



Under the Shadows of War in Ukraine: Illicit Trade



Introduction

With billions of cigarettes crossing its borders into the EU every year, Ukraine remains one of the biggest sources of counterfeit and contraband cigarettes smuggled into the EU.¹ For Ukraine, the illicit tobacco trade results in revenue losses of as much as UAH 20.5 billion in non-paid or underpaid taxes in 2022 alone.²

Compounding this problem, Ukraine's market for illicit tobacco has grown rapidly from about 2% of total tobacco consumption in 2017, to 22% in 2022, according to a report by market research agency *Kantar*.³ This is most likely attributed to the steady increase in excise taxes as part of Ukraine's 7-year plan to reach the minimum excise tax levels agreed with the EU – although recent, record levels of inflation, devaluation of the hryvnia and impacts of the ongoing military conflict cannot be ignored as factors putting upward pressure on consumer demand for cheaper illicit alternatives. Indeed, following the first year 30% increase in excise taxes, the State Financial Monitoring Service of Ukraine, reported on what amounts to a compound problem, “Due to the constant increase in excise duty rates and, therefore, rise in the value of tobacco products and in the context of low purchasing power, Ukrainians are increasingly buying cheap counterfeit (counterfeit) or smuggled (illegal) cigarettes.”

This case study highlights some of the recent efforts of Ukrainian President Zelensky and his administration to tackle the country's problem of illicit trade in tobacco. For example, starting in 2019, the administration cracked down on illegal border crossings⁴ and strengthened customs cooperation with the EU. The government also focused on “de-shadowing the economy” through stronger interagency coordination.⁵ In parallel, The Economic Security Bureau of Ukraine (ESBU) was established in 2021 as an umbrella body to investigate all manner of economic crimes, including illicit tobacco trade.⁶ The Ukrainian government has also implemented important anti-corruption reforms.⁷ In addition, various agencies have been more aggressively acting against illicit cigarettes, such as

the case in August 2022, when Ukraine's State Tax Service shut down the operations of a manufacturer⁸ suspected of illegally producing significant volumes of tobacco products without excise tax stamps.⁹

These are laudable achievements that demonstrate the Zelensky Administration's ambition, commitment and resolve to root out illicit tobacco, including apprehending corrupt officials that benefit from this illegal activity. Along with these accomplishments, however, Ukraine must account for the ongoing process of steadily increasing excise taxes on tobacco products as part of the government's 7-year plan to increase excise tax on tobacco by 20% yearly until 2025 to reach parity with the European Union minimum excise tax rate.

While tax increases do not automatically result in increased illicit trade,¹⁰ they intentionally put upward pressure on prices, which in turn may create demand for cheaper, illicit alternatives. The effects are amplified when a tax increase is simultaneously accompanied by a decrease in disposable income levels and dislocations caused by a diversion of law enforcement activities, such as those currently associated with the Russian conflict.

Research suggests that the capacity of tax administration authorities and levels of governance are among the most important determinants on the extent of illicit trade. Specifically, illicit tobacco trade flourishes when tax administrations are weak, government record-keeping ineffective; border security and inspection procedures modest; and coordination between finance, customs and other agencies involved in tax collection and enforcement are poor.¹¹

Consequently, the recommendations encourage Ukraine to attend to system and governance weaknesses to minimize both supply and demand for illicit tobacco products during the scheduled excise tax increases that will continue for the next several years.

Background on illicit trade in Ukraine

Overview

Ukraine is well-known as a hub for cigarette smuggling, and today it is still one of the biggest sources of cigarettes smuggled into the EU. In 2018 the illicit outflow from Ukraine to the EU was estimated at more than 4 billion cigarettes.¹²

Compounding this problem, Ukraine's market for illicit tobacco has grown rapidly from about 2% of total tobacco consumption in 2017, to as much as 21.9 % in 2022, according to a report by market research agency *Kantar*.¹³ This is largely attributed to the steady increase in excise taxes as part of Ukraine's 7-year plan to reach parity with the European Union minimum excise tax rate.

