Part 4

Cigarette Smuggling — Myths and Realities

Fear of smuggling remains the single biggest obstacle to implementing a health-based tobacco taxation policy in Canada's five low-tax jurisdictions. This fear is likely the product of several years of very deliberate public relations efforts by the tobacco industry — efforts that can safely be described as *myth making.*

The mythical view of cigarette smuggling, as advanced by tobacco manufacturers, runs something like this: through the 1980s and early 1990s, Canadian governments, urged on by health agencies, increased cigarette taxes past the point that consumers (i.e. smokers) were willing to tolerate. Some smokers began crossing into the United States to buy cigarettes, taking advantage of the huge tax differential between the two countries. Realizing there was a tremendous market, small-time smugglers, primarily in the Akwesasne area, began running larger and larger quantities of US-bought cigarettes across the border. Tobacco companies were powerless to stop the spontaneous tax revolt by millions of otherwise law-abiding smokers. Finally, faced with a massive black market, governments did the only sensible thing and rolled back tobacco taxes. Fortunately, claims the Canadian tobacco industry, tax levels have no influence on the "adult choice" of whether or not to smoke.

By force of repetition, this mythical view has become accepted by many as the definitive interpretation of the 1992-94 "smuggling crisis." Yet it ignores several significant facts:

Fact: Prices in seven of 12 Canadian jurisdictions came down by only $5 per carton in 1994. High taxes have been sustained in Western Canada and Newfoundland. If smuggling were a spontaneous tax revolt by individual smokers, why has there been no apparent, significant erosion of legitimate sales due to smuggling into these regions?

Fact: Several countries have higher cigarette taxes than Canada's high-tax provinces, including Australia, Great Britain, Ireland, Norway, Sweden, Finland and Denmark.

Fact: In Europe, smuggling tends to be worse in to Southern Europe than in to Northern Europe, though prices are generally *lower* in the South than in the North.[22]

[22] See "Cigarette smuggling in Europe: who really benefits," by Luk Joosens and Martin Raw, in *Tobacco Control*, 1998;**7**:66-71.

"After the tax cut that was supposed to break this vicious cycle, both levels of government were again denied additional billions in revenue while the companies recorded excellent profits. With the help of smuggling and lower prices during these years, tobacco use increased, especially among the most vulnerable groups -- and in particular, young people. This did not, however, prevent the industry from proclaiming its "right" to promote its products.

These recent revelations have destroyed, once and for all, the image of innocence, the pure-as-driven-snow image, that the tobacco industry has always drawn for itself, and paid for with its own advertising. It's time now to move on to an in-depth inquiry into the practices of the tobacco industry with respect to both the manufacturing and marketing of its products. Compared to the United States, Canada has fallen way behind. It's time to catch up."

Jean-Robert Sansfaçon, "Respectable accomplices" Le Devoir, January 7, 1999 (editorial, translation)

Fact: Cigarette prices in U.S. border states are now considerably higher than in Ontario and Quebec. Indeed, Central Canada now has lower prices than anywhere in the United States. Why has no smuggling been noted flowing from Canada to the U.S.?

Fact: Tobacco manufacturers benefited financially from smuggling. More than 90% of smuggled cigarettes in Canada originated in Canadian factories and were exported to the United States, only to return to Canada as contraband. Manufacturers earned their profit whether or not product was seized by law enforcement officials. The availability of contraband encouraged consumption while pressuring governments to reduce tobacco taxes.

Fact: The tax rollback of 1994 halted the long-term downward trend in per capita cigarette consumption in Canada, and resulted in major jumps in youth smoking in Central Canada. (See Part 5.) Teenagers and young adults provide the overwhelming source of new smokers, and are therefore crucial to the tobacco industry's long-term sales and profits. The Canadian tax cut was also a major argument for the American industry, as it lobbied heavily against cigarette tax increases in that country subsequently.

Recently, evidence has emerged of direct corporate involvement in contraband activity. Convictions have been obtained at both the corporate and managerial levels. Though police investigations in both Canada and the United States are on-going, they provide another reason to be sceptical of the industry's good faith on the smuggling issue. At the very least, the tobacco industry has a significant financial interest in promoting its particular view of smuggling's causes and the available policy solutions.

The Historical Context

Until the early 1980s, there was no discernible upward trend in the real price of cigarettes in Canada. What tax increases there had been since the 1950s had been eaten away by inflation. And thanks to rising incomes, cigarettes were actually far more affordable to Canadians than in the early 1950s. In the early 1980s, Canada had the highest level of per capita cigarette consumption in the world.

Health groups discovered the benefits of tobacco tax increases at about the same time as Canadian governments stepped up their search for new sources of revenue. Increased cigarette taxes could be relied upon to cut smoking, especially among young people, bring in extra revenue, and be popular with the public. The result was a slow but accelerating rise in cigarette prices, and a dramatic drop in cigarette consumption and youth smoking. By 1991, according to government surveys, only 23% of teens aged 15 to

19 were current smokers[23] — down from 43% in 1981.[24] In a single decade, Canada had almost halved youth smoking rates as it moved to put cigarette prices on a par with those in Northern Europe.

Not surprisingly, these tax increases caused alarm amongst Canada's tobacco manufacturers, and at their corporate headquarters in the United States and Europe. At first, the industry responded publicly with its usual boilerplate arguments[25]:

- Tax increases cause inflation.

- Tax increases cause a decrease in consumption, leading to direct job losses in the tobacco industry and indirect losses amongst suppliers. "The unprecedented series of tax increases poses a significant threat to the long term well-being of this important Canadian industry and its suppliers, customers and shareholders," complained Rothmans Ltd. in its 1983 annual report.

