorough customs control, the time assigned for customs controls should be extended (in particular, regarding local trains). This measure requires agreements between “Ukrzaliznytsia” (the Ukrainian state railways agency) and the SCS;
- improve information exchange and co-operation between the State Customs Service of Ukraine and customs services of neighbouring countries. According to the Presidential Decree dated May 23, 2000, the President of Ukraine mandated the Ministry of Foreign Affairs to join the Nairobi Convention dated June 9, 1977, on providing mutual administrative assistance in preventing, investigating, and eliminating violations of customs legislation. Implementation of the Convention will facilitate statistical information exchange, which is crucial for identifying goods which potentially can be smuggled, and the scale of consumer goods contraband.

## APPENDIX A: STRUCTURE OF THE TOBACCO INDUSTRY

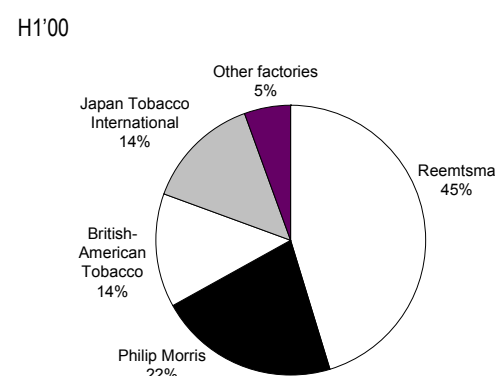
In Ukraine, 23 factories have licenses to produce tobacco products<sup>34</sup>; only 17 of them are currently operating. The 10 largest factories (list given in Table A-1) having membership in the Ukrutiutiu Association of Tobacco Producers account for over 99% of total cigarette production in the country; hence, in our analysis we used data on those factories only. The majority stocks of five factories operating in Ukraine are owned by multinational enterprises (MNEs) which are leading producers of tobacco products in the world—British-American Tobacco (Pryluky Tobacco Factory, Chernihiv oblast), J.T. International (Kremenchuk Tobacco Factory, Poltava oblast), Philip Morris (Kharkiv Tobacco Factory), Reemtsma (Kyiv and Cherkasy tobacco factories).

**Table A-1. Profile of factories having membership in the Ukrutiutiu Association**

| Name                                     | Potential capacity (as of 01.01.2000), billions sticks | Production volume in 1999, billions sticks | Intensity of capacity utilisation |
|--|--|--|-----------------------------------|
| <i>Factories owned by MNEs</i>           |  |  |                                   |
| Reemtsma-Kyiv                            | 20.57  | 15.4854                                    | 75.3%                             |
| Reemtsma-Cherkasy                        | 17.81  | 12.6652                                    | 71.1%                             |
| Philip-Morris-Kharkiv                    | 10.3   | 9.4324                                     | 91.6%                             |
| BAT-Pryluky                              | 6.2  | 6.4046                                     | 103.3%                            |
| J.T. International-Kremenchuk            | 7.88   | 5.274                                      | 66.9%                             |
| <i>Group total:</i>                      | <i>62.76</i>   | <i>49.26</i>                               | <i>78.5%</i>                      |
| <i>Factories without foreign capital</i> |  |  |                                   |
| Kamianets-Podilsky                       | 4.64   | 2.186                                      | 47.1%                             |
| Feodosia                                 | 2.1  | 1.0616                                     | 50.6%                             |
| Ukrainian Tobacco Company                | 1.06   | 0.651                                      | 61.4%                             |
| Dnipropetrovsk                           | 3.3  | 0.531                                      | 16.1%                             |
| Odesa                                    | 1.77   | 0.036                                      | 2.0%                              |
| <i>Group total:</i>                      | <i>12.87</i>   | <i>4.47</i>                                | <i>34.7%</i>                      |
| <b>Total Ukrutiutiu Association</b>      | <b>75.63</b>   | <b>53.72</b>                               | <b>71.0%</b>                      |

In H1 '00, over 94% of supplied cigarettes in Ukraine were produced by the five factories owned by MNEs (see chart A-1). During recent years, the share did not change significantly: in 1999, the factories without foreign capital produced about 8% of the industry's total output; in 1998, the share was about 7%. Moreover, these factories preserve their focus on producing non-filter cigarettes (approximately 98% of their output).

