COMBATING ILLEGAL INTERNATIONAL TRADE AND PROTECTING TAX REVENUE IN THE EU

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Abstract

Illegal international trade poses a serious problem to the EU, as it compromises on the collection of tax revenue, disrupting market competition, and compromising the integrity of the single market. This paper is an analysis of the illegal international trade within the (EU) with special attention to the effect of tax revenue protection it has. The study is based on the scientific literature analysis of the EU and synthesis and analysis of policy reports, and comparative analysis. According to the findings, the VAT fraud, smuggling of excisable goods, counterfeit products, customs fraud, and trade-based money laundering result in large fiscal losses, in particular, the VAT gap and the evasion of the excise taxes. This paper has made the conclusion that strong defense of EU tax revenues must be founded on a multipronged approach that comprises of reinforced enforcement, computerization of tax and customs regimes, bolstered cooperation at the frontiers, focused fiscal structure, and demand side actions to minimize the incentives on illegal trade.

Keywords: VAT fraud, VAT Gap, smuggling of excisable goods, counterfeit goods, trade based money laundering, customs fraud.

Introduction

The illegal international trade has developed to be a rising issue among governments all over the world because it has its negative implications on the administration of finance, competition in the market, and adherence to regulations (Buehn, Schneider, 2012). According to the European Commission (2023), this issue is especially important in the European Union (EU) due to the openness of the Single Market, free flow of goods, and the large scope of the external borders of the EU. However these features are critical towards the development of an economy, but they create channels of illegal activities, such as smuggling of excisable products, supply of counterfeit products, customs malpractice, and money laundering through trade (European Court of Auditors, 2025). The practices have the effect of nullifying the legitimate economic activity and also leading to colossal loss of tax revenues especially value added tax (VAT) fraud and excise duties evasion.

The urgency of the addressed issue has been increasing in the recent years alongside the process of digitalisation, increased e-commerce, and the complexity of cross-border supply chains have both increased the level and the scale of illegal trade. In the case of the EU, the loss of revenue in taxation undermines the ability of the Member States to fund the public services, and distortions in the market decrease the levels of confidence in the fairness and integrity of the Single Market. Since there are sophisticated regulatory systems and special enforcement tools, the phenomenon of illegal international trade remains flexible and is always challenging to taxation authorities and customs.

The paper is a useful addition to the existing body of literature as it offers a combined discussion of illegal international trade in EU with special emphasis on preserving tax revenue (OECD/EUIPO, 2021). In comparison to the research that discusses individual types of illicit trade separately, the aim of the given work is to evaluate the magnitude of the fiscal losses and the efficacy of the existing countermeasures together with the use of the empirical evidence and theoretical approaches. The research is unique given its holistic approach in that it connects the enforcement strategies, fiscal policy instruments, and demand-side measures with long-term tax compliance. By offering the problem in a logical and easy-to-understand format, this study will help educate policy makers and scholars of all fields on the proper ways to fight illegal cross-border trade and protect state revenues.

Research aim: to disclose the strategies for combating illegal international trade, seeking to protect tax revenue collection in the EU.

The following **objectives** have been set to achieve the aim:

1. To analyse the situation of illegal international trade in the EU in the context of EU tax revenue collection.
2. To examine the main forms and channels of illegal international trade (e.g., smuggling, counterfeit goods, customs fraud, money laundering), as well as the theoretical view on tax revenue protection.
3. To propose policy recommendations and strategies for strengthening enforcement, tax revenue collection and protection, and reducing the incentives for illegal international trade in the EU.

Research object and methods

The object of this research is illegal international trade in the EU, in particular, the methods of fighting these illegal streams in order to protect the tax revenues. In order to do so, the research utilizes the methodology that is based on the scientific literature analysis and the compilation of the policy reports to estimate the fiscal losses and to assess the effectiveness of the existing countermeasures. It can be justified by providing a comparative analysis of the main routes of illegal trade along with smuggling, fake goods, fraud in customs, and money laundering in the form of trade as well as a research of their respective effects on the EU tax collection. In addition, the paper deploys a holistic theoretical perspective in which the fiscal exchange theory, deterrence theory, and institutional and governance perspectives have been combined to link the enforcement strategies and fiscal policy tools to long-term tax compliance. These approaches allow the research to suggest policy recommendations that are based on evidence and can maximize the likelihood of increasing enforcement and reduce the incentive institutionality of illegal cross-border trade. AI tool was used to correct the wording of sentences in this research.

