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***“Trade and Investment Opportunities:
East Africa– One Market One Destination”***

**ILLICIT TRADE:
A THREAT TO SUSTAINABLE GROWTH IN THE EAST
AFRICAN COMMUNITY**

Background Paper

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Introduction

East Africa is embarking on an exciting path to a single market which is critical to sustaining the growth needed to improve people's lives. A stable and open marketplace is fundamental to improving competitiveness, increasing investment and producing the jobs and income needed to support families and public services.

Illicit trade undermines each of these goals, and is a growing menace within East Africa's consumer good market. It is broadly defined as products which are smuggled, counterfeited or undeclared local production:

- Smuggling: The movement of product (either genuine or counterfeit) between different excise regimes without payment of applicable taxes and or duties.
- Counterfeits: copies of a branded product manufactured by parties that do not have the relevant intellectual property rights
- Undeclared local production: products manufactured and sold for consumption in the same country, in legal or illegal covert operations on which duties and tax are not paid

This discussion paper has been produced for the East Africa International Business Forum which is being convened by the Commonwealth Business Council, East African Business Council (EABC) and held under the leadership of the Chairman of the East African Community (EAC), HE Paul Kagame in 29-30 October 2008 in Kigali, Rwanda.

The paper aims to highlight the growing problem of counterfeit and illicit trade in East Africa, and to suggest ways to combat this highly corrosive and damaging phenomenon. The paper looks at some of the specific problems and consequences of illicit trade in tobacco products, as one illustration of the wider economic costs of the illicit trade phenomenon, and points to areas in which government and business can work together to stop it.

The paper has been produced in support of the East Africa Business Council programme to combat illicit trade and counterfeiting which will be launched in 2009, and the East African Community Secretariat's Formulation of an EAC Policy on Anti-Counterfeiting, Anti-Piracy and Other Intellectual Property Rights Violations.

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East Africa – Towards One Market

1. East Africa is moving towards the creation of a single market for 120 million citizens. The East African Community (EAC) Customs Union was launched on 1st January 2005. Rwanda and Burundi joined the Customs Union in July 2007 and are expected to start implementing the provisions of the Customs Union with effect from July 2009. The effect of the union is that circulation of products within the region will be free, thereby leading to a high likelihood that illicit trade will expand if a stronger, coherent regional framework is not put in place to control it.
2. The overall goal of the EAC Customs Union (EAC CU) is to deepen the integration process through liberalization and promotion of intra-regional trade. The markets should improve efficiency in response to intra-region competition among businesses, enhancement of domestic, cross border and foreign investment and promotion of industrial diversification and economic development.
3. Free trade is a key to unlocking the potential of the East African Community. It forces producers to find ways to reduce costs and prices to consumers —increasing living standards. It spreads knowledge and skill. It gives people and businesses access to the best technologies and the most effective business practices

Illicit Trade: Undermining the EAC

4. Illicit trade is a multifaceted problem which exploits differences in tax rates between countries (smuggling), avoidance of tax and duties including undeclared local production, piracy, counterfeiting and abuse of trademark and intellectual property rights. What each of these practices share is that they break the rules of trade and commerce: they deny consumers quality products, rob the government of funds for essential public services, and undermines good governance by feeding a culture of illegality that supports organised crime and even terrorism, and. According to the OECD Interpol has highlighted a disturbing relationship of counterfeiting and piracy with terrorist financing¹, and the US Administration put it bluntly that “the deeper we dig into these (cigarette smuggling) cases, the more ties to terrorism we’re discovering”²

¹ OECD 2007 Report on The Economic Impact of Counterfeiting and Piracy

² US Assistant Director of Federal Bureau of Alcohol, Tobacco, Firearms & Explosives

5. The US Government International Trade Commission estimates that that counterfeiting and piracy increased eight times faster than world trade over the period 1982-2000, which means that around 10% of world trade is now accounted for by the counterfeiting alone. Illicit trade is particularly rife in emerging markets where the majority of the world's population lives, where the cost of genuine products are unaffordable to many, and law enforcement is often weaker.
6. From an economic point of view, not only does it eat into the profits of legitimate operators, it also destroys jobs by undermining investment in product development. The impact on investment and living standards is clear and direct. As Kenya's Attorney General has put it, counterfeiting and piracy are not just issues of concern to the developed countries and the industrial giants of the western countries. "In Kenya, it has had a negative effect on foreign direct investment and discouraged the growth of local entrepreneurship. It is estimated that right holders in Kenya lose an estimated Kenya Shillings 30 billion per annum to trade in counterfeit and piracy. Several industries have had to shut down, such as the textile industry and the music industry leading to loss of jobs. The private sector is the engine for economic and social development and to the extent that the private sector is adversely affected by counterfeiting and piracy, it becomes difficult to eradicate poverty."
7. The profitability and market share of legally registered East Africa companies, especially those involved in manufacture of fast moving consumer goods have been negatively affected by counterfeits and pirated products. This has serious negative impacts in the viability of industries, jobs, tax revenues and the health of consumers across the region. Furthermore, the prevalence of counterfeits and pirated products in the market has become a major deterrent to investors, both domestic and foreign in East Africa.
8. Counterfeits and pirated products pose other serious risks including, the loss of international competitiveness by intellectual property owners, damage to human health and safety, loss of government revenue, stifling of creativity and innovation and loss of trade and investment competitiveness.
9. The move towards a single market is a welcome one for business in the region, but the changing regulation can unintentionally crates new opportunities for illicit trade. The profile and awareness of the issues around illicit trade are not growing in EAC as rapidly as they should be. Regardless of the product category, illicit trade can no longer be viewed as a victimless crime, but one with direct and growing negative impact on society.

