



True North in
Canadian public policy

Commentary

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Cause and Effect: Why Higher Taxes Require Better Contraband Enforcement to Reduce Smoking

Christian Leuprecht

Various international organizations encourage governments to implement smoking cessation initiatives, the World Health Organization (WHO) first and foremost among them. The WHO's Framework Convention on Tobacco Control (FCTC) (2003), which entered into force in 2005, is the first international treaty coordinated by the WHO and is among the UN's most widely adopted treaties. Canada was one of the first Contracting Parties to the FCTC, and has been lauded by the WHO "as having one of the best regimes for tobacco product regulation" (WHO Study Group on TobReg 2005). The objective of the Convention is "to protect present and future generations from the devastating health, social, environmental and economic consequences of tobacco consumption."

To this end, its means of choice are "price and tax measures to reduce the demand for tobacco." The FCTC promotes high levels of taxation as fundamental to smoking cessation: encouraging signatory countries to impose a heavy tax burden on smokers is part and parcel of the FCTC strategy. At the same time, the FCTC concedes that smoking is more prevalent among low income earners. The WHO's latest "Tobacco" fact sheet (2018) observes: "nearly 80% of the more than 1 billion smokers worldwide live in low- and middle-income countries, where the burden of tobacco-related illness and death is heaviest."

The same WHO fact sheet broaches illicit tobacco. It distances itself from Big Tobacco's argument that increased tobacco taxes lead to increased tax evasion by listing non-tax factors in the proliferation of contraband, including

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“weak governance, high levels of corruption, poor government commitment to tackling illicit tobacco, ineffective customs and tax administration, and informal distribution channels for tobacco products.” Still, the WHO acknowledges: “implementing and enforcing strong measures to control illicit trade enhances the effectiveness of significantly increased tobacco taxes.” Governments in Canada in general, and Ontario specifically, fail on this count: they impose high tax rates without the capacity to enforce strong measures of the sort the WHO identifies to contain the illicit trade.

High taxation rates to deter consumption have two significant consequences. First, they disproportionately penalize the most economically disadvantaged members of society, since smoking is more prevalent in lower quintiles. Second, they incentivize the manufacture, distribution, and consumption of contraband tobacco, which is priced to undercut the regulated tobacco market. These two issues are closely related: since the relatively deprived have less disposable income, they have a greater incentive to procure contraband. That observation holds across just about all countries: people with lower incomes are more likely to smoke than those with higher earnings (Bobak et al. 2000), even in high-income countries.

The Tobacco Advisory Group of the Royal College of Physicians (2016) in the United Kingdom finds smoking to be far more prevalent amongst unemployed people and those in routine and manual labour occupations than amongst higher managerial and professional occupations. Analysed in the Surgeon General’s report, a 2014 U.S. Department of Health and Human Services survey on drug use and health finds that individuals below the poverty level consistently smoke in greater numbers than those at or above the poverty level.

That is true in Canada as well. A background document prepared by the steering committee and action groups for a 2016 summit, *A Tobacco Endgame for Canada*, notes: “The prevalence rate of current smoking is significantly higher for Canadians with lower levels of education compared to those with higher levels of education.” It cites a 2012 study that found Canadians who had completed post-secondary education to be less likely to smoke than those with only or no high school diploma (Schwartz et al. 2012).

Not only are they more likely to smoke, but they are also less likely to quit. As one study finds: “Most smokers wanted to quit but felt unable to because of the importance of smoking in their daily routine, and their addiction to nicotine. Strategies for maintaining consumption levels in the face of increasing cigarette prices and low income included purchasing contraband cigarettes and tobacco” (Wiltshire et al. 2001). In fact, relatively deprived communities deem the smuggling of illicit tobacco a “community service” that provides tobacco products at affordable prices. Although the sample size in this UK study was small, human nature is constant; so, chances are that behavioural attitudes and attributes of low-income smokers in the UK compare with those of low-income smokers in Canada who resort to contraband as an affordable compromise to sustain their addiction.

