TOBACCO SMUGGLING AND CONTRABAND:

A DEADLY THREAT TO TOBACCO TAXATION, THE MOST EFFECTIVE PUBLIC HEALTH STRATEGY USED TO DATE TO LOWER TOBACCO CONSUMPTION.

AND A THREAT TO MILLIONS IN GOVERNMENT REVENUES NEEDED FOR HEALTH CARE.

IT'S TIME FOR ACTION ON TOBACCO SMUGGLING AND CONTRABAND.

Why are tobacco taxes so important for public health?

Tobacco taxation as a public health strategy is now an accepted practice in Canada. For much of the last century, however, taxes remained quite low and for long periods, real prices for tobacco products actually declined.[1]

That trend changed when evidence provided by numerous economic studies showed that tobacco taxation can be used not only as a fiscal policy but as a public health policy as well. A recent authoritative study of the price elasticity of demand in the Canadian market shows that each 10% increase in price leads to a 4.5 % decrease in tobacco consumption for the general population.[2]

Tobacco taxation as a public health strategy gained a lot of popularity in the 1980s and the beginning of the 1990s. It contributed very significantly to more than a 30% fall in per capita consumption between 1980 and 1993.[1] Indeed, tobacco taxation policies have been shown to be one of the most effective strategy used to date in efforts to reduce smoking.[3]

Why were tobacco taxes rolled back in the 1990s?

The tobacco industry described taxation on numerous occasions as the single most important threat to its market.[4, 5] Smuggled Canadian cigarette brands appeared in 1990 and rose gradually to reach close to 30% of the domestic market in 1993.[6] Cigarettes were exported to U.S. duty-free warehouses and then diverted and reintroduced illegally into Canada, mainly through the Akwesasne/St.Regis aboriginal reserve, which straddles the Canada-U.S. border in eastern Ontario and western Quebec.[7]

Political pressure to resolve the crisis led to a drastic cut in tobacco taxes by the federal government and five provinces (Ontario, Quebec, New Brunswick, Nova Scotia and Prince Edward Island) in 1994.[8] Although taxes remained high in the rest of the country, tobacco smuggling dropped sharply because the Canadian tobacco industry simply decided to stop shipping its cigarettes to U.S. duty-free warehouses.[9]

Unfortunately, the extent of the Canadian industry's involvement in the smuggling crisis only became clear a few years later through testimony of industry whistleblowers and the release of internal industry documents made public following litigation in the United States. The authorities have been conducting extensive investigations of the tobacco industry.[10, 11]


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Tobacco insider talks

Major firms made a killing in cross-border smuggling, former executive says

SPECIAL REPORT

As of this writing, one RJR-Macdonald affiliate pleaded guilty and some executives have also been convicted.[12, 13, 14] Criminal and civil proceedings continue against some companies and executives.[15] Measures to prevent the industry from resuming its smuggling activities, such as a significant export tax in 2001, have also been introduced.[16]

What has happened with tobacco taxes since then?

Following the 1994 tax rollbacks, a "gentlemen's agreement" was reached between the federal government and the provinces to slowly and collectively raise tobacco taxes in tandem and closely monitor any market fluctuation. However, the agreement was eventually abandoned once tobacco taxes returned to their prior levels.

Provincial governments have since responded positively to numerous calls from health agencies for more substantial tax increases. Although provincial taxes in Quebec and Ontario are now the lowest and second-lowest respectively in Canada, the total price for a carton of 200 cigarettes now exceeds $80 (US $72) in several provinces.[17]

What is the current situation?