Tobacco smuggling into the European Union

The country's location on the EU's eastern most border, combined with historically lower tobacco prices than in EU countries, pervasive corruption, soft penalties, and weak regulatory enforcement environment has made Ukraine into an attractive smuggling gateway into the EU. Considerable quantities of illicit cigarettes are manufactured in Ukraine or enter Ukraine from countries like neighboring Belarus — and from there, often into EU economies. Ukraine is also a significant origin country for illicit white cigarettes¹⁴ flooding the EU markets, including the *Compliment* brand which frequently ranks among the most prevalent illicit brands in several EU countries.¹⁵ Signs that the EU is becoming ever more vigilant of the problem with illicit cigarette production just across its borders can be found in a number of recent media stories from Hungary and Slovakia reporting ongoing activities to shutdown illicit tobacco factories in Ukraine and confiscate illicit products heading into the EU.¹⁶ Tobacco smuggling is particularly prevalent along

the Moldova-Ukraine border, where it takes many forms, from small scale packages being hidden in vehicles to larger scale consignments being clandestinely transported over the “green” border, usually at night.

More recently, beyond just acting as a transit point in the flow of smuggled cigarettes into the EU, Ukraine has developed into a global hub for the supply of illicit white brands, which represent the largest part of the domestic illicit cigarette market in Ukraine, as well as a significant source of illicit cigarettes in several EU markets.¹⁷ Media investigations have also highlighted how international tobacco trafficking rings move large quantities of untaxed cigarettes from Romania, Belarus, and the United Arab Emirates into Ukraine through important seaport cities, among them Odesa and Chornomorsk, before being smuggled to the EU using underground tunnels, trucks, boats, and even drones.¹⁸ Consequently, “Ukraine has become a world hub for the supply of illegal cigarettes to Europe. From China, the United Arab Emirates through Odesa, Belarus, Moldova, from uncontrolled territories [of Donbas] through Ukraine, as a kind of a ‘wild land’, illegal cigarettes go to Europe,” according to Oleksiy Honcharuk, Former Deputy Head of the Office of the President.¹⁹

Growing problem at home

Historically, the principal flow of illicit tobacco was *through* Ukraine in transit to the EU, with only a fraction remaining in the Ukrainian market. However, in more recent years the share of domestically produced illicit cigarettes in the market has seen a rapid expansion, with several journalist investigations uncovering massive illegal manufacturing and tax evasion schemes that flood the Ukrainian market with cheap illicit cigarettes.²⁰

A recent study by Kantar research agency found that 22% of all the cigarettes in Ukraine were sold without paying taxes in 2022. This amounts to an estimated UAH 20.7 billion in lost taxes.²¹ Moreover, the majority of the duty non-paid cigarettes were Ukrainian brands, underscoring the role of domestic manufacturing in supplying the illicit market.²² Part of this can be attributed to the economics of illicit demand, where economic hardships deriving from the 2014-2015 economic crisis strained household budgets and forced many Ukrainian smokers to seek cheaper tobacco products, including illicit alternatives. Similarly, a rapid increase in inflation - 23.8 percent in *August of 2022* (the highest since February of 2016)²³ has made cheaper goods, including illicit tobacco products, more appealing. Accommodations should also be made for the impacts of the Russian conflict, which has diverted law enforcement away from illicit trade and contributing to a normalization of the illicit trade with more and more retail outlets openly selling illicit cigarettes across the country.

European Union-Ukraine Association Agreement (EU-UAA)

TITLE V ECONOMIC AND SECTOR COOPERATION

Chapter 4 Taxation

ARTICLE 352

The Parties shall develop their cooperation and harmonise policies in counteracting and fighting fraud and smuggling of excisable products. This cooperation will include, inter alia, the gradual approximation of excise rates on tobacco products, as far as possible, taking into account the constraints of the regional context, including through a dialogue at regional level and in line with the World Health Organisation Framework Convention on Tobacco

Compounding consumer's decreased purchasing power has been a steady rise in excise taxes on tobacco, as the Ukrainian government has introduced a 7-year plan to reach the minimum excise tax level of €90 (US\$99) per 1,000 sticks as required by Article 352 and 353 of the European Union-Ukraine Association Agreement (EU-UAA). The phased schedule increased excise taxes by nearly 30% during the first year of implementation (2018) with planned annual increases of 20% until 2025 (Law No. 2245-VIII of 07.12.2017).