**Chart A-1. Production shares of the major tobacco companies**



Source: Ukrutiutiu Association

<sup>34</sup> According to the State Department for Regulation of Production and Circulation of Alcohol and Tobacco.

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## APPENDIX B: ESTIMATION OF CIGARETTE CONSUMPTION

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We propose to estimate cigarette consumption in Ukraine based on production data, data on legal imports and exports, as well as analysis of factors influencing demand for filter and non-filter cigarettes<sup>35</sup>. Our estimation is based on the following assumptions:

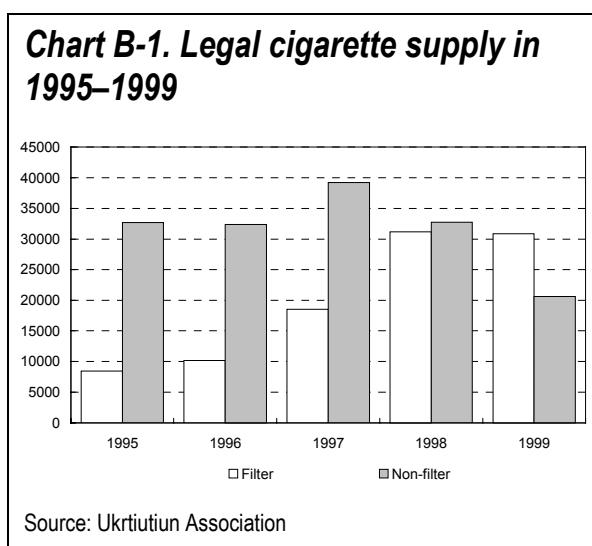
- demand for cigarettes equals supply of cigarettes, since the Ukrainian tobacco market is competitive;
- during 1995–99, total domestic demand (consumption) for cigarettes remained practically unchanged;
- difference between the demand and legal supply is satisfied with illegal supply.

In order to estimate total consumption, we conditionally divide the market into two segments—filter and non-filter. We consider the following major factors influencing consumer choice between filter and non-filter cigarettes:

- overall level of household income and consumption (the higher the level, the larger the share of filter cigarettes in consumption, since they are more expensive);
- difference between the average prices of filter and non-filter cigarettes (increased gap between the prices delays switching from consumption of non-filter to filter cigarettes);
- consumer preferences (quick increase of filter cigarette consumption in Ukraine is impeded by persistent preferences of a large consumer group).

We calculate the legal supply of filter and non-filter cigarettes by the following formula: legal production in the country — legal exports + legal imports. Legal supply was mainly influenced by the following factors:

- existence of illegal cigarette imports;
- conditions of conducting business in tobacco industry;
- production capacity of the factories.



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<sup>35</sup> In our opinion, application of standard consumer survey methods to estimating tobacco consumption entails a high probability of error, due to the following factors: (1) interviews are usually held in the daytime; hence, the sample does not include individuals (particularly, a significant share of males) who are at their workplace; (2) the sample does not usually include representatives of the poorest social strata, prisoners, and the military, but these groups account for a large share of total consumption—and of non-filter cigarette consumption in particular; (3) in answering the question on the cigarette brand preferred, consumers tend to indicate a more expensive brand.

In 1995–97, illegal imports of non-filter cigarettes were practically absent—instead, large-scale illegal imports of filter cigarettes took place. Since the legal supply of non-filter cigarettes was not significantly affected by illegal imports of filter cigarettes, and legal domestic producers satisfied the demand for non-filter cigarettes, production data for this period enable us to estimate the consumption of non-filter cigarettes in Ukraine.

In 1998–99, legally produced filter cigarettes almost completely crowded illegal imports of filter cigarettes out of the market. However, the financial crisis of 1998 led to the appearance and expansion of the black market in non-filter cigarettes. Since illegal imports of filter cigarettes were negligible during this period, and the demand was mainly satisfied by legal domestic production, we estimate the consumption of filter cigarettes based on production data for this period.