The Threats of Illicit Trade on the Trade and Investment Climate in EAC

10. It is critical that EAC Governments do not underestimate both the current and future levels of illicit trade, and its threat to growth within the new single market, and accord more priority to finding solutions to tackle this problem.
11. As noted above, in the East African Community, business has been inundated with a broad range of counterfeit and pirated products. Cheap and substandard products supplied through foreign and local traders and manufacturers are illegally replicating genuine and well-known brand names and designs on their packages and labels. Imitation products is common in a variety of product areas including currencies, batteries, detergent products, ball point pens, electrical and electronic appliances, perfumes, cosmetics, pharmaceuticals, agrochemicals, building appliances, computer software and hardware, audio and visual disks, automotive spare parts, as well as alcohol and tobacco.

Illicit Trade in Tobacco

12. There is an accelerating requirement and expectation that industry and Governments, particularly in the case of tobacco, are proactive in their approach to tackling the problem. The Framework Convention Alliance estimates 2006 global consumption was 5.8tn sticks, with illicit product accounting for 600 bn sticks or 10.7% of volume. BAT estimates illicit trade in tobacco products to be around 6.4% of total consumption globally which is slightly lower than the FCA estimates. The problem is growing and the WHO has estimated that on current trends, the volume of smuggled cigarettes will overtake legal sales by 2020. Table 1 shows the estimated share of illicit trade in each region.

Table 1: Illicit Trade as a Percentage of Markets

Region	IT Market Share %	Counterfeit %	Local Duty Evaded %	Smuggled %
LACAR	16	2	52	46
ASPAC	7.4	13	48	39
Africa & Middle East	11.4	7	6	87
Europe	5.8	20	-	80
Canada	19.1	4	92	4
China	4.8	80	4	20
TOTAL	6.4	31	19	50

13. Table 2 below shows that the problem in the East Africa Community is particularly acute, with illicit trade in tobacco products is estimated to average around 14% of the total market consumption – more than double the estimated global average. This translates into US\$49m in revenue losses to EAC Governments, legitimate manufacturers and traders each year. East African countries are facing different forms of illicit trade and they range from local manufacture duty evaded, counterfeits coming from China and cross border smuggling of genuine tobacco products manufactured in neighbouring EAC countries.

Table 2: Illicit Trade in Tobacco in Burundi, Rwanda, Kenya, and Uganda [Annual Estimates]

		KENYA	UGANDA	RWANDA	BURUNDI
Estimated total market consumption	Mn sticks	6,857	2,500	700	1,000
Total illicit trade included in consumption	Mn sticks	800	500	21	200
Illicit trade as % of total consumption	%	11	20	3	20
Total financial loss from illicit trade	\$ m	43	11	4	11
Broken down by:					
<i>Loss of government revenue</i>	\$ m	21	6	1	7
<i>Loss of trade margin</i>	\$ m	11	2	1	1
<i>Loss of legitimate manufacturers</i>	\$ m	4	2	2	3

Tackling the Causes

14. There are a range of factor which drives illicit trade in the tobacco industry the overall tax regime, the lack of understanding that illicit trade is not a victimless crime but has huge social costs, the specific issue of free trade zones, and the general problem of enforcement.
15. **Stable and Fair Tax Levels:** Higher taxes provide higher margins for non taxpaying criminals. Higher taxes also drive higher prices and lead some smokers to seek lower priced illicit product alternatives> A further factor is the need to make changes in a careful way and avoid sudden or sharp price increases which can lead to a sharp increase in illicit trade, often reducing government revenues.