According to The State Financial Monitoring Service of Ukraine, “Due to the constant increase in excise duty rates and, therefore, rise in the value of tobacco products and in the context of low purchasing power, Ukrainians are increasingly buying cheap counterfeit (counterfeit) or smuggled (illegal) cigarettes.”²⁴

While an increase in domestic demand for illicit substitutes was anticipated, the magnitude was not. As it turned out, the growth exceeded “worst case” scenarios that experts had predicted.²⁵ But, excise tax increases are not the only drivers of illicit supply and demand. The general capacity of tax administration authorities and levels of governance are also critical for mitigating illicit tobacco, and research suggests that countries that struggle with tax compliance and/or governance are those most likely to experience high rates of illicit tobacco trade.²⁶ For these reasons, it is critical that Ukraine step up actions to mitigate the tax-induced demand increases in illicit trade, including strengthening the authorization of the tax administration, strengthening border security and inspections and improving coordination between finance, customs and other agencies involved in tax collection and enforcement.

The Government response

Under President Zelensky the Ukrainian administration has shown renewed resolve to stem the flow of illicit cigarettes. In 2019 Zelensky signed a decree to counter smuggling and corruption at customs points.²⁷ The administration also adopted new legislation to strengthen customs cooperation with the EU to better combat corruption and smuggling, including tobacco products. Moreover, the customs divisions of Ukraine have intensified cooperation with the EU's anti-fraud office (OLAF) in the fight against the illegal movement of tobacco products.²⁸

Building on this work, the Cabinet of Ministers of Ukraine established in 2021 an Interdepartmental Working Group on the de-shadowing of the economy and the development of fair competition. The working group is chaired by the Minister of Economy with the Minister of Finance serving as Deputy Chair, further underscoring the importance the Zelensky government places on addressing the shadow economy. The working group brings together the heads of the State Tax Service, the State Customs Service, the State Financial Monitoring Service, the National Commission on Securities and Stock Market of Ukraine, the Antimonopoly Committee, as well as the Deputy Chairman of the National Bank of Ukraine and the Director - administrator of the Deposit Guarantee Fund.²⁹

In parallel, The Economic Security Bureau of Ukraine (ESBU) was established in 2021 as an umbrella body to investigate all manner of economic crimes, including illicit tobacco trade, and to serve as a platform for constructive dialog between the State and the business community.³⁰ In particular, the ESBU is responsible for analyzing, detecting, and preventing criminal offences and related crimes in the areas of production and distribution of illegal tobacco. This includes putting together recommendations and proposals for

government agencies to improve the regulatory environment and the economic policy.³¹

The Ukrainian government has made efforts to better equip its anti-corruption system, with the establishment of several specialized anti-corruption institutions to investigate, prosecute, and adjudicate high-level corruption cases, including the National Agency on Corruption Prevention (NACP), National Anti-Corruption Bureau of Ukraine (NABU), Specialized Anti-Corruption Prosecution Office (SAPO), Asset Recovery and Management Agency (ARMA), State Bureau of Investigations (SBI) and High Anti-Corruption Court of Ukraine (HACC).³²

In addition, Ukraine has undertaken tangible enforcement actions against the flow of illicit cigarettes.

- In August 2022 Ukraine's State Tax Service revoked United Tobacco LLC's license to produce tobacco products.³³ United Tobacco's factory in Zhovty Vody, Dnipropetrovsk region, was suspected of illegally producing significant volumes of tobacco products without excise tax stamps. According to the head of the parliamentary committee on finance, tax and customs policy, Danylo Hetmantsev, it took the intervention of President Zelensky's office to stop the illegal activity. Preliminary estimates put the lost taxes and fees from the illegal production to UAH 6.5 billion in 2022 alone.³⁴ Later in November Mr Hetmantsev reported that the Security Forces stopped the activity of the factory that has become a symbol of Ukrainian corruption, saturating the market with excise-free tobacco under the tacit consent of all law enforcement officers who were blind to the work of a super powerful enterprise.³⁵