## **B.1 Market for non-filter cigarettes**

During 1995–97, illegal imports of non-filter cigarettes were absent. Hence, in the absence of illegal imports, the legal supply of non-filter cigarettes equalled consumption, and in 1997 it increased to 39 billion sticks<sup>36</sup>.

The decreased legal supply of non-filter cigarettes in 1998 (see chart B-1) resulted from the introduction of cheap new Ukrainian filter brands that became popular among certain groups of consumers, and the beginning of illegal imports of cheaper non-filter cigarettes to Ukraine.

In our opinion, in 1999 consumption of non-filter cigarettes increased again, to 38 billion sticks—or almost to the level of 1997 consumption. This was caused by the following factors:

- significant drop in household incomes resulting from the crisis of 1998;
- inflow of large amounts of cheap illegal non-filter cigarettes.

## **B.2 Market for filter cigarettes**

During 1995–99, legal production of filter cigarettes exhibited steady growth; however, in 1998–99, the legal supply of filter cigarettes to the domestic market stabilised (see chart B-1). In our opinion, illegal imports of filter cigarettes in Ukraine are currently negligible due to the following factors:

- the gap between excise rates on filter cigarettes in Ukraine and Russia is insufficient to promote large-scale illegal imports;
- MNEs started to produce most of the international cigarette brands that were previously smuggled into Ukraine;
- producers actively promote Ukrainian filter brands in the lowest and middle price segments (they are crowding out illegal imports);
- demand for the most expensive filter brands that are not produced in Ukraine and are likely to be smuggled is low (2–3% of the market).

Thus, we consider current demand for filter cigarettes in Ukraine to be almost completely satisfied with domestic production and legal imports. Thus, current consumption of filter cigarettes approximately equals 32–33 billion sticks annually.

## **B.3 Total cigarette consumption**

Hence, the size of Ukrainian market for tobacco products is approximately 70 billion sticks annually, where about 38 billion sticks non-filter cigarettes and 32 billion sticks of filter cigarettes, respectively, are consumed.

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<sup>36</sup> In 1996, a number of normative and legislative acts regulating production and circulation of tobacco products was adopted. In particular, excise stamps were introduced. This led to delays in the delivery of products to consumers. However, it also helped to reduce significantly the scale of illegal cigarette production.

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## APPENDIX C: COMPARATIVE INTERNATIONAL EXPERIENCE

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### C.1 Experience of fighting illegal import and circulation of tobacco products in Ireland<sup>37</sup>

A large-scale inflow of smuggled cigarettes to Ireland started in 1993—immediately after opening its borders to commodity flows within the EU countries. Since that time, illegal circulation of tobacco products in Ireland has been a serious problem, requiring the mutual efforts of state law enforcement agencies.

In order to overcome illegal circulation of tobacco products, the following measures were implemented in Ireland:

1. Higher penalties:

- fines were increased for the illegal import and trade in tobacco products without excise stamps (stamps were introduced in 1995–97);
- customs officers and internal affair agencies (Garda Siochana) were given the right to detain and arrest individuals in the presence of justified suspicion of committing offence in this sphere.

2. Increased performance of law enforcement agencies:

- a central department for risk analysis was established in the structure of the customs service. Officers of this department collect, process, and analyse operational information on freight movements in order to detect suspicious freights when they are crossing the border;
- mobile target groups of customs officers were formed to conduct intelligence on illegal trade in excisable goods within the country;
- officers of customs and tax agencies combined their efforts and established special groups for conducting target operations to fight illegal circulation of tobacco products;
- special x-ray equipment was installed in major airports and seaports, with the financial assistance of the European Commission;
- co-operation was established with foreign customs agencies and private companies conducting trade in tobacco products.

As a result, illegal street trade in tobacco products was almost completely eliminated in Ireland, while the amount of cigarettes detained by customs agencies decreased from 14 million sticks in 1997 to 8.5 million sticks in 1998.

