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ILLICIT CIGARETTE CONSUMPTION IN MEXICO

A Report by Oxford Economics

September 2021



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Illicit consumption in Mexico

- In the first half of 2021, an **estimated 18.8% of all cigarettes consumed were of illicit origin**. In volume terms, this was more than 38% higher than the same period in 2019 (pre-Covid level).
- The rise in Illicit Consumption has been driven by an **increased presence of cigarettes without the SAT's security code**—particularly the brands 'Economicos' and 'Link'—with Domestic Illicit now accounting for around two-thirds of total Illicit Consumption in Mexico (up from 50% in 2019).
- Non-Domestic Illicit consumption—primarily consisting of cigarettes originating from China—has been relatively stable over the last few years.
- Foregone Excise Tax receipts amounted to an **estimated 19.4% of total potential Excise Tax revenues** in 2021 H1.

18.8%

Illicit incidence, 2021 H1

Increasing consumption of Domestic Illicit cigarettes has underpinned a rise in Illicit Consumption, up from 15.5% since 2019.

MEX 13.5bn

Tax Loss, 2020



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Estimating illicit cigarette consumption in Mexico

The primary objective of this report is to provide an independent and robust assessment of the size and scale of Illicit Consumption of cigarettes in Mexico, and how this has changed in recent years. The purpose of this report is to:

- **Establish and validate illicit incidence levels**, reviewing and refining estimates using available sources such as Empty Pack Surveys (EPS);
- **Estimate the volume of Illicit Consumption**, including where possible a breakdown by origin;
- **Estimate the annual government Tax Loss** from indirect taxes on cigarettes including Excise Tax and VAT.

Estimates cover the period 2019 to the first 6 months of 2021 (H1).

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Legal Consumption

- An **estimated 31.3bn cigarettes were consumed legally in the calendar year 2020** (including Non-Domestic Legal Inflows).
- This is **primarily composed of Legal Domestic Sales**, which were adjusted for a small volume of net Outflows of legal cigarettes estimated at around 300mn cigarettes (in particular, there is some evidence to suggest a large presence of Mexico Market Variant cigarettes in California, implying non-negligible Outflows to the US).¹
- **In 2020, legal consumption volumes fell by 12.0% in comparison with 2019.** This decline in consumption was driven a similar fall in Legal Domestic Sales, underpinned by the impact of social mobility restrictions and the economic downturn brought about by the Covid-19 pandemic.
- Legal consumption has gradually recovered in line with the easing of restrictions in the first six months of 2021, rising by 2.1% in comparison with the same period in 2020. **However, when compared with pre-Covid levels (2019 H1), legal consumption volumes remained 16% lower (equivalent to around 2.8bn cigarettes).**

¹ Prieger, James, "Empty Discarded Pack Data and the Prevalence of Illicit Trade in Cigarettes in California" (2019).