- In August 2022 the Economic Security Bureau uncovered more than 1.2 million packs of illegally produced well-known brands of cigarettes with forged excise stamps at a warehouse in the Odesa region, with a market value of UAH 70 million. Nearly 20 tons of raw tobacco raw materials were also uncovered, with an estimated value of UAH 10 million. In addition, equipment capable of producing 2 million packs per month were found in the warehouses.^{36/37}
- In September 2022 the State Bureau of Investigation (SBI) shut down an illegal factory in Dnipro that was producing fake Marlboro and Winston cigarettes on an industrial scale. A single line of the factory was able to produce four thousand cigarettes per minute. Complicating the situation, the family of the former deputy chairman of the Dnepropetrovsk Regional State Administration was involved in the ownership of the building. Further, the SBI investigation uncovered the involvement of corrupt high-ranking local officials and law enforcement officers who assisted in distribution of the finished product throughout Ukraine, as well as smuggling into the EU.³⁸
- In October 2022 the Economic Security Bureau raided a factory in Odesa oblast suspected of manufacturing illicit products and seized goods with an estimated market value of more than UAH 10 million. The illegal manufacturing at the factory during 2020-2022 is estimated to have cost the state more than UAH 18.5 million in lost excise and value added tax.³⁹
- In early November 2022 Law Enforcement raided a manufacturing facility in Bukovina that produced counterfeit cigarettes, the officers seized 1200 kg of tobacco, almost 5,000 cigarettes packaged in packs, 21 boxes with unformed empty packs for cigarettes, industrial manufacturing equipment, a device for packaging with film and tobacco products ready for further sale. Some of the illegally manufactured counterfeit cigarettes were later illegally moved to the EU countries, the rest were illegally sold on the territory of Ukraine.⁴⁰

- Ukraine also works closely with the European Union Border Assistance Mission to Moldova and Ukraine (EUBAM), that assists Ukrainian authorities with combatting cross-border crime and developing comprehensive anti-illicit strategies. A dedicated Task Force on Tobacco (TFT) was launched in 2010 to serve as a platform for combining national and international efforts to combat illicit tobacco products in the Republic of Moldova and Ukraine. The TFT has helped to establish direct contact points with EU counterparts and support law enforcement agencies in their cigarette smuggling investigations and enforcement activities. In 2021 EUBAM successfully coordinated the Joint Border Control Operation "Scorpion II" that led to seizures of 8.5 million cigarettes in Moldova, Ukraine and Romania.⁴¹

These are laudable achievements that demonstrate the Zelensky administration's ambition, commitment and resolve to root out illicit tobacco and apprehend the corrupt officials that benefit from this illegal activity.

By making the reduction of illicit trade a state policy priority, the President has set the tone for more progress. In support of these efforts, monitoring and analyzing the size and scope of the black market might help to improve enforcement capabilities of law enforcement agencies and other relevant State agencies. More thought could also be given to leveraging police raids of illicit manufacturers and retailers by ensuring that these achievements are accompanied by prosecutions, penalties and judicial actions or further investigations of the illicit products.

Recommendations

It is evident that the Ukraine government has taken significant steps to prevent illicit tobacco trade in recent years. These efforts are commendable and represent meaningful steps forward – in Ukraine and as lessons for others. Nonetheless, more needs to be done and additional policy recommendations can help Ukraine formulate more effectively mitigate illicit tobacco.

Ukraine's reform agenda is not only critical for Ukraine's economic outlook and capacity to address illicit trade, but also a prerequisite for its aspiration to join the EU and its recent OECD membership application.⁴² Gaining access to these bodies is considered recognition that a country's economy has reached a level on par with other developed, industrialized countries. In this light, Ukraine's efforts to fight illicit tobacco trade should therefore be considered investments that pay tangible dividends only to Ukraine's economic development and long-term security along its path toward eventual EU membership.