As tobacco companies were doubtless annoyed to discover, these arguments carried little weight with Canadian governments, who correctly realized the tremendous public health gains associated with decreased consumption. The 1991 federal tax increase of $6 per carton appears to have triggered a change in strategy, with a new emphasis on the dangers of smuggling.

In reaction to the federal tax hike, the tobacco lobby launched a major advertising campaign suggesting that then-Finance Minister Michael Wilson "wants you to step outside for a cigarette" — step outside to the United States, that is. At the same time, Canadian manufacturers began increasing their cigarette shipments to the United States. There has never been a market for Canadian-style cigarettes among American smokers, who are used to tobacco blends with a notably different taste. Nor have U.S. cigarettes ever achieved significant market penetration in Canada, with a longstanding market share of less than 1%. As a result, the only legitimate reason to ship cigarettes south would have been to cater to Canadians travelling in the United States.

In the early 1990s, however, there were, increasingly, some pressing **illegitimate** reasons to ship cigarettes south. Various criminal groups had discovered there was money to be made by transporting cigarettes across the border into Canada for sale on the black market. The Mohawk community of Akwesasne, positioned on the Canada-U.S. border,

"This week, an affiliate of RJR Reynolds Tobacco International pleaded guilty and was fined $15 million for helping smugglers slip exported Canadian cigarettes back into Canada through a Mohawk reserve that straddles the border near Cornwall, Ont.…This conviction has real significance. Now we know how the tobacco industry can behave. A company has been found to have participated in actions that broke Canadian law and subverted the tax system.

Perhaps we shouldn't be surprised at such behaviour from an industry with a history of deception in the way its products are developed, manufactured and marketed. Perhaps we shouldn't be surprised when we know how actively Canadian cigarette manufacturers co-operated with smugglers ¾ by increasing their exports from 500 million cigarettes a year in the late 1980s to almost 20 billion before Canada cut its tobacco taxes.

Still, it's reassuring to know that criminal activity has been exposed and that a little more moral ground has been yanked from under the feet of the tobacco industry. If Canada decides to raise taxes again, the cigarette manufacturers won't be taken seriously if they warn about smuggling."

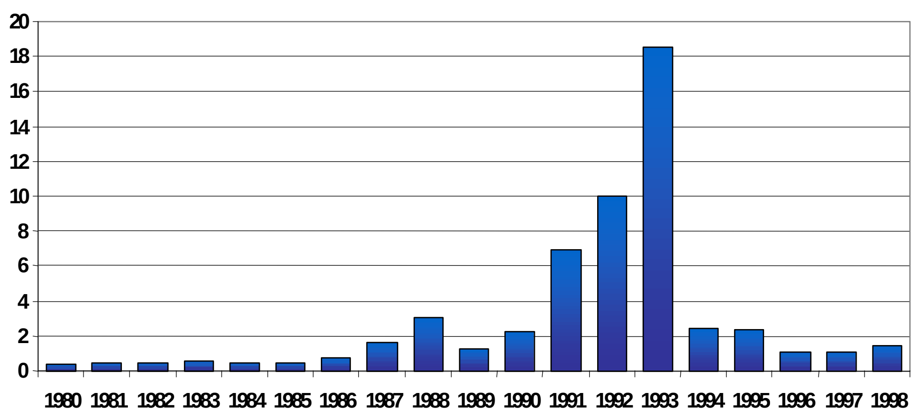
Montreal Gazette, "Caught in the act," editorial, December 26, 1998.

[23] Statistics Canada, General Social Survey, 1991.
[24] Statistics Canada Labour Force Survey, 1981.
[25] See also "Key Area Paper: Excise Taxation of Tobacco Products," a 1992 document from British American Tobacco, which controls Canada's Imperial Tobacco, produced as document 699138223 in the **State of Minnesota et al. v. Philip Morris, Inc., et al.** case. This paper lists arguments to be used to fend off tax increases and lobby for tax rollbacks.

was a particular focal point. A long-running dispute about gambling had already led to a militarization of the community and tense relations with New York State authorities, making it a difficult area for police and customs authorities to intervene.

Canadian cigarette companies have never denied that most of the merchandise shipped south during this period was destined to be re-imported as contraband. But they denied dealing directly with criminals. Limiting their “exports” to the United States would simply mean replacing Canadian-made contraband with American-made contraband, they claimed.[26] This last argument ignored Canadian smokers’ dislike for American-style cigarettes, and the simple fact that American brands, had they been smuggled in large quantities, would have been much more obviously visible as contraband. Further, Canadian companies would quickly have taken action to address smuggling that reduced their collective market share, such as smuggling of new brands with Canadian-style tobacco blends.

Figure 11
Canadian Cigarette Exports (in billions) to the United States, 1980-1986



Sources: Statistics Canada, Exports by Commodity, Catalogue 65-004, December issues, 1980 – 1998. See Appendix A, Table J.

[26] “If there’s smuggling, we’re unapologetic that it should be Canadian cigarettes,” said industry lobbyist Bill Neville. Quoted in “Threats derailed tobacco tax. Companies warning led Ottawa to ease ‘war on smugglers,’” in *The Globe and Mail*, May 22nd, 1992, pp. A1, A6.

Criminal Investigations

As has since emerged in several American criminal cases, the tobacco industry did more than simply fill orders for Canadian cigarettes placed by U.S. wholesalers. By early 1992, for example, truckloads of RJR-Macdonald cigarettes were being sold directly to an organized smuggling ring in upstate New York; one long-time executive with RJR-Macdonald and its U.S. parent, R.J. Reynolds, recently pleaded guilty in connection with this criminal activity.[27]

In late 1992, R.J. Reynolds set up a subsidiary, Northern Brands International, specifically devoted to selling Export "A" cigarettes in the United States. On Dec. 22, 1998, following an investigation by U.S. federal authorities, Northern Brands International pleaded guilty to evading U.S. excise taxes on Export "A" cigarettes destined for the Canadian black market. The company was convicted and fined US$15 million. [28] Police investigations into RJR's role continue.