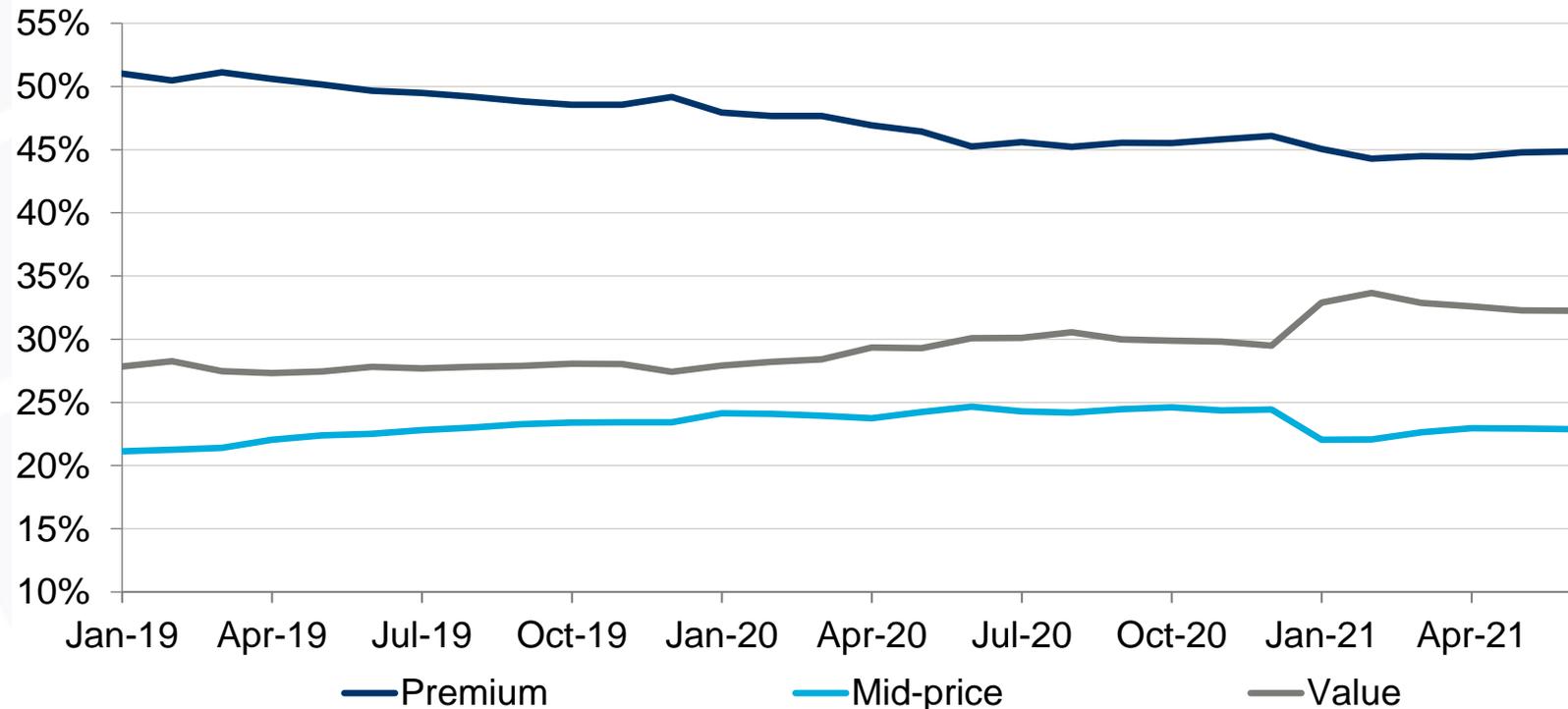
Covid-19 impact

- The Covid-19 pandemic had a profound impact on Mexico, with social distancing measures implemented in the second quarter of 2020 driving an historic decline in economic output and sharp rise in joblessness.
- The pandemic also distorted the market for cigarettes. Based on consumer survey data, **regular smokers reported lower rates of consumption during the pandemic**, with consumers hit by a combination of falling incomes and restrictions to social interactions, as well as concerns over their health and safety.² At the height of the pandemic in 2020 Q2, Legal Domestic Sales were nearly 30% down on the same period in 2019.
- **Consumers also responded to the pandemic by switching to cheaper brands in an effort save money.** This trend of downtrading is evident in the Nielsen retail audit data on legal sales—premium brands have seen a decline in market share from over 50% throughout much of 2019 to below 45% in the most recent data, with mid-price, and particularly value brands, gaining market share over the same period.