According to government and media reports, tobacco smuggling is gradually making a comeback in Canada.[18, 19, 20] Enforcement agencies are reporting that illegal cigarettes are now coming from different sources:

- Illicit manufacturing operations located on some aboriginal reserves in Canada and the U.S., such as the Akwesasne/St.Regis reserve;
- Canadian brand-name cigarettes shipped to aboriginal reserves and diverted back to the domestic market to be sold without all applicable taxes;
- Thefts of cigarette truck shipments;
- Illegal importation of counterfeit cigarettes (copies of Canadian cigarette brands) made in countries such as China;
- Illicit manufacturing operations outside reserves. [20]

Of all these sources, one stands out. According to public statements made by the Royal Canadian Mounted Police (RCMP), "90 per cent of the contraband product is coming into Canada from cigarette factories on the U.S. side of Akwesasne [St.Regis]."[21] Media reports have also pointed to illegal cigarette factories in operation on the Kahnawake reserve located near Montreal.[22, 23]

What is the size of the current smuggling and contraband market?

Unfortunately, there is no way of knowing for sure the size of the current contraband market since none of these factories are reporting their production output. However, anecdotal evidence indicates that it has grown considerably over the past few years.

In fact, it has become enough of a problem to prompt the Canadian tobacco industry to make repeated public calls for the federal government and provinces to address the issue.[24, 25] However, it is important to note that the industry is largely to blame for the current situation. During the initial crisis in the 1990s, it was the availability of industry exports that attracted organized crime groups operating in or around Mohawk territories to the quick and easy financial gains of cigarette smuggling.[7]

Where is the Akwesasne/St.Regis reserve located?

The Akwesasne/St.Regis Mohawk reserve is located 75 kilometres southwest of Montreal and covers a 130 km^2 territory straddling Quebec, Ontario and New York State. The reserve has a population of approximately 13,000.[26]

The reserve's geographical situation presents unique enforcement challenges for Canadian, American and Mohawk authorities.

Nonetheless, several Mohawks were convicted in U.S. District Court in 1998 for smuggling through the reserve, from the U.S. to Canada, products initially supplied by the Canadian tobacco industry in the beginning of the 1990s.[27]

More recently, the authorities have arrested suspects, including Mohawks from Akwesasne, for their involvment in the current cigarette smuggling trade. As part of the crackdown, an illicit manufacturing plant was also shut down.[28]

Unfortunately, the media has reported that the plant in question is in operation again and that only a fraction of the products destined for the black market in Canada are seized by the authorities.[29] Obviously, more needs to be done to curb smuggling.

What does the law say?

The U.S. Court of Customs and Patent Appeals (1937) and the Supreme Court of Canada (2001) have both ruled that aboriginals are not exempt from paying duties when crossing the border in either direction with goods for commercial trade purposes.[30, 31] No treaty or statute grants such an exemption in the United States. In Canada, the traditional trade practice across the border claimed by the Mohawks was not established and therefore not recognized as an aboriginal right.

According to federal and provincial tax laws:

- All manufacturers in Canada, including on-reserve manufacturers, must pay the federal excise tax for all tobacco products shipped to distributors or retailers;
- Aboriginals are exempted from paying the federal Goods and Services Tax (GST) when purchasing goods on a reserve. They are not exempted when goods are imported into Canada. The GST must also be collected when goods are sold on reserves to non-aboriginals;
- Aboriginals are exempted from paying provincial tobacco and sales taxes on products sold on reserves (in Quebec, since distributors are responsible for collecting provincial taxes, a refund system has been put in place for aboriginal retailers). The exemption does not apply for non-aboriginals.[32, 33]

In reality, what is going on?

Unfortunately, cigarettes manufactured on both the Akwesasne/St.Regis and Kahnawake reserves are sold to aboriginals and non-aboriginals alike without any taxes collected, which consequently undermines the public health benefits of higher tobacco prices. Other reserves and clandestine networks operating off-reserves are also selling these products.