Criminal investigations of tobacco companies have not been limited to RJR-Macdonald brands. In 1995, U.S. authorities raided the headquarters of tobacco company Brown & Williamson, the U.S. sister company of Imperial Tobacco, looking for evidence of corporate involvement in smuggling Canadian cigarettes back from duty-free warehouses in Louisiana. This led to the 1997 guilty plea and conviction of Michael Bernstein, Brown & Williamson's East Coast region account manager.

More recently, the largest U.S. tobacco company, Philip Morris, disclosed in a Securities and Exchange Commission filing that it too is under investigation by American authorities for alleged involvement in smuggling along the Canada-U.S. border.[29] Philip Morris International owns 40% of Canada's Rothmans, Benson & Hedges.

In 1992, the Canadian federal government did make one serious attempt to cut off cigarette smugglers' supply lines at the source, i.e. the factory gates of Canada's big three tobacco manufacturers. On Feb. 12 of that year, the government imposed an $8 per carton export tax, designed to make smuggling uneconomical. Shipments to the U.S. dropped steeply.

"700 RCMP officers will be dedicated to anti-contraband operations, double the current level…
Our stepped up enforcement measures will apply everywhere in Canada. The police will seize contraband and lay charges wherever it is appropriate to do so. My message is simple: anyone participating in the contraband trade in any capacity whatsoever is breaking the law. They will be subject to the full range of sanctions and penalties provided by the law".

The Honourable Herb Gray,
Solicitor General of Canada
News conference,
February 8, 1994.

[27] United States of America v. Leslie Thompson, a/k/a Les Thompson, Criminal Action No. 99-CR-93 (TJM), Plea Agreement, dated March 25th, 1999.
[28] United States of America v. Northern Brands International, Inc., Criminal Action No. 98-CR-, Plea Agreement in a Criminal Case, dated Dec. 22nd, 1998.
[29] Philip Morris Companies Inc., Form 10-Q, Quarterly Report to the Securities and Exchange Commission, filed November 16, 1998.

"In February 1992, the Canadian government imposed a $8 per carton tax on cigarette exports in the hope of reducing, if not eliminating, cigarette contraband. However, the tax was repealed in April 1992 as a result of industry pressure involving manufacturing facility closings, moving export production overseas and buying tobacco abroad.

When the export tax was announced. RJR Macdonald moved make/pack equipment from its Canadian production facility to Puerto Rico and began manufacturing Canadian Export A brand cigarettes. This brand accounts for over 85% of the company's total manufactured cigarette volume. While the Puerto Rican made volume is unknown, it is believed to be small. The Puerto Rican volume is intended for sale outside of Canada, however, some of it seems to have found its way back into the country. Even though the export tax was repealed, Puerto Rican production has continued."

Canadian Cigarette Industry Review, 1993. Philip Morris p. 2045680323

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Manufacturers responded with a massive lobbying effort, including threats to move their production facilities out of the country in order to render the export tax meaningless.[30] Less than two months later, the government buckled under the pressure and repealed the tax, in return for industry promises to co-operate in fighting smuggling. Despite these commitments, Canadian tobacco manufacturers continued to increase their shipments to New York state. In 1993, the industry stepped up public relations efforts to obtain a major tax rollback.

In a bizarre reversal of its past position in Canada, the tobacco industry began publicly claiming that higher cigarette taxes have no effect on smoking rates. This denial of normal economic principles was backed up with a study specially commissioned by the industry.[31] Meanwhile, tobacco industry lobbyists in the United States, attempting to fend off a proposed federal tax increase in that country, continued to maintain exactly the opposite.[32]

The industry also used every opportunity to highlight the extent of smuggling, for example by commissioning forensic accountants to produce estimates of the market share of contraband cigarettes. The tobacco industry's spin was clear: smuggling was out of control and caused by overly high tax rates imposed by unrealistic politicians.

In January 1994, Quebec news was dominated by an apparently spontaneous tax revolt by convenience store owners, who began openly selling smuggled cigarettes to push for a tax rollback. *La Presse* soon uncovered close links between the "tax revolt" organizers and the Association des détaillants en alimentation (ADA), a group partially funded by the tobacco industry and run by a former industry public relations employee. A representative of the Canadian Tobacco Manufacturers' Council was present at a meeting where "spontaneous" illegal sales were planned.[33]

Though the story was front-page news, the Quebec and federal governments decided to go ahead with a major tax rollback in early February. Including sales taxes, the net result was to reduce the real price of cigarettes in Quebec from $47 to $23 per carton.

[30] See, for example, Imasco's 1991 annual report, published in 1992 during the period when the export tax was in effect. In reference to the "misguided" tax, CEO Jean-Louis Mercier commented in his report: "We do not condone smuggling but we are prepared to take whatever steps are necessary to protect the company's interests in legitimate export markets. Ultimately, this could involve transferring some production outside Canada." (p. 6 of annual report.)
[31] Paul M. Jacobsen and M.C. McCracken, *Smoking Trends in Canada: An Analysis of the Data*, February 1993 Informetrica study.
[32] See for example "The Facts about Tobacco Taxes and Jobs," entered as Philip Morris document no. 2044720151 in the **State of Minnesota et al. v. Philip Morris, Inc., et al.** case.
[33] "Les Épiciers ont créé de toutes pièces le mouvement des 'dépanneurs généreux," in *La Presse*, Jan. 27, 1994, pp. A1-A2. See also: "Retailers group links protesters to tobacco firms," *Globe and Mail*, Jan. 28, 1994, p. A4.