Legal Domestic Sales by segment, 2019-2021 H1

Share of Legal Domestic Sales



Source: Oxford Economics, Nielsen Retail Audit



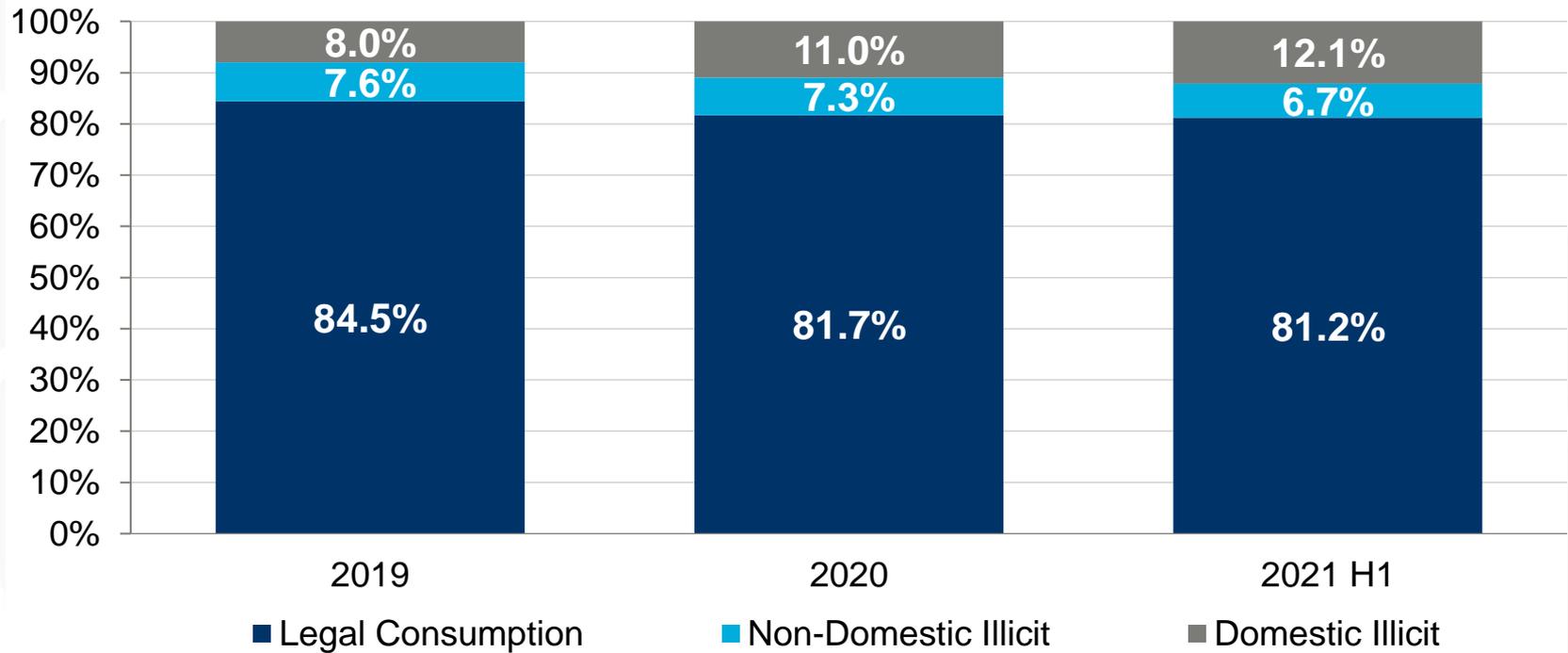
Illicit consumption

- In total, an **estimated 7bn illicit cigarettes were consumed in Mexico in 2020**. This was equivalent to **18.3% of all cigarettes consumed** during the calendar year (approximately 1 in every 5.5 cigarettes consumed), increasing by 7.1% in comparison with 2019. This was despite the wider decline in legal consumption over the same period.
- This **trend of rising Illicit Consumption continued into the beginning of this year**, with the illicit incidence rising by 0.5pp to 18.8% in 2021 H1. This represented an annual rate of increase in the volume of illicit cigarettes consumed of 0.6% in comparison with the first half of 2020, and was as much as 38% above the 2019 H1 level (pre-Covid).
- The trend of downtrading to cheaper brands as a result of the financial hardships brought about by the Covid-19 pandemic is likely to have contributed towards these higher levels of Illicit Consumption.
- As a consequence, the rise in Illicit Consumption has helped to partially offset the 12.0% decline in legal consumption, leading to a **more modest 9.0% decline in Total Consumption** in 2020.



Total Consumption, 2019-2021 H1

% Total Consumption



Source: Oxford Economics



Total Consumption, 2019-2021 H1

	2019		2020		% change 2019-2020	2021 H1		% change 2020 H1- 2021 H1
	Cigarettes mn	%	Cigarettes mn	%		Cigarettes mn	%	
Legal Domestic Consumption	35,342	84.0%	31,129	81.3%	-11.9%	14,357	80.5%	1.6%
Total Non-Domestic Inflows	3,376	8.0%	2,960	7.7%	-12.3%	1,320	7.4%	-11.0%
Non-Domestic Legal	198	0.5%	156	0.4%	-21.4%	125	0.7%	94.3%
Non-Domestic Illicit	3,178	7.6%	2,804	7.3%	-11.8%	1,195	6.7%	-15.8%
Domestic Illicit	3,364	8.0%	4,201	11.0%	24.9%	2,159	12.1%	13.5%
Total Consumption	42,082	100.0%	38,290	100.0%	-9.0%	17,835	100.0%	1.8%
Total Illicit Consumption	6,541	15.5%	7,005	18.3%	7.1%	3,353	18.8%	1.0%

