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Illicit alcohol in time of crisis

Contribution
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Introduction

As recently highlighted by the OECD (OECD 2022), alcohol is an attractive target for illicit trade and the market is large and complex, ranging from high quality artisanal drinks to toxic illicit beverages. At a global level, an average of 25% of all alcohol consumed is unregulated, although it is much more prevalent in lower income countries (WHO 2018). In 2016 the average share of unrecorded alcohol consumed in high income countries was 11.4%, compared to between 37% and 44% in lower income and lower middle-income countries. There have been no recent studies to indicate how this has changed following the COVID pandemic, though as reported by TRACIT (TRACIT 2021) there are multiple examples of huge increases in the scale of illicit alcohol during the pandemic.

Studies by Euromonitor International (Euromonitor 2018) demonstrate that 81% of the illicit market is distilled alcohol, 10% beer and 9% other fermented (mainly wine). This predominance of illegal distilled spirits has been attributed to the following factors (Allen 2020):

- The higher unit price generates a greater profit margin for producers of low cost illicit, counterfeit and smugglers,
- Production of illicit spirits can be as simple as mixing ethanol with colouring and flavouring.
- Genuine bottles can be refilled with cheap counterfeit
- Revenue controls on ethanol and or spirits production may be ineffective or inadequate.

By contrast the lower unit price and higher production costs of beer make it less attractive to criminals. As a bulky product, criminals would need to produce and sell large quantities of beer for the venture to be profitable. This also makes beer less susceptible to large scale smuggling, since smuggling a large quantity is much easier to detect.

The global beer industry

The regulated beer industry makes a significant contribution to the global economy and is well placed to support the global economic recovery. A recent report from Oxford Economics found that in 2019 the beer industry helped generate 262 billion USD in government tax revenue in the 70 countries studied, generated 555 billion USD of gross value added (GVA) to global GDP and supported an estimated 23.1 million jobs (Oxford Economics 2022). In developing economies, the economic impact was even greater. While globally, the beer sector was linked to 1 in every 131 USD of global GDP in 2019, the sector's economic significance was found to be even larger in lower- and lower-middle-income countries (LMICs) (1.6% vs. 0.9% of GDP in high income countries). In addition, the beer sector supports 1.4% of national employment in LMICs, vs. 1.1% in high income countries.

Beer and the COVID pandemic

One of the main competitors to the regulated alcohol industry in low- and middle-income countries is the unregulated illicit alcohol market. Far from being a cottage industry, in many countries the illicit alcohol market is highly organised, with large criminal organisations leading the growth of the illicit trade by using existing well developed logistic links and taking advantage of weaknesses in the control environment to grow their illegal network (OECD 2022).

As the Covid pandemic spread across the globe, governments took different approaches to the regulated alcohol market. In some countries this took the form of extended closure of the hospitality sector, in others the response was more severe, and governments went as far as a total ban on the sale of alcohol. In countries where alcohol sales were allowed, the restrictions led to a shift in the place of consumption, from bar to home, though for many the amount consumed was unchanged (Steffen et al 2021, Foster et al 2021, Stevely et al 2021).

But where the response was a total ban, the lack of legal outlets opened the door for illicit operators to enter the market or to expand their existing networks. The TRACIT report “Prohibition, illicit alcohol and lessons learned from lockdown” includes many examples of the increase in the scale of the illicit alcohol market and the accompanying health risks and revenue loss (TRACIT *ibid*).

The WHO Global Strategy to address alcohol related harm (WHO 2018) recommends that consideration be given to undercutting the market for illicit alcohol, by adopting government efforts to control these markets and tax policies that make lower-alcohol forms of culturally preferred beverages more accessible to consumers. However, draft Global Action Plan (WHO 2021) notes the limited progress in tackling the illicit and informal alcohol markets. TRACIT reports that the alcohol ban in South Africa contributed to undoing a decade long drive to formalise the alcohol sector and bring it under regulatory control (TRACIT *ibid*).

Now as the height of the pandemic crisis has abated (though remains a threat) governments are looking to rebuild public sector coffers. Mobilizing domestic revenues is challenging in normal times, but in times of crisis even more so and the temptation to increase taxes will be strong. In view of its strong economic footprint, the beer sector may be seen as a suitable target for sharp excise tax rises, but while legitimate businesses are rebuilding, many remain fragile. Consumer spending remains deflated across the globe and affordability is a challenge. Rather than raising taxes, collecting the tax revenues already due should be the immediate priority. Targeting the tax lost through illicit alcohol is a win-win for Government, registered producers, and consumers.