Fearful of a possible surge in inter-provincial smuggling, Ontario, New Brunswick and PEI soon followed with their own cuts. Nova Scotia held out a few months longer, but eventually cuts its taxes also. Western Canada, Newfoundland and the two territories held the line. In contrast, the Northwest Territories increased its tobacco taxes in 1994 by $5 per carton, to replace the $5 per carton federal decrease.

At the time of the federal tax rollback, the government restored the 1992 tax on tobacco exports, albeit with new exemptions, and imposed a surtax on tobacco company profits, both of which are still in effect.

In the opinion of PM Inc. and PMI, increases in excise and similar taxes have had an adverse impact on sales of cigarettes. Any future increases, the extent of which cannot be predicted, could result in volume declines for the cigarette industry, including PM Inc. and PMI, and might cause sales to shift from the premium segment to the discount segment.

Cigarette company Philip Morris, 10-Q filing with the U.S. Securities Exchange Commission, Aug. 12, 1999, p. 30.

The Disappearing, Re-Appearing Price Differential

Just as Canadian public health was suffering its biggest setback in decades, with the tax rollback, the tobacco industry in the United States came under unexpected attack from a new quarter. In 1994, the State of Mississippi filed a lawsuit against cigarette manufacturers to recover health costs incurred to treat smokers for tobacco-induced disease. This set off a series of lawsuits across the United States, forced the release of tens of millions of hitherto secret industry documents, and also made it politically much easier to raise excise taxes.

In November 1998, U.S. tobacco companies agreed to pay out US$ 206 billion over 25 years to settle outstanding claims from 46 states. This was over and above the US$ 40 billion agreed to in previous settlements with Mississippi, Florida, Texas and Minnesota. The result was an almost immediate increase in American cigarette prices to cover the cost of the settlement. U.S. manufacture price increases in 1997 – 1998 totalled CDN$11, plus a further CDN$ 3 in August 1999.

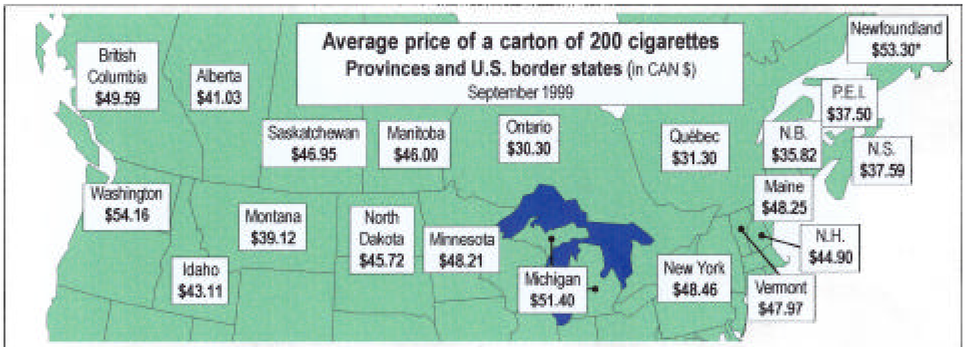
The combined effect of the settlement, assorted state tax increases, and the falling Canadian dollar is that **cigarettes are now more expensive** in **every single state** in the United States than they are in Ontario and Quebec. This includes tobacco-belt states such as Kentucky, where the state excise tax is only 3¢ per pack.

In all but one of the U.S. states bordering Ontario and Quebec, a carton of cigarettes is now over CDN$17 Can. more expensive than north of the border. In the remaining state, New Hampshire, a carton is CDN$ 13 more expensive than in neighbouring Quebec.

Figure 12

Cigarette prices along the Canada-United States border, September 1999

> *"Cigarette smuggling is not caused principally by "market forces". It is mainly caused by fraud, by the illegal evasion of import duty."*
>
> **Luk Joossens and Martin "Raw cigarette smuggling in Europe: who really benefits?" *Tobacco Control* 1998;7:66-71 (Spring)**



Notes:
Canadian data as of July 1999. U.S. data taken from an industry publication, *The Tax Burden on Tobacco*, adjusted for estimated price increases due to litigation settlement, July 1999 tax increase in New Hampshire, and manufacturers' increase announced to wholesalers Aug. 27, 1999. ("Cigarette Packs to Jump 22 Cents," Associated Press, Aug. 31, 1999.) At Sept. 7th exchange rate: $1 U.S. = $1.4913 CAN.
Prices include all state, provincial and federal taxes. Local sales and tobacco taxes in U.S. are excluded.
*Lower taxes are in effect in part of Labrador.
Source: Smoking and Health Action Foundation, Ottawa.

Aboriginal Status and Cigarette Smuggling

The 1989 Oka crisis and the role of Akwesasne as a point of entry for smugglers have left some policy-makers and members of the general public with the impression that the legal status of aboriginal Canadians in general, and of Mohawks in particular, is an insurmountable obstacle to any major cigarette tax increase. This view appears often to be based on lack of knowledge of the legal situation as well as on pessimism on the state of relations between aboriginal and non-aboriginal Canadians.

First, a quick note on the tax status of aboriginals. Under Canadian law, tobacco products sold on Indian reserves to status Indians (as defined by the *Indian Act*) are not subject to provincial tobacco taxes, provincial sales taxes, the federal GST or the Harmonized Sales Tax (HST, in effect in New Brunswick, Nova Scotia and Newfoundland). Federal tobacco taxes do apply, however. On-reserve sales to non-Indians must include all of these taxes. All sales off-reserve, whether to Indians or non-Indians, must include all taxes.