The impact is being felt especially in Quebec and Ontario and also, according to a State Department of Health report, New York.[25, 34] However, the smuggling and contraband problem is also spreading to other provinces such as New Brunswick, Nova Scotia, Manitoba and Saskatchewan.[35, 36]

Sadly, it is aboriginals themselves who suffer the most from the sale of low cost cigarettes: recent surveys show much higher smoking prevalence rates in their communities.[37, 38]

The smuggling trade is not limited to cigarettes and has attracted strong criticism from inside the aboriginal community, notably from Akwesasne Grand Chief Michael Mitchell, who wrote in 1989:

> "Our people in Akwesasne have shown that they are against smuggling; they have cooperated with police, and our own Mohawk police have made a number of drug busts. Cigarettes are perhaps the least of our worries. Drugs, liquor, and automatic weapons, all of which are harmful to our people, have been brought into the territory in great quantities."[31]

Are tobacco tax increases the main cause of smuggling?

It is important to dispel here a long-running popular belief. It is wrong to assume that increases in tobacco taxes automatically generate smuggling. Tobacco smuggling is more prevalent in Ontario and Quebec and yet, taxes are much higher in other provinces such as BC, Alberta or Newfoundland.

The blame lies much more on a failure to properly control the illicit supply of tobacco. Effective measures to curb the problem are available but require political will and allocation of resources. Time is also of the essence since delays will only make it harder for governments to deal successfully with the problem.

What solution should be avoided?

The worst case scenario would be to drastically lower tobacco taxes once again. The move would result in an alarming increase in smoking rates.

Furthermore, it wouldn't work because, even if taxes were slashed by half, Mohawk manufacturers would still have an economic incentive to produce and sell tax-free cigarettes in Canada. Manufacturing cigarettes is really a cheap operation. It could still be a profitable venture for illicit manufacturers to sell their products at $12 a carton.

As mentioned earlier, the main reason why the tax rollback in 1994 worked was because the Canadian tobacco industry voluntarily stopped exporting large volumes of its own cigarettes to the U.S.

What options can further protect tobacco taxation?

1. Control of raw materials

Issue: A key problem is the fact that Canadian federal and provincial inspectors do not have access to some manufacturing facilities on reserves to make sure that they have all their mandatory licences and comply with fiscal and health laws. For example, it has been reported that some Mohawk leaders are blocking inspectors from entering the Kahnawake reserve.[22]

Solution: Prohibit the supply of raw materials to unlawful tobacco manufacturers.

If inspectors cannot enter reserves, Canadian and American authorities need to act outside Mohawk territory by introducing (or strictly enforcing) legislation making it illegal for suppliers to ship raw materials, such as cigarette filters and paper, to any manufacturer that does not have its mandatory licences or does not comply with fiscal and health laws.

As an example, the Quebec government amended its *Tobacco Tax Act* in 2004 to make it illegal to sell or ship raw tobacco to unlicensed manufacturers.[39] For the 2006 fall period alone, the Quebec authorities have intercepted more than 250,000 kgs of tobacco, a large portion bound for the Kahnawake reserve near Montreal.[40]

Penalties need to be sufficiently steep to discourage any supplier from still trying to do business, in spite of any prohibition, with unlawful manufacturers. Suppliers should also be required to submit regular reports to the authorities for all of their shipments.

2. Tobacco manufacturing licences

Issue: The federal government has granted many manufacturing licences to on-reserve cigarette production facilities.[41] However, many of these facilities don't have the required provincial licence to operate. Many also fail to collect and remit tobacco taxes to the authorities. Furthermore, their cigarettes do not necessarily meet the mandatory fire-safety standard and they are often shipped in plastic bags or in packages without any illustrated health warnings.

Solution: Federal and provincial governments should immediately revoke licences from any cigarette manufacturer operating illegally.

Considerable effort and resources were spent to finally submit tobacco products to the current regulatory framework to better protect the Canadian population from their devastating health impact. Any manufacturer who deliberately operates outside that regulatory framework should automatically lose its licences.

For example, the federal government should not hesitate to revoke its licence if a tobacco manufacturer operates without a mandatory provincial licence and vice versa. The same should be done if manufacturers don't comply with fiscal obligations or continue to market products which do not meet manufacturing or packaging standards.

As suggested in the previous section, the next logical step would obviously consist of notifying suppliers of raw materials that these manufacturers are no longer licensed and therefore can no longer do business with them.