16. **Coherence Across the Community:** Variations in excise rates between neighbouring countries constitute the first target of illicit traders.
17. **Targeting the Criminals:** regulation and legislation should be targeted against criminals, not aimed at legitimate manufacturers, and greater emphasis on enforcement. Strong laws are not sufficient to form a deterrent without effective enforcement.
18. **Penalties are lightweight** compared to the potential financial rewards. It is clear that organised crime are the main perpetrators of illicit trade in tobacco products mainly because of the very significant profits they are able to earn from smuggling and manufacturing counterfeit tobacco products . Appropriate sanctions are necessary to act as a meaningful deterrent.
19. **The lack of control over Free Trade Zones** is of particular concern. Free Trade Zones (FTZ)³ have been established as a means of increasing economic activity for a host country by attracting investment and technology and generating employment. Whilst many FTZ have achieved these objectives, some of them have also provided a safe haven for those engaged in illegal trading activities. The World Customs Organisation (WCO) has identified the role of FTZ in facilitating illicit trade as a key component in illicit trade that must be addressed. FTZ are sometimes treated as being outside the host nation's customs territory with the result that goods enter or exit these areas with minimum or no customs controls. This often means there is a lack of clear regulations governing activities within FTZ resulting in ambiguity as to the powers of the enforcement authorities of the host country.
20. **Improved Governance: Measures to tackle corruption** are critical. In Transparency International's list of most corrupt countries, Africa occupies six of the top 12 places and EAC countries figure in the top 50 out of a surveyed list of 181 countries

Targeting Illicit Trade: Recommendations for Action

21. In order to cap and reduce illicit trade, the following measures should be considered as a priority for government and business actions:
 1. **Harmonise legal and fiscal frameworks** between countries. EAC countries have to do more to pursue sound, consistent and logical fiscal policies. For example, it

³ In 2002 there were approximately 3,000 Free Trade Zones spanning 116 countries. Ports and Free Trade Zones that are utilised by smugglers and producers of counterfeit products have been designated as "hot spots". There are over 42 Free Trade Zones in the Middle East and some 76 in Africa.

makes no sense to implement zero tariffs between countries if domestic taxes discriminate between local manufacturers and importers.

2. **Harmonise excise regimes and external tariffs.** Cross border illicit trade flourishes on product pricing gaps between markets. These gaps are created by varying excise structure applications and varying excise rate calculations between markets. The harmonisation of customs tariffs and excise will discourage illicit trade. Non tariff barriers such as quantitative restrictions, barrier to entry and other administrative and legal obstacles should be removed.
3. **Strengthening Enforcement.** Governments need to ensure that they improve the level of enforcement capacity at their borders and within their homeland (including police, customs and regulatory agencies)which is commensurate with potential revenue losses caused by the sale of illicit product and that:
 - 3.1. there is sufficient coordination and cooperation between each of the enforcement agencies ;
 - 3.2. the enforcement agencies are given wide powers to search and seize illegal products as well as machinery and materials used to make illegal products;
 - 3.3. Undercover, pre-texting and surveillance techniques are permitted to be used by law enforcement agencies in partnership with private sector to fight illicit trade.
4. **Free Trade Zones.** National legislation needs to be amended to:
 - 4.1. empower Customs authorities to exercise jurisdiction before the entry and after the exit of goods into a FTZ, and to inspect goods in a FTZ or a free port to ensure that no offence is being committed
 - 4.2. prohibit the admission to, processing in and export from the FTZ of counterfeit goods, irrespective of country of origin or destination of such goods
 - 4.3. There should be close cooperation between customs and special authorities of FTZ to provide effective enforcement in FTZ.
 - 4.4. The authorisation which enables traders to operate within an FTZ should only allow them to perform certain specific operations within the zone;
 - 4.5. Increased powers should be given to Customs to monitor a trader's adherence to the terms of their FTZ authorisations. These powers should allow Customs to seize goods produced in, or passing through, their country which are intended for illegal sale in another country;
 - 4.6. National legislation covering the operation of the FTZ should, where possible, be based upon guidance provided by the WCO and reference to

their guidelines should be encouraged when reviews of legislation are being considered;

- 4.7. All cigarette manufacturers based within a country's FTZ should be subject to the same regulatory regime, including any licensing requirements, as a manufacturer based inside the host country;
5. **Increased penalties.** Appropriate sanctions are necessary to act as a meaningful deterrent. These should include:
 - 5.1. Appropriately heavy jail sentences, large fines and loss of licence where appropriate for those convicted of the manufacturing, movement, storage and sale of illegal tobacco products;
 - 5.2. Fines and loss of licence where appropriate for manufacturers who do not take commercially reasonable steps to prevent their products being smuggled;
 - 5.3. Mandatory destruction of all seized illicit product - auction or resale should not be permitted;
 - 5.4. Counterfeiting to be treated as a serious criminal offence, including mandatory destruction of the machinery and materials used;
 - 5.5. The right of brand owners to claim damages (including statutory damages and the ability to seize and freeze assets) against those involved in or knowingly facilitating the production, movement and sale of counterfeit cigarettes including through the internet, or those knowingly supplying materials to the counterfeiters; and
 - 5.6. The counterfeiting of tax markers to be treated with the same seriousness as the forging of banknotes.
6. **Corruption** Governments must spare no effort in tackling corruption at all levels. Corruption discourages efficiency and entrepreneurship and is a factor in supporting illicit trade, and reinforcing cycles of poor governance and corruption.
7. **Better Public Education.** Tackling the traditional views on illicit trade and sensitization of enforcers and the public that it has high social costs. Sensitization of traders especially wholesalers and retailers on the consequences of getting involved in illicit trade and the means and ways of identifying counterfeits. Organizing sensitization workshops for judiciary staff, police, customs officials on the applicable laws, illicit trade routes etc.