Some aboriginals, in particular some Mohawks, have argued that they never ceded control of international commerce to the British or Canadian Crown and that it is therefore perfectly legal for them to cross the Canada-U.S. border with shipments of cigarettes (or other goods) and sell them to non-aboriginals. This interpretation has been rejected by Canadian courts.[34] It is, at any rate, largely irrelevant. With respect to the prospects of preventing a repeat of the 1992-94 smuggling crisis, the issue is **not** whether governments can "control" aboriginal smugglers. The issue is whether they can control the smugglers' suppliers, i.e. Canada's tobacco companies. In this respect, the export tax re-instated in 1994 is an obstacle to any resurgence in smuggling, and would be more so if deficiencies in the current export tax are corrected.

It should also be noted that aboriginal communities are far from overjoyed at being misused as centres of organized crime. Aboriginal leaders are also increasingly expressing concern about the exceptionally high smoking rates in their communities. In various parts of Canada, several recent initiatives have directly addressed the issue of tobacco taxation on reserves. Authorities in Kahnawake, near Montreal, recently signed an agreement with the Quebec government with respect to tobacco, alcohol and fuel taxes, under which the community is setting up a system to restrict tax-free sales of these products to community members.[35] Meanwhile, in British Columbia, the Kamloops, Cowichan, Westbank and Sliammon reserves have authority to collect their own tobacco taxes as part of a pilot project.

The Export Tax

When smuggling was at high levels in 1991-1994, the bulk of contraband originated in Canada, was exported to the U.S., and returned to Canada as contraband. Most of the exports to the U.S. were made on a tax-exempt basis, that is without even paying U.S. tobacco taxes. To address this export supply ending up as contraband, an $8.00 per carton export tax was imposed in February 1992, only to be repealed less than two months later following heavy industry lobbying.

On February 8, 1994, the federal government reimposed the export tax, this time with exemptions for brands not sold in Canada, for products on which the foreign national tobacco tax was paid, and for products totalling not more than 3% of prior year's production. In November 1996, a further exemption was added, namely shipments going to duty-free outlets. In the 1999 federal budget, the exemption for prior year's production was reduced from 3% to 2.5%.

The fact that tax-exempt tobacco is available in U.S. duty-free outlets does not undermine the opportunity that now exists to increase Canadian taxes in light of the new high U.S. prices. Past smuggling into Canada did not arise because of the existence of duty-free

[34] R. v. Vincent (1993), 12 O.R. (3d) 427 (Ont. C.A.).
[35] *Agreement on fiscal matters related to tobacco, petroleum and alcohol products*, signed March 30th, 1999.

"New Democratic Party Health Critic Judy Wasylycia-Leis called on the federal government today to substantially increase tobacco taxes and to dedicate part of the revenue to a campaign to discourage smoking by young people.

'The significant rise in U.S. tobacco prices has opened the door for the Liberal government to take decisive action on this vital health concern,' said Wasylycia-Leis. 'There has been a tremendous outpouring of support for strong measures to discourage youth smoking.'

New Democratic Party news release, January 14, 1999.

tobacco outlets, but because of the complicity and actions of manufacturers. Police scrutiny and a properly drafted export tax will prevent manufacturers from re-starting tax-exempt exports to the U.S. that can come back to Canada as contraband. If there is no supply, there is no contraband.

The U.S. market has demonstrated that it can sustain high prices notwithstanding the fact that there are duty-free outlets on the other side of its northern and southern borders. If the U.S. can sustain high prices without smuggling, so can Canada.

The current export tax should be reformed. The only exemptions should be brands not sold in Canada, and 1.5% (down from 2.5%) of prior year's production (this 1.5% would be sufficient to cover traditional level legitimate exports to duty-free outlets plus to tax-paid distribution). The 1.5% could be defined to cover cigarette equivalent units (cigarettes, sticks, fine cut). At present, the exemptions to the export tax are so extensive that there is insufficient control on the quantity of tobacco products that manufacturers could potentially export without the export tax.

Conclusions and Recommendations

In our view, the primary cause of the 1992-94 cigarette smuggling crisis was a high-risk tobacco industry strategy to reverse the world precedent-setting Canadian tax increases of the 1980s and early 1990s. Smuggling was supply-driven, with the supply provided by Canadian manufacturers.

Much of Canada is now at the low end of tobacco tax levels in developed countries, and more is known about corporate involvement in past smuggling activities. Both facts make a repeat of the tragic events of the early 1990s unlikely.

Nevertheless, several policy measures could effectively reduce the smuggling risk still further:

- Loopholes in Canada's existing export tax on cigarettes should be closed. In particular, the blanket exemption for cigarette shipments going to foreign (mostly U.S.) duty-free stores should be eliminated, as should the exemption for products on which the foreign tax has been paid. Instead, there should be a total ceiling of 1.5% of prior-year production for all exemptions to the export tax, whatever the stated destination of the export shipments, and this total ceiling should truly reflect reasonable levels of legitimate exports. The exemption for brands not sold in Canada could remain.

- The export tax should be increased to $12 per carton, with an equivalent amount for tobacco sticks and roll-your-own tobacco. This would further cut into the profit margin of anyone trying to smuggle back duty-free, Canadian-made cigarettes from the United States.

- Canada should entirely eliminate duty-free sales of tobacco, which provide access to low-priced tobacco and reduce government revenue. The European Union recently eliminated duty-free tobacco sales for travellers within the EU, establishing a precedent for other regions. Norway and Australia are also considering similar steps.[36] Canada should enter into a bilateral agreement with the United States, the EU and other jurisdictions until a multilateral agreement can be reached.