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Mexico is a case in point. Until 2010, contraband made up about 2 percent of Mexico's tobacco market (McCleskey 2012). In line with recommendations by the WHO's FCTC, the government imposed a tax shock that hiked the cost of cigarettes by 30 percent. Over the course of just one year, Mexico's federal chamber of commerce estimated the contraband rate to have jumped to 16.6 percent (René 2015). At that rate, the cost in diversion of legitimate sales amounts to about US\$980 million annually. Another way to gauge the expansion in the illicit market is as a function of seizures of illicit product. In 2012, Mexico conducted the largest seizures of contraband in that country's history: just two interceptions yielded nearly 6 million cigarettes (René 2015).

In general then, raising taxes generates more demand for contraband tobacco. Since smoking rates are distributed unevenly across social quintiles, high levels of taxation on tobacco products disproportionately discriminate against those who can least afford the product to begin with, but who are also the most resilient to cessation. Consumption taxes already impose a disproportionate burden on Canadians with low incomes or on fixed incomes; they cannot avoid value-added taxes on the necessities of life: electricity, gas, water, sewer. As such, consumption taxes are regressive, affecting low income earners disproportionately, as they consume a larger proportion of disposable income than among higher earners.

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This is why governments tend to offer rebates of one form or another on federal and provincial sales taxes. Unlike the necessities of life however, smokers have a choice in defecting from taxes on tobacco. The greater the price gap between legal and illicit product, the greater the incentive to defect. Ergo, high tax rates imposed by provincial and federal governments, aided and abetted by the WHO's FCTC, are enticing a disproportionate number of the poor to resort to criminality. The WHO's FCTC is thus effectively encouraging governments to capitalize on the relative resilience of these communities against cessation to criminalize otherwise legal behaviour, thereby, perversely, lowering the tolerance for crime precisely among those communities most susceptible to criminal behaviour in the first place.

Nicotine is more addictive than heroin; so, the poor, the marginalized, and those challenged to make ends meet maximize their utility: \$115 or more for legally produced but highly taxed carton of cigarettes at a local convenience store versus \$40 for a carton of contraband cigarettes of comparable quality in Ontario, and \$12 for baggies of 200 “illicit whites.” Canadian organized crime has done the math: contraband cigarettes are eight times more profitable than cocaine – whilst the chances of getting caught, let alone convicted, are marginal at best.

Heeding the FCTC's call, legitimate tobacco products are subject to levels of taxation far in excess of those imposed on any other legal commodity or service. In Ontario, for example, federal and provincial tax make up two-thirds of the total cost for a legally produced and purchased pack of cigarettes (NSRA 2017). The level of taxation on tobacco is consistently trending upwards. The revenue collected contributes more than \$1.2 billion

to provincial coffers annually (Physicians for a Smoke-Free Canada 2017). That amount partially offsets health care costs associated with smoking-related illnesses, smoking cessation initiatives, and enforcement of tobacco and anti-smoking regulations.

Ontario is the epicentre of contraband in Canada. The only Canadian province where tobacco is grown, it houses the country's greatest number of manufacturers (both licensed and unlicensed), it maintains an allocation system whereby legally-produced cigarettes are made available tax-free on reserves, and it is optimally situated in proximity to US tobacco-growing states whence raw cut-leaf is smuggled into Canada on an epic scale. The provincial government has recently entered into tobacco production agreements with three First Nations communities. In absolute numbers it counts more smokers than any other Canadian province, and, as a result, in absolute terms no province draws more revenue from taxing tobacco.

The Ontario government's smoking cessation policy, legislation, and initiatives together form the Smoke-Free Ontario Strategy, whose website (2017) reveals the following:

- each year, tobacco claims 13,000 lives in Ontario - that equals 36 lives every day
- tobacco-related disease costs Ontario's health care system an estimated \$2.2 billion in direct health care costs
- it also costs an extra \$5.3 billion in indirect costs such as time off work
- Ontario's smoking rate dropped from 24.5 percent in 2000 to 17.4 percent in 2014, meaning 408,257 fewer smokers ("Smoke-Free facts")

But herein lies the problem: a sampling error that skews the data. Smoke-Free Ontario (SFO) touts that its smoking cessation programs are working, and that smoking rates in the province are decreasing. However, its statistics are largely based on research that reflects only the legitimate sales of cigarettes sold at legal retail outlets. Conveniently, SFO statistics do not track socio-demographics; if they did, they would find an uneven distribution in the reduction of smoking rates across income brackets. By virtue of the fact that contraband is sold off-ledger, the illicit market is necessarily difficult to gauge.