Source: Oxford Economics



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Illicit consumption breakdown

- **Total Illicit Consumption is primarily composed of Domestic Illicit cigarettes, which are manufactured locally.** In the first half of 2021, nearly two-thirds of illicit cigarettes consumed were domestic cigarettes without the SAT's security code.
- This was not always the case however—with Domestic Illicit cigarettes gaining significant market share in recent years. This might be driven by a **substitution effect underpinned by restrictions** on international travel during the Covid-19 pandemic, reducing the supply of Non-Domestic Inflows, with consumers instead switching to cheap non-duty-paid domestic alternatives.
- **In 2019 the ratio between Domestic and Non-Domestic Illicit was roughly 50:50, rising to 60:40 in 2020.**
- However, a comparison of the 2018 Q4 EPS and 2019 Q4 EPS suggests that the trend of rising Domestic Illicit consumption in Mexico pre-dates the effects of the Covid-19 pandemic.



Domestic Illicit consumption

- In recent years, Domestic Illicit cigarettes—representing packs that exhibit Mexico Market Variant characteristics but do not display the appropriate SAT security code—have grown in prominence in Mexico.
- In the first half of 2021, **Domestic Illicit cigarettes accounted for over 12% of the total cigarette market**, up 4 percentage points (pp) from 8% in 2019.
- In volume terms, this **represented a near doubling in consumption levels of Domestic Illicit cigarettes since the same period in 2019** (the pre-Covid level)—which is equivalent to an additional 1bn non-duty-paid cigarettes consumed per annum.
- According to the 2020 Q4 EPS, the brands ‘Economicos’ and ‘Link’—missing the SAT security code—accounted for nearly 80% of all Domestic Illicit cigarettes consumed in Mexico.



Non-Domestic Illicit consumption

- **The volume of Non-Domestic Illicit cigarettes consumed was relatively stable since 2019**, with consumption levels in the first half of 2021 falling by just 0.4% in comparison with 2019 H1 levels.
- However, the **incidence of Non-Domestic Illicit cigarettes in Mexico has fallen** over the same period, down by nearly 1pp since 2019 to 6.7% in 2021 H1.
- The decline in market share of Non-Domestic Illicit was underpinned by rising Domestic Illicit rather than a decline in the consumption of Non-Domestic Illicit cigarettes.
- **Counterfeit cigarettes represent a negligible component of Total Consumption** in Mexico, with analysis of the 2020 Q4 EPS suggesting an incidence of less than 0.1% in Total Consumption.³

³ Cigarette packets collected during the EPS are forensically analysed by the participating companies only to identify Counterfeit products and may therefore underestimate the true volume of Counterfeit consumption.