- The quantity of duty-free tobacco products that returning residents can bring into Canada should be reduced. The present quota is unreasonably high: 200 cigarettes, *plus* 200 tobacco sticks, *plus* 200 grams of roll-your-own, *plus* 50 cigars. A more sensible approach would be to set an overall quota of 200 cigarettes or cigarette-equivalent units.

- Clearly visible, province-specific tax markings should be printed on cigarette packs. This would address concerns about inter-provincial smuggling, and make it impossible to simply re-wrap smuggled packs with fraudulent 'tax-paid' tear tapes. This measure was announced in the 1999 federal budget and should be implemented as soon as possible.

- Canada should support the development of the International Framework Convention on Tobacco Control, with provisions to address international tobacco smuggling.[37]

- The RCMP should step up its enforcement activities against cigarette smuggling, and investigations should concentrate on major suppliers of contraband, rather than on small-time smugglers. Corporate involvement in smuggling should be one of the issues investigated by a Royal Commission of Inquiry into the tobacco industry, as recommended by the National Tobacco OR Kids Coalition.

"The Minister of National Revenue will be making changes to the requirements for stamping and packaging of tobacco products under the Tobacco Departmental Regulations to further improve enforcement. The security features of tear strips, which are used as stamps under the Excise Act to provide evidence of payment of excise duties, will be improved. In addition, a province-specific identifier will be required on each package containing tobacco products. These changes will ensure that the identification of the intended province of sale cannot be altered and will assist enforcement agencies in controlling the illegal movement of tobacco products from provinces with reduced rates of federal tobacco taxes to other provinces."

The Budget Plan 1999, p.217

[36] Bloomberg News, "Norway's Finance Minister Considers Scrapping Tax-Free, DN Says," Feb. 4, 1999.
[37] In May, the 191 member governments of the World Health Assembly, the governing body of the World Health Organization, approved plans to begin work on drafting such a convention. See WHO press release: "World Health Assembly Paves Way for Framework Convention on Tobacco Control," May 24, 1999.

"Where the government went wrong, the single biggest blunder it made in this war on cigarette smoking was in 1994 when it capitulated and dramatically decreased the amount of tax on a package of cigarettes."

Progressive Conservative M.P. Greg Thompson, House of Commons, September 30, 1998.

Fear of a resurgence in smuggling should not block governments from restoring tobacco taxes to levels more favourable to public health. A $10.00 per carton increase in the low-tax provinces will not prompt significant smuggling for the following reasons:

- As shown in the tax map on page 30, the retail price of a carton of cigarettes in Ontario and Quebec is now about CDN$17.00 per carton *lower* than in neighbouring U.S. states such as New York and Maine. New Brunswick prices are about CDN$ 10.50 Can. per carton lower than in neighbouring Maine. At the time of high smuggling in 1993, the reverse was true, with prices in Canada dramatically higher than in the U.S.

- Unlike in 1993, there is now an export tax in place that will help prevent Canadian companies from engaging in massive exports of product intended for the contraband market. Canadian companies will no longer feed into the smuggling chain. This export tax can easily be improved to remove any existing deficiencies. If there were to be smuggling of non-Canadian cigarettes, then Canadian companies would actively co-operate with police to stop this type of smuggling.

- With an effective export tax in place, U.S. reserves and duty-free stores cannot be expected to be a significant source of contraband into Canada since these outlets cannot obtain tax-exempt product (without the export tax) directly or indirectly from Canadian manufacturers, except in small, traditional quantities that would serve the legitimate duty-free market. Similarly, smuggling from Canadian reserves should not increase significantly if smugglers cannot obtain tax-exempt Canadian product (without the export tax) from Canadian manufacturers via the United States.

- Police, governments and the media are now aware of the tactics and illegal activities the industry previously used to cause smuggling. Tobacco companies would not engage in the same behaviour again with impunity. Further, RJR-Macdonald is no longer controlled by R.J. Reynolds of the United States, but rather by Japan Tobacco, in which the Japanese government has a controlling share. This should have a chilling effect on contributions to smuggling.

- Canadian cigarettes exported to the U.S. do not have the prominent black and white warnings now found on packages sold in Canada. This difference helps to distinguish packages legitimately and illegitimately available in the Canadian market.

- Quebec restructured tobacco taxes in 1998 to remove provincial sales tax on tobacco but to increase tobacco tax by an equivalent amount. This has helped address tax evasion through Indian reserves, where sales tax was often not being collected.

Further changes to the Quebec *Tobacco Tax Act* help to control the quantity of tax-exempt tobacco available on reserves.

- Higher tobacco taxes in Ontario and Quebec would reduce the price differential between Central Canada and the West, and thus *reduce* what inter-provincial smuggling there may be now or in the future.

Figure 13
Advertisement for individually marked cigarettes

This product advertisement from the trade journal "Tobacco Reporter" illustrates the capacity to individually mark cigarettes and to protect trade marks – and tax revenues – from counterfeit and smuggling.

Tobacco Reporter*, *May 1999, p. 15.

Cigarette Smuggling — Key Dates

"ITL decided in March to once again make our products available to distributors in the U.S. Following substantial competitive losses in volume and share in DFX (duty free exports) channels in 1993 and early 1992. This, coupled with a newly reached agreement with Philip Morris USA to distribute Player's products south of the border resulted in full availability of all major Canadian brands in alternative channels by the second half of the year.

"The Annual Tobacco Industry Review 1993. Strictly Confidential." Imperial Tobacco Market Analysis Group. February 1994.