Disrupting the illicit alcohol supply chain

The focus of any anti-illicit alcohol strategy should be to make the trading environment as difficult as possible for unregistered and criminal producers while allowing compliant traders to operate efficiently. As highlighted by the OECD, “anti-illicit alcohol policies should not be developed in isolation from the realities of the local market”, and “should take into account the proportionality between curbing illicit trade, the cost of the remedy and the potential disruption to legitimate business” (OECD *ibid*). It is impossible to assess whether a control strategy meets these criteria without a robust understanding of the shape (which products) and size (revenue loss) of the domestic illicit alcohol market. In turn this requires physical controls, data that can be checked and analysed and enforcement.

While no country has managed to eliminate illicit trade in alcohol, there are examples where an effective combination of regulation and enforcement have had a significant impact in reducing the level (Allen *ibid*). These include:

- Improved customs resources, training and using risk analysis to target smuggling
- Raising awareness with local consumers of the risks associated with illicit products.
- Encouraging a migration to the formal sector including incentives to small scale producers to register for quality controls
- Where licenced producers are under-recording production (tax evasion) use of modern controls including remote access to production and bottling data and unannounced audits.

A growing number of lower income countries have looked to measures such as tax stamps/fiscal marks as a way of controlling the illicit alcohol market. Tax stamps are far from a new phenomenon – a paper strip or banderol to show that the required tax has been paid on excisable products has been common practice since the 19th century. They have a role to play in some circumstances, but unless the Government already has a robust and enforced excise control system in place and invests in a taskforce to physically check and control the market, tax stamps are unlikely to have the desired impact.

Tax stamps have traditionally been applied to tobacco and spirits but increasingly are being extended to beer. This expansion to the beer sector is of questionable benefit. As research consistently shows (Euromonitor *ibid*), the incidence of illicit trade in beer is low, and counterfeit beer is negligible. Therefore, registered brewers in the regulated market are not part of the problem, rather valuable industry stakeholders with a vested interest in disrupting the trade of non-tax paying elements.

Furthermore, the regulated beer sector is already highly controlled by other well-established methods. Most countries that allow the legal consumption of alcohol have excise systems in place that cover both the taxes charged on alcohol and systems to control the supply chain from the receipt of raw materials through to production and the point that taxes are due. A well-resourced and trained revenue authority can identify instances of tax evasion through checks, controls, and reconciliation of inputs to outputs at

critical points in the alcohol supply chain thus ensuring the continued compliance of registered producers. The problem therefore is not a lack of control policies - rather that despite their existence, enforcement is often weakest in countries where the illicit alcohol market is large (OECD *ibid*).

Therefore, applying additional measures to an already controlled industry will add costs and burdens to legitimate business but is unlikely to lead to additional government revenue or have a significant impact on the illegal traders. Even where a risk analysis indicates that there is tax leakage from registered producers, there are other more cost-effective methods of obtaining real time information of production volumes, and therefore expected tax revenues. For these reasons the business case for implementing tax stamps on beer is unclear.

Some examples from existing tax stamp regimes highlight the challenges and limitations of marking beer.

Proportionality

Cost

The evidence as to whether the revenue gains from a tax stamp/marketing system exceed the cost of the system is inconclusive. In most countries, it is the producer who covers the cost of each stamp or mark, in addition to the excise due. The taxpayer is therefore placed in the position of subsidising a system which, if poorly targeted does not even cover its own costs. Where the producer bears the cost, it will be passed on to the consumer thereby impacting the price of the goods, and potentially pushing the consumer further away from the legal product.

Ecuador. For example, the SIMAR system in Ecuador cost over \$43million for the years 2017-2020. Over the same period excise receipts on beer rose (but this was in line with an increase in the excise tax rates), while receipts on spirits and tobacco fell. Notably, 90% of the SIMAR budget was spent on marking beer, which represented only 0.7% of the illicit alcohol market.

Dominican Republic - Following several high-profile illicit alcohol related deaths in 2017 and 2019 in the Dominican Republic, the Government introduced the Trafico system which introduced the requirement to digitally mark all domestically produced alcohol and apply a physical stamp to all imports. In terms of alcohol beverage units (cans bottles etc) beer represents 85.6% of the total, but only 0.026% of the total illicit alcohol market (Euromonitor). However, tax officials who have full access to production records and flow meters are stationed full time at production premises. It must therefore be questioned the extent to which the system will address the serious problem of counterfeit spirits, or whether it places a proportionate burden on the regulated beer sector.