The recommendations provided below are presented as possible steps to better enable the Ukraine government and interested stakeholders to tackle illicit tobacco trade:

1. Create a dedicated multi-agency task force coordinated at the highest level. A successful strategy against illicit trade will require concerted, sustained, and joined up efforts between all the responsible government bodies. Currently, violations related to illicit tobacco trade fall within the authorities of several different agencies: ESBU, State Tax Service, Police, Customs and in some cases the State Security Service. Unfortunately, there is very little coordination among those agencies when it comes to the systematic fight against illicit tobacco. Apart from the coordination involving the Anti-money Laundering / Financial Monitoring agencies will ensure the financial

flows are tackled and adding the judicial branch (prosecution office) to such multi-agency task force will maximize the cooperation between enforcement and judicial authorities. To oversee the cooperation, Ukraine should consider appointing an interagency coordinator with high-level authority within the national government. Objectives would include raising the profile on illicit trade, promoting joint training opportunities and exercises to ensure that enforcement bodies understand constraints and expectations of other agencies, allocating necessary financial and personnel resources, defining clear objectives and KPIs for each agency and territory/region authorities, and more aggressively enforcing anti-illicit trade regulations. At the same time, inter-institutional competition should be avoided.

2. Strengthen Cross-Border Cooperation. While some progress has been made in this area, improvements in interaction and data sharing with law enforcement agencies and customs sharing borders with Ukraine needs to be prioritized. Cooperation with EU Member States bordering Ukraine is especially important given the high impact on these economies from illicit white brands of Ukrainian origin. Greater consideration might be given to strengthening regional and international cooperation, such as building upon mechanisms like the European Union-Ukraine Association Agreement (EU-UAA) to create a platform for cooperation with neighboring countries holding common objectives to mitigate illicit trade in tobacco. In this context, consideration also should be given to strengthening customs officials' knowledge on the economic and social impacts of tobacco smuggling.

3. Create a system for monitoring, analyzing, and collecting data on illegal manufacturing, trafficking and sales of tobacco goods.

Understanding the nature of the illicit trade in tobacco products is crucial to preventing it. Regular and ongoing market studies aimed at estimating the scope and nature of illicit trade provide much-needed information to policymakers, law enforcement and other stakeholders involved in eliminating illicit trade in tobacco products. Attention should also be given to monitoring import of key raw materials, which can indicate illegal production, as well as potential inflows of smuggled cigarettes from neighboring countries with lower cigarettes prices as Ukraine continues to approximate its excise taxes to EU levels. Modern digital technologies can also be utilized as a powerful tool for collecting data and countering illicit cigarette trade. One innovative application of such modern technologies could be the development of an app-based interface that would allow citizens to help by reporting illegal products or suspicious activities.

4. Strengthen sanctions for critical violations related to illegal manufacturing, trafficking, and sales of excisable tobacco products, including the introduction of criminal liability for the smuggling of excisable tobacco products, especially those destined for EU markets. In addition to ensuring that court-imposed penalties and fines are at levels sufficient to deter criminal activity, consideration should be given to rescinding tobacco licenses from retailers, manufacturers and distributors involved in illicit trade.

5. Tackle corrupt practices that continue to facilitate illicit trade. Unless Ukraine addresses the corruption reported within its government agencies, its attempts to improve and strengthen enforcement actions will have limited impact. The recent establishment of several specialized anti-corruption institutions, mainly NABU, SAPO, and the National Anti-Corruption Prevention Commission

(NACP), demonstrate the government's acknowledgement of the problem hold great potential to reduce the corrupt practices that facilitate illicit trade. Going forward, it will be critical that they remain sufficiently resourced, staffed and empowered to enforce controls.

6. Strengthen integrity in Customs. Since smuggling is such a big part of Ukraine's illicit tobacco problem it will be critical to implement mechanisms—such as background checks and vetting of key officials—to ensure that corruption does not limit border enforcement and seizures. Consider adopting and implementing “whistle blower” programs to enable reporting of corrupt activities, by customs or other border control officials.

7. Continue to empower the Economic Security Bureau of Ukraine to tackle illicit trade. Recent actions by the ESBU have demonstrated its willingness and ability to tackle illicit tobacco production. Continued support from the ESBU can go a long way to complement Ukraine's government wide efforts to stop illicit trade in tobacco.

If Ukraine were to successfully seize and confiscate only 10% (approximately USD 1.16 billion) of illicitly obtained assets circulating in the country, this would finance the construction of roughly 212 large schools (each for 1,700 students), or some 474 secondary schools throughout the country.