Origin of Non-Domestic Illicit cigarettes

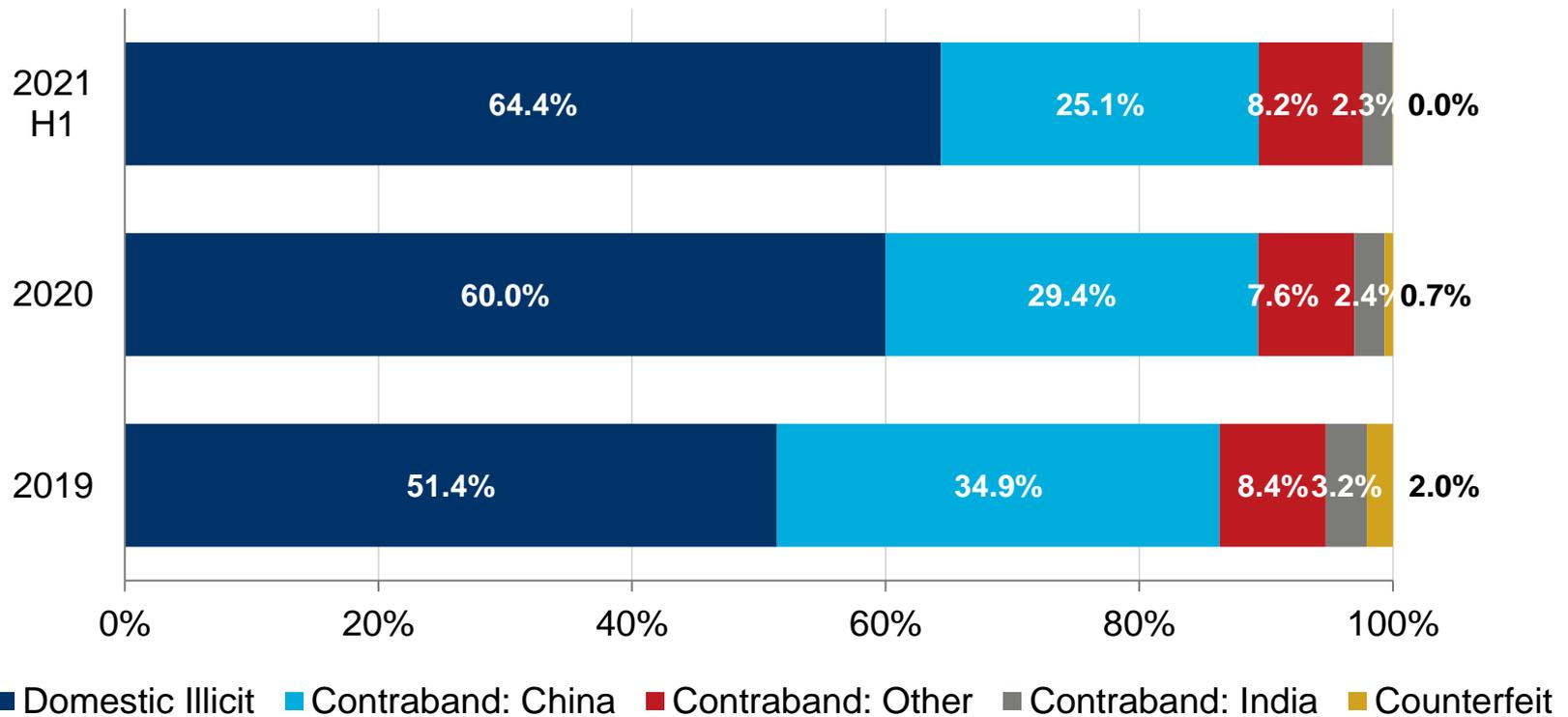
- The majority of **Non-Domestic Illicit cigarettes consumed in Mexico originated from China**. Based on the latest available data, around 70% of all Non-Domestic Illicit cigarettes are typically manufactured in China.
- Furthermore, analysis of the 2020 Q4 EPS survey indicates that around 50% of Non-Domestic Inflows are composed of just two Chinese brands, ‘Brass’ and ‘Win’. These brands were also present in the 2019 Q4 EPS, however with a much lower market share, with other brands such as ‘Marshall’ and ‘Marble’ also prominent in consumption.
- Other notable origin markets for Non-Domestic Illicit cigarettes include India and Vietnam.
- It is understood that large volumes of these Inflows enter Mexico via Free Trade Zones in Panama and Belize,⁴ both of which perform poorly in international benchmarks in terms of Illicit trade prevention.⁵

⁴ KPMG, “Project Eos: A study of illicit cigarette consumption in selected markets from Latin American and Canada” (2019).

⁵ Economist Intelligence unit, “The Global Illicit Trade Environment Index: Free Trade Zones, Fives Case Studies” (2018).