3. Tax-exempt tobacco products

Issue: Because status natives are exempt from provincial tobacco taxes, provincial sales tax and federal GST for on-reserve purchases, there is the potential for abuse. Some non-aboriginals illegally purchase tax-exempt products on reserves. Some products supposedly intended for on-reserve sale are diverted illegally into off-reserve distribution channels.

For example, brands such as DK's and Putters, manufactured by Grand River Enterprises, located on the Six Nations reserve in Ontario, have been found repeatedly in illegal distribution channels.

Solution: Introduce quota and refund systems for tax-exempt tobacco products supplied to First Nation reserves

All provinces should implement a quota (based on reserve population) for the quantity of tax-exempt tobacco supplied to each reserve. Wholesalers would be responsible for ensuring that no product is supplied in excess of the quota. Retailers could acquire any brand they want for sale on the reserve, but the total amount acquired by all retailers cannot exceed the reserve quota. BC, Saskatchewan, Manitoba, Ontario, New Brunswick and Nova Scotia currently have a quota system. Obviously, the initiative relies very much on the governments' commitment to adequately enforce the quota.

All provinces should also implement a refund system whereby the manufacturer/distributor includes a deposit equal to the provincial tobacco tax. After an on-reserve retailer makes sales to eligible status natives, the retailer could apply to the province for a monthly refund. A refund system is currently in place in Alberta, Saskatchewan, Manitoba, Quebec, and New Brunswick.

It is important to have both quota and refund systems. A quota helps prevent abuse in the quantity of refunds claimed. A refund system makes it much more difficult for a manufacturer to evade the quota system by supplying tax-exempt products to a reserve. There should be a different coloured provincial marking for products intended for tax-exempt on-reserve sale, as BC, Alberta, Ontario and New Brunswick have done.

Better controlling the tax-exempt tobacco entering the reserve helps prevent contraband from leaving the reserve.

4. Tracking and tracing

Issue: Canadian and American authorities still do not have the capability to closely monitor their respective domestic cigarette markets, an oversight which is no longer acceptable considering the harm caused by smuggling.

Solution: Introduce an effective tracking and tracing system.

The problem can be addressed through a key recommendation under the Framework Convention on Tobacco Control (FCTC), a WHO treaty which deals with the global tobacco epidemic and which Canada has endorsed, namely the implementation of an effective tracking and tracing system controlled by the authorities.[42]

The technology is currently available to apply a covert code directly onto a pack of cigarettes. This code could contain information identifying each step in the product's distribution chain from the manufacturer right down to the retailer. Parcel delivery services, such as Federal Express and UPS, use similar systems and pride themselves on their ability to locate a package at all times during its delivery.

Special scanners are then used by inspectors to read the codes on packages, and the extracted information can be relayed to a central computer system for validation. Such a system is valuable for the following reasons:

- It would be possible to quickly identify counterfeit products since only legitimate manufacturers would be able to print the covert code on their products;
- Some tobacco products are simply diverted to the smuggling market during delivery. When such cigarettes are seized, the authorities currently have no way to determine where in the distribution chain the diversion occured. With a tracking and tracing system, the last known scanned entry would obviously be a good starting point for launching an investigation;
- Other cigarette shipments are stolen in transit. The codes of such shipments would be immediately registered in the central computer system, making it riskier for any retailer or individual trying to resell the cigarettes since they can be traced;
- The databank created by the central computer system would be of great value to monitor market shifts across the country. If abnormal drops in legal sales are registered in some regions, it could be easier to locate where smuggling networks are operating.

Tracking and tracing systems are effective for controlling tobacco smuggling. Malaysia opted for such a solution in 2004 and was able to recover approximately US $100 million in extra revenue during the first year alone.[43] The State of California also introduced in 2004 an improved tax stamp system, including tracking and tracing features, and collected US $75 million in additional revenue over a two year span.[44]

The timing is right for the introduction of such a system in Canada, since Imperial Tobacco Canada recently decided to move all its cigarette production to Mexico.[45] As the federal export tax mentioned earlier will no longer apply to Imperial's products, the company would have the ability, once again, to ship cigarettes that would later end up in Canada through smuggling channels, a possibility which must be closed off.