Research results and discussion

1. Situation analysis of illegal international trade in the EU in the context of EU tax revenue collection

The EU is constantly challenged by illegal international trade, which erodes tax revenues, and threatens the truthfulness of the Single Market. The EU is especially vulnerable to illegal goods flows because of its openness to international trade, 27-member structure, and wide external borders (OECD/EUIPO, 2021). Smuggling excisable goods (fuel, alcohol, and tobacco), counterfeit goods, trade-based money laundering, and customs fraud are forms of illicit trades in the EU (Joossens et al., 2010).

The EU's vast internal market and free movement of goods present appealing opportunities for organized crime networks involved in cross-border illicit trade, despite its sophisticated regulatory frameworks and established networks of customs cooperation (Buehn, Schneider, 2012). Smuggling provokes the excisable goods to exploit the differences in tax rates among Member States, reducing legitimate excise and VAT revenues, counterfeiting and piracy alone had caused billions of lost revenues and serious distortions in the market (OECD, 2016). Similar to how trade-based tax evasion and money laundering schemes hides the illegal financial flows under the guise of lawful commerce, fraudulent customs declarations such as undervaluing imports or falsifying origin, allows traders to avoid duties (FATF, 2022). When taken as a whole, these illegal activities reduce market competition, erode tax compliance, and make it harder for the EU to protect its financial interests. In order to discuss the fiscal impact of illegal international trade in the EU in a more detailed way, it will be required to look at the effect of this issue on the revenues via major channels. The sections below thus concentrate on the VAT losses, smuggling of the excisable and the overall effects of illicit trade on the collection of the tax revenue.

VAT losses

The VAT Gap, which calculates the difference between the amount of VAT collected and the amount that would have been collected if everyone had complied, is one of the best indicators of tax revenue loss associated with illegal trade. In 2022, fraud, evasion, legal avoidance, and VAT non-compliance cost EU member states approximately 89 billion EUR (European Commission, 2023). A significant amount of this loss is attributable to VAT fraud schemes, particularly invoice manipulations, cross-border avoidance, and Missing Trader Intra-Community fraud (MTIC) (CASE, 2023). According to recent assessments by the European Commission (EC), the MTIC gap—that is, the revenue lost because of intra-EU VAT carousel fraud ranges from 12.5 billion EUR to 32.8 billion EUR annually (estimates for 2010–2023) (Eurofisc, 2022).

Smuggling of excisable goods

Based on the European Anti Fraud Office (OLAF, 2023) illegal cigarettes and raw tobacco are frequently seized in large quantities, resulting in direct revenue losses for EU tax authorities. In 2022, the activities of the European Anti Fraud Office (OLAF) allowed seizing 209 tonnes of raw tobacco and more than 531 million contraband cigarettes (199 million at external borders and 317 million in the EU) and prevented 153 million EUR in lost revenue. OLAF activities in 2023 included over 616 million illegal cigarettes, even at the external EU borders, 140 tons of raw tobacco, and the arrest of smugglers and factories. For that year, the estimated avoided loss to the national and EU budgets was 151 million EUR. Additionally, illicit cigarette markets show that in 2017, 44.7 billion illegal cigarettes were consumed in Europe, costing EU governments approximately 10 billion EUR in lost tax revenue in the form of counterfeit or contrabands cigarettes.

Impacts on tax revenue collection

There are significant direct revenue losses from customs duty evasion, excise/tobacco smuggling (hundreds of millions to billions depending on scale), and VAT fraud (tens of billions of euros annually) (European Commission, 2023). Illegal trade increases compliance costs in addition to lost collections, requiring more enforcement, investigations, customs inspections, legal actions, etc., all of which use up public funds (Joossens et al., 2010). Additionally, it weakens the integrity and fairness of the tax system, which encourages law-abiding citizens and businesses to voluntarily comply. Market distortions brought on by unfair competition from illegal goods deter investment and trade, which over time may lower the taxable base (European Court of Auditors, 2021).

2. Forms and channels of illegal international trade in the EU

The EU illegal international trade has various leading forms whose main cause is the tax differentials, high consumer demand and cross-border trade opportunities. The most prevalent and financially harmful actions, which directly harm tax incomes and pervert the fair competition in the market, are the smuggling of excisable goods and restricted goods, the trade in counterfeit and pirated products, customs fraud and under undervaluation and trade-based money laundering.