### C.2 Modernisation of customs controls in New Zealand<sup>38</sup>

Over the last ten years, New Zealand has encountered a twofold increase in the inflow of goods and tourists; consequently, there has been a need to improve border controls. In response to changes in the amount of international trade and tourism, customs agencies have improved the policies and procedures governing customs control. The customs service of New Zealand renounced controlling each product consignment or person crossing the border; instead, the principle of administration with allowance for risk was introduced. Under this principle, border passages and collecting taxes/duties are performed with

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<sup>37</sup> Source: *Welcoming Address of Commissioner Frank M. Daly on Organised Cigarette Smuggling Project, Killarney 30 June–1 July 2000*, Revenue Commission Annual Reports, 1997–1999.

<sup>38</sup> Source: “NZ Customs Service – Briefing for the Incoming Minister” ([www.customs.govt.nz/about/home/mbrief.pdf](http://www.customs.govt.nz/about/home/mbrief.pdf)).

minimum apparent interference of customs officers. Nowadays, New Zealand's customs service inspects only about 1% of freights and 2% of passengers crossing the border.

The increased performance of customs agencies became feasible owing to implementation of the following measures:

- The customs service completely reconsidered its objectives and elaborated a strategy for change. In 1996, new legislation was adopted; in 1997, the service invested in new computer systems and special software; in 1998, a strategic business plan was approved (the plan was based on the new legislation and computer system);
- Utilisation of information technologies was broadened (for example, electronic processing of information on trade operations, scanning of passport data, and an automated system for determining risk groups);
- Technologies for managing risks were introduced, based on the information collected through intelligence, statistics, etc., and stored and analysed by the computer system of the customs service. Thanks to this technology, the customs service is able to detect passengers and freights pertaining to high-risk groups.

The customs service of New Zealand considers that the key element of effectiveness in fulfilling its objectives is co-operation among all agencies involved in the legal activities associated with the borders. In order to ensure the consideration of the needs of the private sector, and to form public awareness and responsibility for the situation on the border, the customs service established an information exchange and co-operates with firms performing air and sea transportation, as well as ports, customs brokers, and trade companies.

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## APPENDIX D: LIABILITY FOR THE ILLEGAL IMPORT AND CIRCULATION OF TOBACCO PRODUCTS (EXTRACT FROM EXISTING LEGISLATION)

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### D.1 Criminal Code of Ukraine:

**Article 70. Contraband**, i.e., the transportation of commodities, currency, valuables, and other goods across the customs border of Ukraine while avoiding or concealing from customs controls, committed in large amounts or by a group of individuals organised to conduct contraband; as well as illegal transportation of historical and cultural valuables, poisonous, toxic, radioactive, explosive substances, arms and ammunition (except for smooth-bore hunting guns and corresponding ammunition) imply imprisonment for a period from 3 to 10 years, with the seizure of property.

*Note: “large amounts” means the value of goods exceeding 200 minimum [monthly] wages.*

### D.2 Customs Code of Ukraine:

**Article 115. Transportation of goods across the Ukrainian customs border while concealing them from customs controls** — subject to seizure of the goods involved in the offence, as well as objects purposely arranged as hidings and used for cross-border transportation and concealment of the goods involved in the offence; or for individuals: a fine of up to 200 minimum [monthly] wages, as of the date of the offence, with seizure of the abovementioned goods; for officials — a fine from 300 to 1,000 minimum [monthly] wages, as of the date of the offence, with or without seizure of the abovementioned goods.

**Article 116. Transportation of goods across the Ukrainian customs border while avoiding customs controls** — subject to a fine of up to 200 minimum [monthly] wages as of the date of the offence, with seizure of the goods involved in the offence; with regards to officials, the fine is up to 1,000 minimum [monthly] wages as of the date of the offence, with seizure of the abovementioned goods.

**Article 117. Storage, transportation, or purchase of goods imported to Ukraine that avoided customs controls or concealed from controls** — subject to a fine: for individuals the fine is up to one minimum [monthly] wage as of the date of the offence, with or without seizure of the goods involved in the offence; for officials, the fine amounts to 2.5–10 minimum [monthly] wages as of the date of the offence, with or without seizure of the abovementioned goods.

