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POLICY BRIEF

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Abstract

Illicit cigarette trade or the manufacture, distribution, and sale of cigarettes that evade taxes and violate trademarks, persists in the Philippines. Enhancing the affordability and availability of cigarettes undermines the effectiveness of the series of tax policy reforms meant to lower, if not eliminate, tobacco use in the country. Worse, it results in a loss in government tax revenues. This *Policy Brief* presents the estimates and recommends policy actions to address the problem. The results from residual methods provide a strong presence of illicit cigarette trade in the country. The magnitude ranges from 3.3% to 42.8% of total cigarette consumption, resulting in a loss in tax revenue from Ph11.96 billion to PHP40 billion.

Policy Recommendations

Non-price factors are considered more important determinants of illicit trade. These include corruption, the presence of informal distribution networks, and weak regulatory frameworks. A review of the Philippine regulatory environment to control illicit cigarette trade shows that the entire system of cigarette manufacturing and cigarette importation are both highly regulated. However, the illicit cigarette trade continues to weaken the effectiveness of government measures to lower tobacco consumption, particularly the increase in excise tax. The study recommends that the increase in illicit trade should not be an excuse not to increase the excise tax on cigarettes. Instead, the ongoing tax policy reforms should be part of a comprehensive program to lower cigarette consumption and must be accompanied by the following: (a) strengthening tax administration and enforcement should be given priority so that the required taxes are paid and collected prior to the release of the cigarettes from the place of production and ports; (b) government institutions involved in the entire system should be strengthened to prevent corruption, informal distribution channels, and organized crime networks; (c) a coordinated approach in combatting illicit trade with the country's neighbors, particularly China, Vietnam, and Indonesia, should be pursued; and (d) the rehabilitation of smokers who are struggling to quit smoking should be given equal importance. Otherwise, nicotine addiction will always be an easy excuse for smokers to look for cheaper substitutes and a reason for the illicit cigarette trade to thrive.

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Introduction

The Philippines is one of the largest tobacco-consuming countries in the Western Pacific region. As a signatory to the World Health Organization Framework Convention on Tobacco Control

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(WHO FCTC), the Philippine government has implemented tobacco control measures to reduce, if not eliminate, smoking and other forms of tobacco use. The increase in excise tax is the most effective and cost-effective measure to lower tobacco use. In 2012, the Aquino Administration implemented the Sin Tax Reform Act, which significantly increased the specific excise tax on tobacco, simplified the tax structure from a multi-tiered classification to a unitary tax system effective 2017, removed the price classification freeze, and indexed the tax rates to address inflation. Despite the recent increases in tobacco excise tax, illicit cigarette trade continues to remain.

Illicit tobacco trade is defined as “any practice or conduct prohibited by law and which relates to production, shipment, receipt, possession, distribution, sale or purchase including any practice or conduct intended to facilitate such activity” (World Health Organization, 2013, p. 6). It could take the following schemes where excise taxes and tariffs are avoided, and trademarks are violated: (a) illicit manufacturing, (b) counterfeit, (c) smuggling, and (d) bootlegging.

The illicit cigarette trade weakens the effects of the tax reforms on tobacco consumption as it enhances the affordability and availability of cigarettes. Illicit tobacco products are usually sold at a lower price than the retail market price; this makes tobacco products more affordable to price-sensitive smokers. Likewise, illicit tobacco products are usually distributed and sold via unregulated channels; this increases their availability. The enhanced availability of low-priced tobacco products encourages smokers who may otherwise quit smoking to continue their habit. Another effect of illicit trade is the loss in government revenues as perpetrators avoid or evade taxes. Furthermore, it undermines health warnings because illegal tobacco markets do not comply with local laws.

This policy brief presents the results of residual methods to measure the size of illicit trade in the country and estimate the tax revenue loss due to illicit trade covering the period 2009–2017. They include three approaches: (a) comparison of tax-paid sales to survey data of self-reported reported consumption; (b) comparison of tax-paid sales to results of econometric modeling that estimates total consumption after accounting for factors that affect demand for tobacco products; and (c) trade gap analyses.

Estimation Results

The study by Austria and Villanueva (2021) provided strong evidence of illicit trade in the country during 2009–2017. The study used the residual methods employed by existing studies such as Ahsan et al. (2014), van Walbeek(2014), and Abola et al. (2014).

(i). *Comparison between survey-based estimates of consumption and tax-paid cigarette sales.* Estimates based on this approach show no evidence of illicit trade up until 2013. However, consumption of illicit cigarettes is found to exist in 2014, 2016, and 2017 in all but one under-reporting threshold. The magnitude of illicit consumption is increasing, accounting for 3.3% to 12.8% of total cigarette consumption if the 10% under-reporting threshold is considered (Table 1). There was a substantial increase in 2017, signifying that illicit trade has become rampant. Even if no respondent under-reporting is assumed to exist, 2.8% (equivalent to 1.74 billion cigarette sticks) of total cigarette consumption is considered illicit. However, the magnitude is almost 43% if the 40% under-reporting level is considered. The illicit trade could be primarily of domestic origin. It was in 2017 when the unitary excise tax scheme took effect where the relative price increase is the same for all cigarette brands and thus, removing the incentive for smokers to shift to lower-price brands. It was the same year when Mighty Corporation came under fire for its counterfeit production and use of fake tax stamps.

The volume of illicit trade implies huge tax revenue loss for the government. In 2017 alone, tax revenue lost ranges from a low PhP11.96 billion to a high of PhP40.0 billion using the under-reporting threshold of 10% and 40%, respectively (Table 2).