January 1992: Leslie Thompson, a long-time executive with RJR-Macdonald and its U.S. parent, R.J. Reynolds, begins selling truckloads of Canadian cigarettes to an organized smuggling ring in upstate New York.[38]

February 12, 1992: The federal government attempts to stem the flow of Canadian cigarettes to smuggling rings in the United States by imposing an $8 per carton export tax. Following intensive industry lobbying, this was repealed on April 8, 1992.

1992: Imperial Tobacco decides to supply cigarettes to U.S. distributors to facilitate their being smuggled back to Canada.

Late 1992: R.J. Reynolds sets up a new subsidiary, Northern Brands International, perportedly to promote the sale of Export "A" cigarettes in the United States.

1993: In February, U.S. police pull over a rental truck in Louisiana for failing to stop at a weigh station. They discover contraband: 150 cases of Canadian-made Imperial Tobacco cigarettes, en route back to Canada. In the ensuing investigation, U.S. Customs authorities raid a bonded warehouse in Louisiana and find records for 8,000 cases of Canadian-made cigarettes supposedly sold duty-free to fishing vessels passing through the area. A warehouse employee fingers Brown & Williamson, the U.S. sister company of Canada's Imperial Tobacco, as supplier of the cigarettes. U.S. Customs sends in an undercover agent to investigate.

1992-93: Imperial Tobacco, frustrated with Brown & Williamson, makes an agreement with Phillip Morris to distribute Player's to U.S. markets.[39]

1993: Imperial Tobacco expresses concerns internally that "RJR have also continued to operate on the fringes of the law; often off-pricing and actively developing smuggled distribution."[40]

Feb. 1, 1994: Health groups run a full-page ad in *the Globe and Mail* warning of the dramatic health and financial impact of an impending tobacco tax roll-back.

Feb. 8, 1994: Federal rollback in tobacco taxes matched by Quebec, and followed by New Brunswick, Ontario, PEI and Nova Scotia.

[38] This chronology draws on documents filed in U.S. district Court, Northern District of New York in 1998.

[39] William Marsden, "CEO knew of tobacco smuggling," *Montreal Gazette*, April 29, 1999, p. A1-A2.

[40] "The Annual Tobacco Industry Review 1993." Strictly Confidential. Imperial Tobacco Market Analysis Group, February 1994.

1994: The U.S. Customs undercover agent buys Canadian cigarettes from Michael Bernstein, Brown & Williamson's East Coast Regional Account Manager. Once sufficient incriminating evidence has been gathered against Bernstein, authorities confront him. According to court documents filed by U.S. federal agents, Bernstein and one of his subordinates, Richard Wingate, "confirmed the company's knowledge and intent to defraud the United States and Canadian Governments of tax revenues," and agreed to help provide proof.

1995: On Jan. 11th, a party of 50 to 100 U.S. federal agents raid the headquarters of Brown & Williamson in search of evidence related to the smuggling of cigarettes into Canada and Mexico. They seized numerous computer and paper files.

May 1996: The U.S. Department of Justice charges Bernstein and Wingate with "conspiracy to defraud the United States" and with assisting smuggling. The alleged smuggling stretched back to 1989.

July 1996: Bernstein's former subordinate, Wingate, pleads guilty.

July 11, 1997: RJR-Macdonald issues news release: "Following the publication in the Syracuse Post-Standard and the Hamilton Spectator of an article which alleges that RJR-Macdonald is the subject of a police investigation, the company issued the following statement today: 'It is RJR-Macdonald's policy not to comment on matters of this nature. We can only confirm that RJR-Macdonald has not seen the affidavit and has not been contacted by any law enforcement officials about it. RJR-Macdonald's sales of its products are always made in full compliance with applicable laws, both in the U.S. and in Canada. We are, as always, ready to fully co-operate with the authorities should they contact us.' "

July 16, 1997: Bernstein pleads guilty to charges of trafficking in contraband cigarettes. He is later fined.

July 24, 1997: R.J. Reynolds and subsidiary Northern Brands International receive subpoenas from a federal grand jury relating to smuggling into Canada.[41]

January 20, 1998: CBC-TV broadcasts a documentary on *The Fifth Estate* detailing the Brown & Williamson and RJR-Macdonald cases, including evidence of parties at a secluded fishing lodge in British Columbia involving smugglers and RJR-Macdonald executives. One executive, RJR-Macdonald Chief Operating Officer Stan Smith, is named in the broadcast. His employment with the company is subsequently ended. Smith was a

[41] "RJR Nabisco is Subpoenaed in Smuggling Investigation," *Wall Street Journal*, Aug. 12, 1997.

plaintiff along with the company in challenging the constitutionality of advertising and promotion restrictions in the federal *Tobacco Act*, which was passed in April 1997.[42]

Jan. 21, 1998: The Canadian Cancer Society, the Non-Smokers' Rights Association and the Canadian Council for Tobacco Control call for both a criminal investigation of the tobacco manufacturers related to smuggling and a Royal Commission into the tobacco industry.[43]

Jan. 24, 1998: In an interview on CBC Radio's *The House*, CTMC President Robert Parker comments on *the fifth estate* broadcast: "I personally think that's the sleaziest piece of attack journalism I've seen in a long time. ... I think the absence of charges, after all these years, is eloquent evidence that there's nothing to these charges."[44]

June 26, 1998: Knight Ridder news service reports that RJR and Imperial Tobacco are under investigation by the R.C.M.P. for smuggling matters.[45]

[42] Lisa Fitterman, "Tobacco firm picks plaintiff; Executive cited in CBC investigation," *Montreal Gazette*, Feb. 4, 1998, p. A4.

[43] Canadian Cancer Society, Non-Smokers' Rights Association and Canadian Council for Tobacco Control, "Health organizations call for both a criminal investigation of the tobacco manufacturers related to smuggling and a Royal Commission into the tobacco industry" [news release] January 21, 1998.