Smuggling of excisable and restricted goods

In the EU, smuggling continues to be the most widespread and visible type of illicit trade. In order to avoid paying excise taxes and customs duties, it mainly entails the illegal transportation of excisable goods—such as fuel, alcohol, and tobacco—across international borders. Over 616 million illegal cigarettes and 140 tonnes of raw tobacco were seized across EU borders in 2023, saving about 151 million EUR in lost revenue, according to the European Anti Fraud Office (OLAF, 2023). Smugglers commonly exploit tax disparities between EU member states and between the EU and non-EU neighbours such as Belarus and Ukraine, to profit from arbitrage opportunities (Renda, 2020). Also, through the false transit documents and misreported goods, smuggling activities take advantage of the free trade zones and lack of customs surveillance. These operations are typically funded and managed by organized crime networks, which conceals the place of origin and location of profits by money laundering techniques of logistics. The internal and external freedom of movements of the EU has its opportunities and challenges due to its vast borders.

Counterfeit and pirated goods

The Issuing of pirated and counterfeit goods is also a type of illicit trade. The OECD/EUIPO (2021) report estimated that 5.8% of EU imports consisted of counterfeit and pirated goods, with a market value of 119 billion EUR annually. Such commodities are luxury goods, pharmaceutical, electronics, cosmetics and auto parts. Besides depriving governments of the import taxes and VAT, counterfeit trade threatens the health and safety of the people.

The illicit traders are increasingly issuing counterfeit goods through platforms and postal networks especially in small packages that cannot be detected through customs laws. The growth of e-commerce has opened up new avenues in such type of trade, whereby the goods are shipped in high volume of low-value consignments. According to the 2024 enforcement report by the EC, over 152 million counterfeit goods with a value of approximately EUR3.4 billion were confiscated in the EU in 2023 (European Commission, EUIPO, 2024). These figures indicate the manner in which the illegal trades are changing to the common, online, dealings to massive container smugglings.

Customs fraud and undervaluation

Another important medium through which illegal trade is carried out is customs fraud whereby deliberately dangerous values of imports, product classifications, or product origin are forged to lower the tax burden. Some of the strategies embraced by traders include undervaluing invoices, misclassifying under low tariff codes and falsifying information concerning the country of origin to attract traders. Some of the high-risk industries, including the Asian electronics and textiles, caused a loss of over 2.7 billion Euros due to customs undervaluation between 2015 -2020 (European Court of Auditors, 2022). These fraudulent activities lower the revenue of EU customs, distort trade statistics, and endanger healthy competition. The trend towards the development of ecommerce and speedy delivery of parcels has complicated the issue of customs monitoring. In the EU everyday low value shipments enter in millions through online retail platforms. Since the EU lifted the VAT exemption on low-value imports in 2021, all imported goods are now subject to VAT but fraudulent low-parcel value undervaluation is still applied to avoid customs duties and decrease the probability of detection.

Trade based money laundering

Trade based money laundering a sophisticated financial crime covers the source of illicit funds by using legit trade transactions. Criminals use over-invoicing, under-invoicing, or the forgery of trade documents to transfer value across borders undetected. The Financial Action Task Force (FATF) states that trade-based money laundering is a crucial connection between illegal trade and tax evasion (FATF, 2022). Trade based money laundering exploits flaws in the EU financial reporting and customs declarations, especially in free trade zones and through complex supply chains. Such actions weaken tax enforcement by concealing taxable profits and encouraging the erosion of the tax base.

Table 1. Estimated revenue losses attributable to major types of illegal international trade in the EU during 2022–2023

Type of illicit activity	Estimated annual revenue loss (billion EUR)
VAT (MTIC) Fraud	12.5 – 32.8
Counterfeit & Pirated Goods	~119 (value of illicit imports, not tax loss)
Tobacco Smuggling	10 (2017 est.)
Customs Undervaluation	2.7 (2015–2020 cumulative)

Source: according to European Commission, EUIPO (2024), OLAF (2023), OECD/EUIPO (2021)

The key types of illegal international trade in the EU and their specific features of operation are compared in **Table *1*** and help to understand the interdependency of the effect on the tax collection.