Impact on illicit trade

The presence of a tax stamp can provide some assurance that a product is genuine, though this may create a false sense of confidence. Illicit actors often act quickly to the introduction of new tax stamps, often producing a counterfeit within weeks of a new stamp being issued. This undermines the system, and further exacerbates the competition between the regulated and unregulated sectors. The response has been to continually update the security features of the stamp. For high value goods, this has some logic, but where the value of the good traded is low, for example beer soft drinks and water it means extra cost to the producer with doubtful benefits.

- **Kenya** Tax stamps were first implemented in Kenya in 2003, but the stamps were easily counterfeited and have undergone multiple modifications in an attempt to keep ahead of the illicit traders. In 2013 Kenya introduced “Digital Tax Stamps”. Despite this, counterfeit stamps are still prevalent in the market and in 2021 the Government launched the latest generation of tax stamps. According to WHO estimates unrecorded alcohol consumption levels were unchanged in the period 2005 to 2012 .

Disruption to legitimate business

Depending on how they are introduced, tax stamp systems can impose a disproportionate burden on legitimate businesses. This includes the capital and installation cost of new equipment, administrative burdens around ordering and storage of stamps, loss of efficiency and disruptions, including slower bottling lines. Tax stamp application can increase the costs of bottling by 7-10% on automated lines and as much as 50% when the stamps are applied manually. These increased costs are particularly onerous for small producers.

- **Ghana** the introduction of a tax stamp regime resulted in beer production lines slowing down and higher production costs. As a result, alcohol beverage companies moved to neighbouring countries including Burkina Faso and Togo leading to a loss of direct foreign investment and capital investment in Ghana (ITIC 2018).

Moreover, the proliferation of competing systems in different markets exacerbates the costs for business, and potentially creates a barrier to international trade. As multiple jurisdictions adopt different tax stamp requirements, the cost of administering these for internationally traded beer increases exponentially. It is simply not feasible to meet the needs of multiple systems at the point of bottling. Therefore, product has to be manually marked at the point of import which is a significant financial and operational burden.

The role of technology

The factors that undermine the value of tax stamps as a tool against the illicit alcohol market, do not mean that there is no role for technology. Indeed, as highlighted by ITIC (Allen *ibid*) blockchain is evolving rapidly as a potential means to control the whole supply chain, including raw materials and other inputs. Alcohol production by large (and many smaller) producers is fully automated, and authorities can obtain real time information on production, imports, purchases and sales.

Where governments require unique product marking, this can be achieved without the cost of adding in an additional marking regime. Modern bottling lines are already equipped with machinery that can print and scan information. This machinery can also be used to apply a code that gives each bottle a unique digital signature, that can be transmitted to the authorities. The code can be scanned using a mobile phone app, allowing government, retailers and consumers to check the authenticity of the product. All this can be achieved at a fraction of the cost of a proprietary tax stamp programme. However, there is still an additional cost for producers and question remains as to whether such technology is necessary for products like beer, where the incidence of tax evasion and smuggling is very low.

Conclusion

Addressing the illicit alcohol market is of particular importance in developing economies. The COVID pandemic increased the space for the illegal market to grow at the expense of both domestic revenues, consumer health and the legitimate industry. There is no silver bullet to solve this problem, but some approaches will increase costs and burdens without leading to long term improvement.

No strategy to address illicit alcohol should be implemented until the costs and benefits of the proposed solution have been examined. In particular

- Analyze the scale and type of the illicit alcohol (i.e., smuggling vs. domestic counterfeit vs. illicit artisan) to ensure that the solution matches the problem.
- Undertake empirical assessments and modelling of proposed remedies to show how they will impact the collection of tax revenues, impacts on taxpayers and economic burdens to industry, trade and economic activity.
- Collaborate with legitimate industry players most impacted by the regulations to benefit from their market knowledge, technical expertise, supply chain parameters, import/export challenges and full costs of implementing a tax stamp scheme. Moreover, brand owners have the expertise and are often the most knowledgeable in determining best practices within a set of standards defined by the government.

- Publicize the results of the assessment to improve commensurate awareness among potential consumers of illicit alcoholic beverages, and communicate the objectives to all stakeholders as a matter of sound and transparent public policy

Robust country alcohol policies, strengthening enforcement, intergovernmental partnerships and collaboration with legitimate industry can work together to disrupt the illicit market.

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