**Article 118. Failure to declare goods, or making a false declaration** is subject to a fine: for individuals the fine is up to one minimum [monthly] wage as of the date of the offence, with or without seizure of the goods involved in the offence; for officials, the fine amounts to 2.5–10 minimum [monthly] wages as of the date of the offence, with or without seizure of the abovementioned goods.

### D.3 The Code of Ukraine on Administrative Offences:

**Article 156. Retail or wholesale trade (including import or export) in ethanol, cognac, and fruit alcohol or retail trade in alcoholic beverages or tobacco products without the necessary license or excise stamps or with counterfeit excise stamps** — subject to a fine ranging from 20 to 100 non-taxable minimum [monthly] wages, with seizure of the goods and proceeds from the sales of the goods.

**Vendor trade in alcoholic beverages or tobacco products, or trade in improper locations or other places prohibited by village and city councils for retail trade in alcoholic beverages and tobacco products** — subject to a fine ranging from one to seven non-taxable minimum [monthly] wages, with seizure of the goods being traded.

**Article 156-2. Violation of established procedures for industrial processing, storage, transportation, or destruction of seized alcohol, alcoholic beverages or tobacco products** is subject to a fine on officials ranging from 20 to 50 non-taxed minimum [monthly] wages.

**Article 164-5. Storage or transportation of alcoholic beverages or tobacco products without standard excise stamps** — subject to a fine ranging from 20 to 100 non-taxable minimum [monthly] wages, with seizure of the alcoholic beverages or tobacco products. The same activities committed by an individual who was a repeat offender during the previous year for any offence indicated in the first part of this article, or committed in large amounts — subject to a fine ranging from 100 to 300 non-taxable minimum [monthly] wages, with seizure of the alcoholic beverages or tobacco products.

**Illegal storage of excise stamps** — subject to a fine ranging from 3 to 15 non-taxable minimum [monthly] wages, with seizure of the excise stamps.

*Note: “large amounts” means the value of alcoholic beverages or tobacco products of 100 or more non-taxable minimum [monthly] wages.*

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## APPENDIX E: AUTHORITIES OF THE AGENCIES INVOLVED IN FIGHTING THE ILLEGAL IMPORT AND DISTRIBUTION OF TOBACCO PRODUCTS

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**State Customs Service of Ukraine (SCS).** According to the Customs Code of Ukraine dated December 12, 1991, the SCS performs customs control, imposes administrative penalties for violation of customs rules, and conducts inquests in cases of contraband.

**State Committee for Protection of the State Border of Ukraine.** According to the Criminal-Procedural Code of Ukraine (Article 101), the Committee conducts inquests in cases of illegal border crossings. Within controlled border areas and the frontier, the Committee implements measures to counteract contraband across the state border while avoiding customs controls and frontier checkpoints.

**National Security Service of Ukraine (NSS).** According to the Criminal-Procedural Code of Ukraine (Articles 101 and 102), the NSS conducts inquests and primary investigations in cases of contraband. According to the Law “On combating corruption” dated May 10, 1995, the NSS is also aimed at combating corruption.

**Tax agencies.** According to the Criminal-Procedural Code of Ukraine (Articles 101 and 102), the tax police conduct inquests and primary investigations in cases of tax evasion. According to the Law “On the State Tax Service” revision dated April 20, 2000, tax agencies conduct activities to fight illegal circulation of alcoholic beverages and tobacco products, keep registers of importers, exporters, wholesale and retail traders, and places where alcoholic beverages and tobacco products are stored. The tax police includes a special department conducting activities for fighting illegal circulation of alcoholic beverages and tobacco products.

**Internal affairs agencies of Ukraine (IAA).** According to the Criminal-Procedural Code of Ukraine (Articles 101 and 102) and the Law “On the militia” dated December 20, 1990, the IAA conduct local inquests and primary investigations concerning legal entities and individuals.