Illicit consumption by origin, 2019-2021 H1



Source: Oxford Economics



Illicit consumption trends

- Analysis of the 2020 Q4 EPS suggests that the **incidence of illicit cigarettes is higher in the central and western central regions of Mexico**, with cities displaying the highest levels of Illicit Consumption including Tepic, León, Aguascalientes, San Luis Potosí, Celaya, and Tepexpan. This is broadly consistent with the most densely population areas of Mexico.
- Based on survey data, the retail price of Non-Domestic Illicit cigarettes typically range from around MXN 20-24 per pack of 20 cigarettes, while Domestic Illicit cigarettes cost on average MXN 28 per pack.⁶
- By comparison, the price of a pack the most sold brand of cigarettes in Mexico is MXN 66, **which in more than double the equivalent price for a pack of illicit cigarettes**. Indeed, with total taxes accounting for nearly 70% of the retail price of the most sold brand (including VAT), a pack of illicit cigarettes typically retails at a price below the contribution to tax from the sale of a legal pack of cigarettes in Mexico.⁷

⁶ National point-of-sale survey tracking the availability of Domestic and Non-Domestic Illicit cigarettes, conducted by BAT.

⁷ WHO report on the global tobacco epidemic 2021: addressing new and emerging products. Geneva: World Health Organization; 2021. 19



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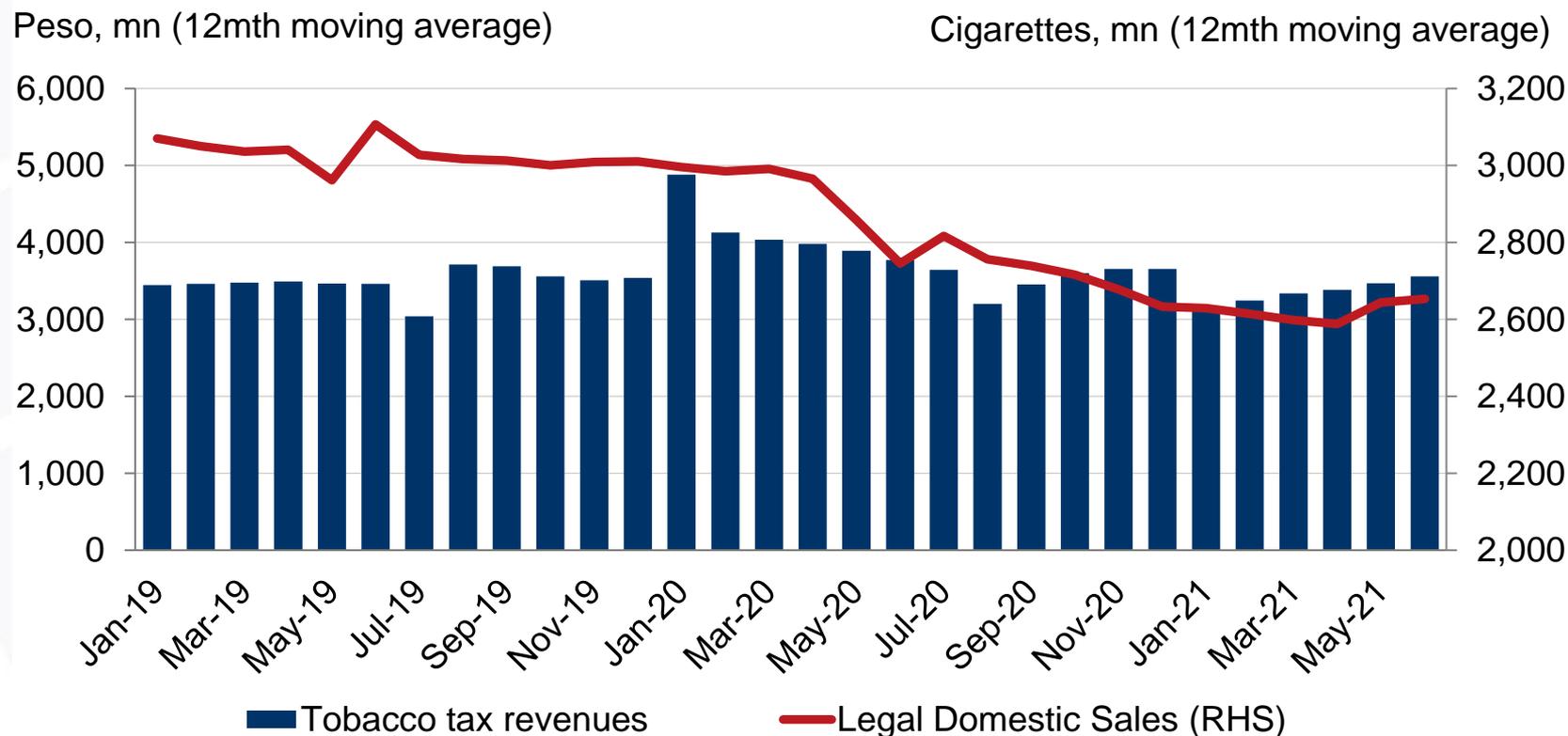
Cigarette taxation in Mexico