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Theoretical perspectives on tax revenue protection

Several public finance and economic criminology theoretical frameworks can be used to understand how tax revenue is protected from illicit trade.

a) the fiscal exchange theory

Fiscal exchange theory states that when taxpayers believe there is a fair and transparent exchange between the taxes they pay and the public goods they receive, they are more likely to comply (Alm & Torgler, 2011). By lowering government revenue and eroding public confidence in the justice of the tax system, illegal trade upsets this equilibrium. Increased illicit activity can therefore set off a "compliance spiral," in which perceived unfairness encourages more tax evasion and decreases voluntary compliance.

b) the deterrence theory

According to Becker (1968) deterrence theory, people commit crimes when the anticipated reward outweighs the possibility of being caught and punished. Strong enforcement capabilities, regular penalties, and a high likelihood of detection are necessary for effective deterrence in the context of illicit trade. Higher audit probabilities and more severe legal penalties are associated with lower rates of non-compliance, according to studies on tax evasion and smuggling (Allingham & Sandmo, 1972).

c) the institutional and governance perspective

From an institutional perspective, administrative effectiveness, institutional integrity, and governance quality all play a role in protecting tax revenue. Opportunities for illicit trade are increased by weak customs capacity, corruption, and disjointed data systems (Bussy, Tassi, 2025). Therefore, institutional theory's emphasis on systemic reform rather than reactive enforcement is consistent with the EU's efforts to digitize customs and VAT administration through programs like the "VAT in the Digital Age" (ViDA) and Customs Data Hub.

Overall, the theoretical standpoints presented suggest that the combination of trust, deterrence, and institutional strength is the key to the effective protection against illegal trade and tax revenues. Fiscal exchange theory emphasizes the significance of impartiality and openness in maintaining voluntary compliance, whereas deterrence theory emphasizes the significance of a powerful enforcement and plausible penalties to deter the malicious act. The institutional and governance school of thought also shows that a strong administrative capacity and a complete data system is needed to curtail illegal trade opportunities. These structures combined imply that permanent declines in illicit trade must be achieved by establishing coordinated enforcement, proper governance and policies that would increase trust in the tax system.

3. Policy recommendations and strategies for strengthening enforcement, tax revenue collection and protection, and reducing the incentives for illegal international trade in the EU

A comprehensive policy approach that incorporates legal reform, institutional capacity building, digitalization of tax and customs procedures, international cooperation, and targeted demand-side measures is necessary to combat illicit international trade and safeguard tax revenues in the EU. Success requires integrated strategies that lower the profitability of illicit trade, increase the likelihood of detection and sanction, and strengthen the resilience of fiscal institutions, according to evidence from academic research and expert assessments.

Strengthen legal and institutional frameworks with harmonized penalties and clearer mandates

Closing legal and enforcement gaps that let criminals take advantage of variations among Member States is the top priority. Reducing "forum shopping" by illegal traders looking for the weakest regime is achieved by harmonizing penalties and guaranteeing uniform criminal and administrative sanctions throughout the EU (Joossens et al., 2015). Empirical research emphasizes that nations with laxer laws and inconsistent enforcement are more vulnerable to VAT carousel schemes and smuggling. To increase the expected cost of unlawful activity, the EU must promote uniform minimum penalties for tax and customs infractions and keep strengthening partnerships through OLAF, Europol, and European public prosecutor’s office (EPPO). This calls for accelerated asset seizure procedures and judicial prosecutions for organized networks engaged in trade-based money laundering and cross-border smuggling (Johan Van der Paal, 2019).

Expand digital tax and customs tools (real-time data, e-invoicing, and risk analytics)

The literature strongly advocates for the digitalisation of tax and customs administration to reduce VAT fraud and improve detection. Implementing mandatory e-invoicing, real-time transaction reporting, and centralised invoice storage enhances the chances of identifying MTIC/carousel schemes by enabling rapid cross-checking of supplies, invoices and refund claims by tax authorities (European Commission, 2022).

Implement robust track-and-trace, authentication and supply chain transparency for excisable goods

Technical identity tracing and track-and-trace systems are of significant importance to identify illicit diversion of excisable products such as fuel, alcohol, tobacco, and related products whereby authorities can trace the products through the supply chain and detect any anomalies in the distribution as well (Schroeder, 2021; Joossens et al., 2010). In cases of independent audits, cross-border interoperability, and stringent controls in free-trade zones and production sites, the literature appraising track-and-trace regimes within the EU environment shows that it could present clear advantages (Bowers et al., 2022). Most importantly, it is important that traceability be accompanied with effective inspections and criminal enforcement and prevent illegal manufactures who may instead adjust to new regulations. Academic reviews indicates that track and trace works best when paired up with rigid governance policies and supplier due diligence specifications (Liberman, 2020).