Annex: BAT Global Policies - How we tackle illicit trade



With our help 1.2 billion illicit cigarettes were seized in 2007

Tackling illicit trade requires co-operation and understanding between legitimate tobacco companies, governments and organisations such as the World Customs Organisation, World Trade Organisation and World Health Organisation.

For our part, we specifically require our companies to ensure that their business practices are directed at supporting only the legitimate trade in their products, and our companies are committed to doing everything they reasonably can to minimise the risk of their products being diverted into illicit trade channels.

Our internal controls

Our Standards of Business Conduct prohibit employees from knowingly engaging in unlawful trade. The Standards also require our companies to have effective 'Know Your Customer' controls - tight controls over whom they will sell to – and controls over quantities they sell to ensure these are commensurate with legitimate demand. Our companies will also cease supply to customers who are knowingly or recklessly involved in illicit trade activities. Our companies continued to report actions in 2007 to prevent illicit trade activity amongst customers, including ceasing supplies. Find out more in [Group companies' anti-illicit trade activities](#).

Our companies are supported by an anti-illicit trade unit at our headquarters and a Group Head of Anti-Illicit Trade who reports to a member of the Management Board.

Fighting illicit trade

BATMark is a specialist Group company that protects our intellectual property rights, including some 100,000 trademarks, one of the biggest portfolios in the world. The team responds to a constant stream of information from around the world and has developed one of the most sophisticated computer systems of its kind to support it.

Our products carry an authorisation device enabling counterfeits to be identified so that enforcement agencies can confiscate them.

Our Brand Enforcement Group works hand-in-hand with law enforcement agencies worldwide to gather and share intelligence, monitor the destruction of seized products and machinery and analyse suspect fakes in our laboratories.

Seizures: With our help, some 1.2 billion cigarettes - both fakes and genuine but smuggled packs - were seized by the authorities globally (excluding China) in 2007 and 305 suspicious cargo containers were tracked. The seizures involved trademarks from all the major manufacturers.

In China, the biggest source of counterfeits, crack downs are supported by an agreement between the Chinese State Tobacco Monopoly Administration and international tobacco companies, including us. In 2007 there were 299 raids in China involving the seizure of 114 cigarette making machines and 753 million fakes.

Destroying used machinery: We destroy our used manufacturing equipment to ensure that it can't find its way into illegal manufacturers' hands.

Our suppliers

We expect our suppliers of materials such as machinery, paper and card to only do business with other reputable firms, not criminals.

Criteria on tackling illicit trade are included in our Business Enabler Survey Tool (BEST), which establishes the standards we expect of our materials suppliers. Our regular BEST assessments of suppliers include obtaining assurance that they have adopted rigorous 'Know Your Customer' due diligence controls similar to our own, with the aim of ensuring that sales are made only to reputable customers. Directors and General Managers within the Group have backed up BEST by writing to global, regional and local suppliers, asking them to verify adoption of these controls.

International efforts

We are actively involved in the International Trademark Association, the International AntiCounterfeiting Coalition and the Quality Brands Protection Committee, an alliance of over 100 multinational companies in China. We were a founder member of the Global Business Leaders Alliance Against Counterfeiting (GBLAAC), working with companies in many other business sectors to raise political awareness about the damage caused by counterfeiting. The organisation has now merged with Business Action to Stop Counterfeiting and Piracy (BASCAP). BAT Chief Executive Paul Adams spoke at the first Global Congress on Combating Counterfeiting, at the World Customs Organisation Headquarters in 2004.

We have helped to form Business Action for Improving Customs Administration in Africa (BAFICAA), after leading a workstream on customs reform within the Commission for Africa business forum. Our companies belong to several local brand protection groups that seek to lobby governments on combating illicit trade and protecting intellectual property rights.

Working with customs

Our companies have signed Memoranda of Understanding (MoU) and industry agreements with customs authorities in some 37 countries to tackle illicit trade, based on joint action and shared intelligence. For example, following an MoU with UK Revenue & Customs in 2002, we signed this further MoU in 2006.

We support efforts aimed at streamlining customs procedures and urge governments to continue to seek ways to harmonise their customs procedures so that companies can trade efficiently across international borders. In several countries, we provide training for customs officers in tackling illicit trade.

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