- Mexico applies a **mixed Excise Tax system**—a special excise tax on product and services (IEPS)—composed of both specific and ad-valorem components.
- The ad-valorem component is comprised of a rate of 160% applied to the wholesale price of cigarettes (manufactured).
- The specific component is charged at a fixed amount of MXN 0.5108 per cigarette. Since January 2020, this has been indexed to inflation in Mexico, and was increased from MXN 0.4944 in January 2021.
- In addition, cigarettes are subject to VAT at a rate of 16%.
- **Revenues from Excise Taxes on Legal Domestic Sales amounted to MXN 43.8bn in 2020**, representing an increase of 3.2% in comparison with 2019, despite the corresponding decline in Legal Domestic Sales volumes over the same period.⁸ Excise Tax on tobacco products accounted for around 1.3% of total Federal Government revenue from taxes in 2020.⁹

⁸ The Ministry of Finance and Public Credit (SHCP).

⁹ Banco de México.

Tobacco tax revenues and legal sales, 2019-2021 H1



Source: The Ministry of Finance and Public Credit (SHCP), CONAINTA, Nielsen Retail Audit



Tax Loss due to Illicit Consumption

- **Nearly 20% of potential Excise Tax revenues from Legal Domestic Sales in Mexico are forgone due to the presence of illicit non-duty-paid cigarettes.**
- **The total Tax Loss amounted to an estimated MXN 13.5bn in the full calendar year 2020.** Of this, around 80% was underpinned by Excise Tax evasion and a further 20% was driven by foregone VAT receipts.
- In line with the recent growth in Illicit Consumption, the **Tax Loss due to Illicit Consumption has also increased in recent years**, rising from an estimated MXN 10.7bn in 2019. This was equivalent to an increase of around 26.6% in Tax Loss and occurred during a period where wider government tax revenues were squeezed as economic activity collapsed in the wake of the Covid-19 pandemic.
- The Tax Loss in 2021 H1 of MXN 6.7bn is around half of the total for 2020, suggesting that lost revenues will remain high this year.



Tobacco tax revenues and Legal Domestic Sales, 2019-2021 H1

	2019		2020		2021 H1	
	MXN bn	USD mn	MXN bn	USD mn	MXN bn	USD mn
Legal Domestic Sales (cigarettes bn)	36.1		31.6		14.6	
Excise Tax Revenues	42.5	2,203	43.8	2,171	22.4	1,119
Illicit cigarettes (cigarettes bn)	6.5		7.0		3.4	
Estimated Tax Loss	10.7	555	13.5	629	6.7	334
Excise - ad valorem	6.2	321	7.4	344	3.7	183
Excise - specific	2.3	119	3.5	161	1.7	85
VAT	2.2	114	2.7	124	1.3	66
Excise Tax Loss as % potential total Excise Tax revenues	16.6%		19.9%		19.4%	

Source: Oxford Economics



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Methodology—overview

- Estimates of **Legal Domestic Sales** in Mexico were derived through a combination of Nielsen retail audit and sales data provided by CONAINTA. **Legal Domestic Consumption** was estimated by subtracting Outflows, based on passenger data, Smoking Prevalence rates, and the duty-free personal import allowance for the US, and CONAINTA estimates for other markets.
- Results of Empty Pack Survey's for 2018 Q4, 2019 Q4, and 2020 Q4 (conducted by WSPM Group) were combined with point-of-sale survey data (sourced from BAT) to determine a robust estimate for the incidence of **Non-Domestic Inflows** of cigarettes for 2019 to 2021 H1.
- Estimates of **Non-Domestic Legal Inflows** were derived using passenger data, Smoking Prevalence rates, and the duty-free personal import allowance of 200 cigarettes. Tourism data was sourced from Oxford Economics and the Mexican Institute of Statistics and Geography (INEGI). Smoking Prevalence data was sourced from the World Bank.
- **Non-Domestic Illicit consumption** was derived by subtracting Non-Domestic Legal Inflows from total Non-Domestic Inflows. **Domestic Illicit consumption** was based on a forensic analysis of the Empty Pack Survey data, through the identification of domestic packs without the requisite SAT security code or brands listed as illicit by the Federal Commission for Protection Against Health Risks (COFEPRIS).
- **Tax Loss** estimates were based on multiplying the volume of Illicit Consumption by weighted average Excise and VAT tax rates, calculated by applying statutory tax rates to retail audit and CONAINTA data (ad-valorem Excise Tax incidence based on WHO report on the global tobacco epidemic 2021).