Tackle trade based money laundering and organized crime linkages through financial-trade integration

Large scale illegal trade is made possible in large part by trade-based money laundering, which conceals proceeds through intricate trading patterns and invoice manipulation (Ferwerda, 2013). Stronger ties between customs data and financial intelligence units (FIUs), required beneficial-ownership transparency for trading firms, and improved due diligence for trade finance instruments are all necessary for effective policy (Unger, 2014). Co-located task forces where customs, tax, FIUs, and law enforcement share data and collaborate to investigate suspicious trade patterns improve prosecution rates and revenue recovery, according to FATF guidelines and scholarly reviews (FATF, 2022). The EU should expand information exchange protocols across jurisdictions and provide incentives for national adoption of such integrated task forces.

It is helpful to analyse the anticipated impact of various policy categories on lowering illicit international trade in order to evaluate their relative efficacy. Based on conclusions from scholarly research and assessments of EU policy.

Reduce incentives for illicit trade via fiscal harmonization, targeted excise alignment and demand-reduction policies

Smugglers take advantage of arbitrage opportunities created by tax differences across borders (Joossens et al., 2010). Targeted harmonization of excise bands for high-risk products (such as minimum excise thresholds for fuel and tobacco) would lessen price arbitrage incentives, even though complete tax harmonization across the EU may be politically challenging (Merriman, 2012). Concurrently, market demand for illegal goods is decreased by successful demand-side interventions, such as public awareness campaigns, the encouragement of legal supply chains, and improved consumer protection against the negative effects of counterfeit goods (OECD, 2016). To achieve long-term reductions in illegal markets, academic policy analyses advise combining supply-side deterrence with demand-side education (Von Lampe, 2011).

Improve cross-border cooperation, measurement and evaluation

Lastly, more accurate assessment of the size of the illicit market and the customs gap is necessary for focused policy (Basu, 2014). In order to estimate customs duty losses and the size of illicit flows—data that are currently fragmented and inconsistent researchers advocate for uniform methodologies across Member States (Anastasiou et al., 2024). Additionally, funding academic-policy collaborations will allow for independent assessments of new initiatives (such as e-invoicing rollouts and track-and-trace pilots) and evidence-based iterative improvement (Eukeria Mashiri, 2015).

The proposed policy recommendations highlight the need for a coordinated EU approach to reduce illegal international trade and protect tax revenues. Effective strategies require stronger enforcement through improved customs controls and cross-border cooperation, supported by the digitalisation of tax and customs systems and enhanced data sharing. In parallel, reducing incentives for illicit trade involves narrowing tax differentials, strengthening institutional governance, and addressing demand through consumer awareness measures. Overall, the analysis shows that sustainable progress depends on combining enforcement, fiscal measures, and institutional reforms.

Conclusions

1. The research has attained its objective of identifying and examining the measures of fighting the illegal international trade in the EU with the intention of safeguarding the collection of tax revenue. The paper shows that illicit international trade is still a structural and evolutionary process, which can still jeopardise EU state funds even though there are sophisticated frameworks of regulations and enforcement. The analysis of the current situation allows the research to establish that the illicit trade is a significant cause of losses in revenue, specifically via VAT fraud, evasion of excise, and customs fraud, and the imposition of indirect costs due to distortion of the competing framework and undermining of voluntary compliance with taxation levels.

2. Through the analysis of the key modes and pathways of illegal global commerce, this paper confirms the existence of interdependent relationships among smuggling, counterfeiting, trade-based money laundering, and customs fraud, which take advantage of regulatory loopholes, price disparities, and cross border complexities. The theoretical analysis explains that effective protection of tax revenue (as opposed to deterrence and enforcement) requires tax system institutional trust, equity, and transparency. These trends indicate that fragmented or simply penal strategies cannot fully deal with the structural causes of illicit trade.

3. It is on these insights that the research finds that an integrated policy approach is necessary in reducing illegal international trade in the EU. The increased enforcement, improved cross-border cooperation, and tax and customs systems digitalisation should be accompanied by specific fiscal harmonisation and demand-side policies that ensure the minimisation of the incentives to engage in the illegal activity. Overall, the research aims have been met, and the results present a logical framework of studying how the idea of coordinated policy strategies can be used to enhance tax revenue protection and the integrity of the EU Single Market.

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