5. Strict liability

Issue: Tobacco manufacturers often blame others, such as criminal organizations, for smuggling their products. They claim that they deliver their products to legitimate customers but no longer have control over them beyond that point.

Solution: Introduce legislation that holds all tobacco manufacturers liable if their products are seized on the smuggling market.

Penalties should be stiff enough so that it would become a financial incentive for manufacturers to stop supplying any customer (distributor or retailer) involved in any kind of smuggling activity.

If the industry argues that such a solution is not practical, it should be noted that Philip Morris International signed an anti-contraband and anti-counterfeit agreement with the European Community in 2004, which included strict liability provisions.[46] The company has to make significant payments when the authorities seize its own cigarettes on the smuggling market.

6. First Nations tobacco tax

Issue: People on reserves working for and profiting from the manufacturing and shipping of contraband tobacco will obviously oppose any attempts to control the problem. However, it is only a matter of time before the Canadian and American governments stop tolerating the situation and finally take serious action for the purpose of protecting their own tobacco tax policy.

Solution: Accelerate ability of First Nations to impose their own tobacco taxes.

Tax agreements with First Nations might be explored as a means for protecting the public health benefits of tobacco taxation.

In 1998, the Government of Canada began providing tax powers for and entering into bilateral agreements with First Nations, making it possible for them to enact by-laws imposing their own tax on sales on reserves for fuel, tobacco products and alcoholic beverages. That tax is known as the First Nations Sales Tax (FNST).

Some of those First Nations who impose taxes subsequently began to request a broadening of the tax powers so First Nation sales taxes would be applicable to the full range of goods and services that are taxed under the GST. In 2003, the Government of Canada enacted the *First Nations Goods and Services Tax Act* (FNGSTA).[47]

The FNGSTA enables a First Nation to enact a law that imposes a tax like the GST on First Nations reserves or settlement lands. The FNGSTA also makes it legally possible for Canada to not impose the GST where the FNGST applies. At least eleven First Nations have chosen to implement the FNGST since 2004. Work is also under way currently with several other First Nations to bring them into the FNGST framework.

Higher prices would definitely lower tobacco consumption amongst First Nations communities. New revenues could be used in part to replace the recent elimination of the $10.8 million in funding for the First Nations and Inuit Tobacco Control Strategy by the federal government.[48] The revenues could also help fund much-needed economic and social programs for poverty-stricken communities.

Conclusion

Tobacco taxation is the most effective public health policy in lowering tobacco consumption. Unfortunately, the policy has been regularly under siege because of smuggling of cheaper tobacco products. Currently, illicit manufacturing operations located on the Akwesasne/St. Regis reserve are the main source of the smuggling market in Canada.

However, tobacco smuggling is not the result of higher tobacco taxes since it is virtually non-existent in some Canadian provinces with higher tax rates. Rather, it is the fact that illicit manufacturers are still operating with complete impunity. Governments need to urgently address the lack of enforcement issue. Solutions are available:

1. Prohibit the supply of raw materials to unlicensed manufacturers;
2. Revoke licenses of unlawful tobacco manufacturers;
3. Impose quota and refund systems for tax-exempt tobacco products supplied to First Nation reserves;
4. Introduce an effective tracking and tracing system;
5. Introduce legislation that holds all tobacco manufacturers strictly liable if their products are seized on the smuggling market;
6. Accelerate ability of First Nations to impose own tobacco taxes.

Tobacco remains first and foremost a public health issue. Thousand of lives are at stake. The availability of cheap cigarettes means that more kids will become addicted to cigarettes and fewer smokers will try to quit. Tobacco smuggling requires immediate action.

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