Table 1 Penetration of Illicit Cigarette Trade, by Under-Reporting Thresholds, 2013–2017

Under-reporting Thresholds	2013	2014	2015	2016	2017
0%					2.79
10%		3.27		3.91	12.79
20%		13.27		13.91	22.79
30%		23.27		23.91	32.79
40%	8.48	33.27	3.39	33.91	42.79

Source: Authors’ estimates

Table 2 Estimates of Tax Revenue Loss Due to Illicit Cigarette Trade, 2013–2017

Scenario 1: Tax revenue loss, by under-reporting level, (Ph Billion)	2013	2014	2015	2016	2017
0%					2.612
10%		1.970		2.982	11.960
20%		7.986		10.614	21.309
30%		14.003		18.246	30.657
40%	3.521	20.020	2.156	25.879	40.005
Scenario 2: Tax revenue loss, by under-reporting level, (Ph Billion)					
0%					2.612
10%		3.128		3.459	11.960
20%		12.684		12.312	21.309
30%		22.240		21.166	30.657
40%	7.336	31.796	2.875	30.019	40.005

Assumptions:

Scenario 1: if net retail price is P11.50 and below per pack

Scenario 2: if net retail price is more than P11.50 per pack

Source: Authors' estimates

(ii). *Comparison between tax-paid cigarette sales and predicted changes in cigarette consumption.* Based on this method, illicit trade is recorded in 2009, 2011, 2014, 2016, and 2017 (Table 3). The highest growth was registered at almost 19% in 2016.

Table 3

Illicit Cigarette Trade: Comparison Between Predicted Changes in Cigarette Consumption and Changes in Tax-Paid Cigarettes, 2009–2017

Scenario	2009	2010	2011	2012	2013	2014	2015	2016	2017
1	10.73	-26.38	8.46	-25.83	-13.90	15.99	-10.39	18.80	2.68
2	10.73	-26.38	8.46	-25.83	-20.15	15.47	-10.39	18.80	2.68

Scenario 1: 2009 price & income elasticities were used to estimate changes in cigarette consumption for 2009-2014, while 2015 price & income elasticities were used 2015-2017.

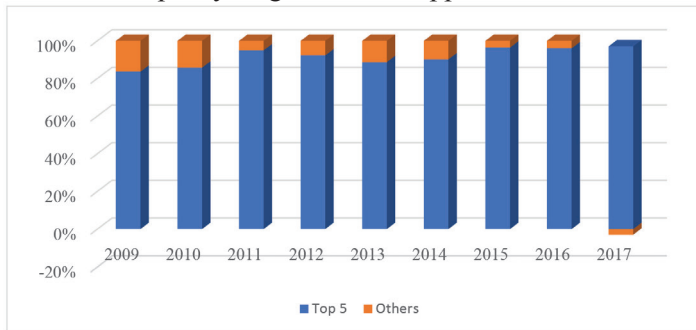
Scenario 2: 2009 price & income elasticities were used to estimate changes in cigarette consumption for 2009-2012, while 2015 price & income elasticities were used for 2013-2017.

Source: Authors' estimates.

(iii). *Trade gap analysis or smuggling.* Illicit trade due to smuggling has gone down from 97% in 2009 to 56% in 2017 (Figure 1). Given the presence of illicit cigarette consumption and the growth of the illicit cigarette market, the decline in smuggling implies that the source of illicit trade has shifted to the domestic origin, such as the use of fake cigarette stamps to counterfeit production.

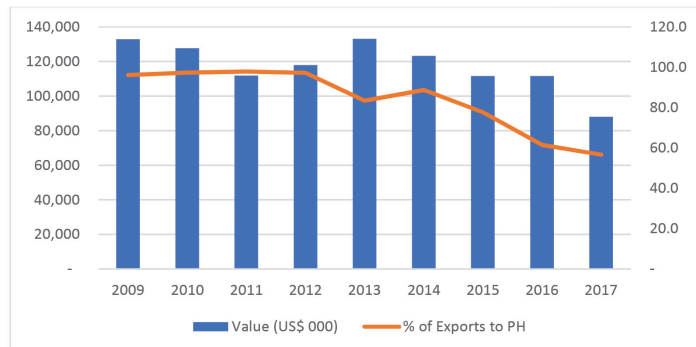
The top five sources of cigarette smuggling in the country include Hong Kong, Singapore, China, Indonesia, and Vietnam. Together, they account for about 85–96% of the total, and their share has been increasing over the years (Figure 2). In contrast to Hong Kong and Singapore, whose shares have been decreasing, smuggling from China, Indonesia, and Vietnam have significantly gone up. China's contribution rose from only 8% in 2009 to almost a quarter in 2017; for Vietnam, from less than 1% to about a third in 2017; and for Indonesia, from less than 6% to almost one-fifth in 2017.

Figure 1
 Trade Discrepancy, Cigarettes, Philippines, 2009-2017



Source: Authors' estimates

Figure 2
 Share of Top 5 Sources of Illicit Cigarette Trade, Philippines, 2009-2017 (%)



Source: Authors' estimates

Conclusion

The illicit cigarette trade highly persists in the country. The implementation of the unitary excise tax rate drove illicit cigarette consumption to its peak in 2017. The downward trend of cigarette smuggling in the country suggests that illicit trade could be primarily due to counterfeit production and the use of fake stamps.

The illicit cigarette trade undermines the government's prevention and control measures against the use of tobacco products. It further enhances the affordability and availability of cigarettes and results in a loss in government tax revenues. This calls for the government's swift action to address the increasing volume of illicit trade. The estimates of the size of illicit cigarette trade and tax revenue loss due to illicit cigarette trade will help the government in future tax policy reforms and in improving anti-illicit trade tobacco measures.

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