Source: UNICRI. (2021). *Illicit Financial Flows and Asset Recovery in Ukraine*. Torino: UNICRI. Available at: https://unicri.it/sites/default/files/2021-06/Illicit%20Financial%20Flows%20and%20Asset%20Recovery%20in%20Ukraine_1.pdf

- 8. Tighten controls on money laundering.** In likely most instances, the profits of illicit trade stay abroad (in tax havens), hence it is important to focus the efforts of Anti Money Laundering agencies on illicit tobacco. Denying access to entities and mechanisms used to launder proceeds of crime—and thereby depriving criminals and their networks of related profits—is one of the most effective ways to deter illicit trade. This requires a holistic, comprehensive anti-money laundering regime including the ability to trace, freeze, seize and confiscate assets related to illicit financial flows.
- 9. Implement mechanisms for effective implementation of asset tracing, freezing and seizure, along with confiscation of any financial proceeds of illicit tobacco trade.** This includes strengthening operational efforts to seize and confiscate illegal assets at border crossings, particularly in areas of porous border control.
- 10. Adopt civil confiscation as a modality for more effective seizure and confiscation of assets.** Non-conviction-based confiscation laws (referred to as “civil forfeiture” in some jurisdictions) treat the issue of confiscation separately from the issue of criminal penalty. Such laws enable governments to recover illegally obtained assets from the offender by means of a direct action against his or her property without the requirement of a criminal conviction. The prosecutor has still to prove within the balance of probabilities that the offender’s assets are either the proceeds of crime or represent property used to commit a crime, i.e., the so-called instrumentalities of the crime.⁴³ In this context it might be worth considering for Ukraine shifting the burden of proof from the Prosecutor to the accused which has proven to be an extremely effective tool used in some legal systems.
- 11. Invest in capacity-building for more effective adjudication of illicit trade crimes.** Ensure that practitioners (law enforcement authorities, prosecutors, judges, etc.) receive proper training to handle the complexities of illicit trade cases. Judicial authorities may consider establishing a special body (or designate an already existing body) to centralize information concerning illicit trade investigations. The centralized body may serve as an intelligence hub and may gather information from all relevant investigators and law enforcement.
- 12. Improve public awareness and education on the threat of illicit trade in tobacco.** Efforts to address illicit trade are hampered by a lack of public awareness on its dangers, which has led to a degree of social acceptability. To this end, local and regional educational campaigns and community-level awareness activities are essential to help shift public perception and understanding of the negative impacts of illicit trade.



Conclusion

This paper highlights some of the recent efforts of Ukrainian President Zelensky and his administration to tackle the country’s problem of illicit trade in tobacco. It has documented efforts from 2019, where the administration, for example, cracked down on illegal border crossings and strengthened customs cooperation with the EU. In addition, the report points to where various agencies have been more aggressively acting against illicit cigarettes.

It is evident that the Ukraine government has taken significant steps to prevent illicit tobacco trade in recent years. These are laudable achievements that demonstrate the Zelensky Administration’s ambition, commitment and resolve to root out illicit tobacco, including apprehending corrupt officials that benefit from this illegal activity. Moreover, these efforts and achievements provide useful examples for other governments to consider.

Nonetheless, more needs to be done and additional policy recommendations can usefully complement the Ukraine’s efforts so far. As such, a set of policy recommendations are presented for which the Ukrainian government is encouraged to consider as it continues its work to rid the economy of illicit trade in tobacco.

Endnotes

- 1 This figure includes illicit whites. See KPMG LLP. (2022). *Study on illicit cigarette consumption in the European Union (EU), the United Kingdom, Norway and Switzerland, results 2021*. KPMG. Global. Available at: https://www.pmi.com/resources/docs/default-source/itp/kpmg-eu-illicit-cigarette-consumption-report-2021-results.pdf?sfvrsn=5fe773b6_6
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- 14 Illicit Whites are Cigarettes that are usually manufactured legally in one country/market but which the evidence suggests have been smuggled across-borders during their transit to the destination market under review where they have limited or no legal distribution and are sold without payment of tax.
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