[44] Transcript, *The House*, CBC Radio, Jan. 24, 1998.

[45] Raja Mishra (Knight Ridder), "Canada tax drove up cigarette smuggling" *Lexington (KY) Herald Leader*, June 26, 1998.

September 1998: RJR-Macdonald sales representative Christopher Gibb-Carsley, an employee in Montreal, is charged in Quebec Court with smuggling offences.[46]

Nov. 5, 1998: After a lengthy investigation and a string of plea bargains by accomplices, smuggler Larry Miller, the head of a network in New York State, pleads guilty to assorted charges and agrees to testify against his suppliers in the tobacco industry.[47]

November 1998: Philip Morris, the largest U.S. tobacco company, reports to the Securities and Exchange Commission that it is under investigation for alleged involvement in smuggling along the Canada-U.S. border.

December 22, 1998: Northern Brands International pleads guilty to evading U.S. taxes and agrees to pay US$15 million as part of a plea bargain.[48]

March 25, 1999: Leslie Thompson, a former senior executive with RJR-Macdonald and Northern Brands International, pleads guilty to a smuggling conspiracy. It is reported that

[46] Michel Auger, "Contrebande; RJR Macdonald nie toute complicité" *Le Journal de Montreal*, Sept. 30, 1998, p.5.

[47] « Le dirigeant d'un réseau de contrebande mohawk avoue tout », La Presse Canadienne, Nov. 7, 1998.

[48] U.S. Department of Justice, "R.J. Reynolds Affiliate Pleads Guilty, Pays $15 Million in Criminal Fines and Forfeitures as Part of Cigarette Smuggling Operation," news release, Dec. 22, 1998.

the conspiracy defrauded the Canadian government of more than US$ 650 million in tobacco taxes. The plea bargain in U.S. district court in Syracuse, New York includes a seven-year jail term, although this was still to require court approval.[49]

March 26, 1999: RJR-Nabisco acknowledges that its Canadian subsidiary RJR-Macdonald is co-operating with the R.C.M.P. in a smuggling investigation relating to the same events that gave rise to the Northern Brands International investigation.[50]

April 17, 1999: *La Presse* reports that RJR-Macdonald and Revenue Canada are discussing a plea bargain arrangement for smuggling that would see the company pay about $150 million in fines.[51]

April 28, 1999: Imperial Tobacco Chairman, Don Brown, tells the *Montreal Gazette* that Imperial Tobacco willingly supplied cigarettes for eventual return to Canada via smugglers.[52]

May 3, 1999: *Globe and Mail* reports that the RCMP executed a search warrant at the RJR-Macdonald headquarters in Toronto and its factory in Montreal.[53]

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[49]William Marsden, "RJR Nabisco executive pleads guilty for part in $650M cigarette smuggling scam" *National Post*, March 27, 1999. American Press, "Tobacco Exec Charged with Smuggling" March 25, 1999. "RJR Executive Helped Smugglers Sell Cigarettes Illegally in Canada" *Wall Street Journal*, March 26, 1999.

[50]RJR-Nabisco Holdings Corp., 10-K filing with the U.S. Securities and Exchange Commission, March 26, 1999, p.12.

[51]André Noël, "Tabac: des nicodollars à recouvrer" *La Presse*, April 17, 1999, pp.A1-A2.

[52] "CEO knew of tobacco smuggling, " Montreal Gazette, April 29, 1999, p. A1.

[53]Paul Waldie, "Mounties search tobacco firm in contraband case" *Globe and Mail* May 3, 1999.

Part 5:

The Impact of the Tax Cut: A Five-Year Review

Governments presented the 1994 tobacco tax rollback as a temporary, strategic retreat that in no way signalled diminished commitment to protecting the health of Canadians from the disastrous effects of tobacco products and the misleading marketing of the tobacco industry. Five years later, a sober examination of the facts shows that very serious damage has been done and continues to be done, far beyond what governments predicted at the time of the rollback. Lower cigarette prices have injured public health by increasing cigarette smoking to levels higher than would otherwise be the case. They have also robbed public finances of billions of dollars. Five years later, it is also clear who gained most from the rollback: tobacco companies, which continue to set new profit records and have added to their Canadian customer base for decades to come.

High- and Low-tax Regions: A unique policy comparison

Although cigarette taxes were reduced by $5.00 per carton throughout Canada on February 8, 1994, subsequent cuts were much less evenly felt. Five provinces elected to join the federal government in reducing the price of cigarettes. Five provinces made no reductions at all.

As a result, cigarettes in the ‘high-tax’ provinces (British Columbia, Alberta, Saskatchewan, Manitoba and Newfoundland) are almost twice as expensive as they are in ‘low-tax’ provinces (Ontario, Quebec, New Brunswick, Nova Scotia, Prince Edward Island). More than 75% of Canadians live in the ‘low-tax’ provinces.

City	Price per 200 cigarettes	Price per 200 cigarettes
	Jan 94	*Jan 99*
St. John’s	$59.43	$52.07
Yellowknife	$46.62	$50.77
Vancouver	$51.30	$50.11
Regina	$48.83	$48.23
Winnipeg	$48.69	$45.25
Whitehorse	$49.10	$44.31
Edmonton	$43.47	$39.92
Saint John	$48.78	$38.84
Charlottetown	$50.02	$36.71
Halifax	$49.01	$36.09
Montreal	$47.46	$29.88
Toronto	$45.57	$27.95

Source: Statistics Canada, “Tobacco Prices, 1994-1999,” custom printout, July 26, 1994.

This variety in cigarette tax policies across Canada has created a unique, if unintended, social laboratory in which to monitor the impact of the cigarette