Methodology—glossary of terms(I)

- **Bn:** Billion
- **CONAINTA:** Consejo Nacional de la Industria Tabacalera, members: BAT, JTI, and PMI.
Contraband: Genuine product that have been either bought in a low-tax country and which exceeds the legal border limits, or is acquired without payment of taxes for export purposes to be illegally re-sold (for financial profit) in a higher-priced market. Most brands are included in the COFEPRIS sanitary alert and do not comply with mandatory health warnings.
- **Counterfeit:** Cigarettes that are illegally manufactured and sold by a party other than the original trademark owner. In this report, Counterfeit volumes are reported by the participating manufacturers of BAT, JTI, and PMI. No other Counterfeit is included in the volumes reported due to a lack of information.
- **Domestic Illicit:** Cigarettes that are produced for the domestic market but are missing the Tax Administration Service (SAT) security code and do not comply with mandatory health warnings.
- **Duty-Free:** Cigarettes bought without payment of customs or excise duties. Consumers may buy Duty-Free cigarettes when travelling into or out o the country by land, air, or sea at legal Duty-Free shops.
- **Empty Pack Survey (EPS):** Studies done by independent research agencies, during which agencies collect empty packs discarded by smokers in public places, recording brands and origins. Samples are analysed for authenticity by forensic experts of participating companies.



Methodology—glossary of terms(II)

- **Excise Tax:** An indirect tax on the consumption of certain goods. Excise Taxes on cigarettes can be either specific, i.e., expressed as a monetary amount per quantity/weight of the product; ad-valorem, i.e., expressed as a proportion of the value of a product; or a combination of both.
- **Free Trade Zone:** Part of the territory of a State where any goods introduced are generally regarded, insofar as import duty and taxes are concerned, as being outside the customs territory and are not subject to the usual customs control.
- **Illicit Consumption:** Sum of Domestic Illicit and Non-Domestic Illicit.
- **Inflows/Outflows:** Inflows/Outflows of Non-Domestic product into/from a market.
- **Legal Domestic Consumption:** Defined as Legal Domestic Sales net of Outflows.
- **Legal Domestic Sales:** Sales of genuine domestic tax-paid product through legitimate, domestic channels.
- **Mn:** Million
- **Market Share:** The proportion of total market sales, expressed as a percentage, accounted for by a company, product, or brand.
- **Market Variant:** Term used to designate the market in which a pack of cigarettes was initially intended to be sold. To be sold in a given market, a pack has to bear the required labelling (e.g., health warning) and potentially a fiscal marking. The Empty Pack Survey methodology estimates the incidence of packs by Market Variant.



Methodology—glossary of terms(II)

- **MXN:** Mexican Peso
- **Non-Domestic:** Product not originally intended for the market in which it is consumed.
- **Non-Domestic Illicit:** Counterfeit, Contraband, and imports of other illicit cigarettes.
- **Non-Domestic Legal:** Product that is brought into the market legally by consumers, such as during a cross-border trip, subject to Duty-Free allowance.
- **RHS:** Right hand side.
- **Smoking Prevalence:** The percentage of smokers in the total adult population.
- **Tax Loss:** Government revenues that are lost due to tobacco tax (Excise Tax, including Earmarked Taxes, and VAT) that is not paid on illicit cigarettes.
- **Total Consumption:** Total Consumption of legal and illicit cigarettes in Mexico.
- **VAT:** Value-Added Tax.



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