A rough method of approximation consists of so-called butt-counts that sample the proportion of butts from illicit product relative to legitimate product in areas where smoking is more prevalent, such as around hospitals, schools, and office buildings.

The Ontario Convenience Store Association (OCSA) commissions an annual study to determine levels of contraband consumption. The most-recent "butt study" data (OCSA 2017) show that 37 percent of cigarettes smoked in the province are contraband. In Ontario's north, where wages are typically lower and unemployment higher, the percentage is triple the average: in North Bay, almost 76 percent of cigarettes sampled were contraband. This reality runs counter to the narrative of governments and smoking cessation advocates that hegemonize much of the public discourse and who would rather not have the facts get in the way of their good story.

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As a result, the public is misinformed: to ignore the illicit cigarette market fundamentally distorts the policy picture – overestimating policy success while underestimating the extent to which the corollary of the same government policy criminalizes the poor. Policy intentions by governments and regulators thus run afoul of the way such taxes spawn an underground economy in illicit tobacco products. Regulatory taxation, public safety, and health authorities conveniently dismiss contraband and its profitability for organized crime, as well as the significant loss in taxes, which the Ontario government, by its own estimates, has pegged around \$800 million annually – a lot of money to relinquish to organized crime that could otherwise be used to build hospitals and schools, improve health care for an aging population, or fund smoking cessation and anti-contraband activities.

Interestingly, the \$1.2 billion in tax revenue and \$800 million in tax losses amount to a total potential tax revenue from cigarettes of \$2 billion. This suggests that even by the government’s own fiscal estimates, the illicit market runs around 40 percent – which triangulates with OCSA and other available data on the expanse of the illicit market in Ontario.

The RCMP and FPSS *Federal Tobacco Control Strategy (FTCS) 2016 Annual Report* documents 139 seizures in Canada, totalling 28,000 cartons of contraband cigarettes and 800 pounds of raw-leaf tobacco as part of its mandate to enforce the *Federal Excise Act* (2017, 5). By way of comparison, the Canada Border Services Agency for 2015 reported 1763 seizures which included 26,300 cartons of cigarettes and more than 50,000 kg of manufactured tobacco (Health Canada and the Public Health Agency of Canada 2017, 26).

Some researchers capitalize on the low number of seizures claimed by the RCMP as evidence that the use of contraband in Ontario is on the wane (Zhang and Schwartz 2015, 10). In fact, the number of local seizures – by police forces with no explicit mandate to enforce the *Federal Excise Act* – suggests that the RCMP’s figures instead reflect enforcement priorities and should thus not be misconstrued as indicative of the size or trends in the contraband trade. That contraband cigarettes are a low enforcement priority should come as no surprise when governments and the public overestimate the successes of their own policies and underestimate the contraband market.

Still, commenting on the *Smoke Free Ontario Act*, the FTCS report observes: “the province of Ontario aims to have the lowest smoking rates in Canada. The availability of contraband tobacco undermines the provincial government’s efforts in reducing smoking rates and protecting youth from smoking” (RCMP and FPSS 2017, 7-8). While outlining the province’s tobacco tax increase in 2016 and planned inflationary increases for 2017–2021, which are intended to support the Smoke-Free Ontario Strategy, the report cautions: “There is potential that with an increase in tobacco taxes, purchasing contraband tobacco is more likely; therefore, the police presence in areas prone to smuggling should also increase” (RCMP and FPSS 2017, 8). This concern is echoed later in the report: “Prices continue to increase on the provincial and federal duties on tobacco products. This has been directly linked to growth in the contraband sector due to the price discrepancy between legal and illicit product” (16).

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Even advocates of higher taxes concede implications for the contraband market. The background paper for the 2016 Endgame Summit summarizes: “We are cognizant of the possibility that unless appropriate measures are taken, contraband could become a challenge of a different order of magnitude, the farther down the road we go toward constraining and transforming the existing commercial industry and the price/tax structure.” Similarly, a 2015 study on the link between taxation and contraband in Canada concludes: “the benefits of increased tobacco taxes outweigh any minor increase in contraband use that might occur. Tax increases are best accompanied by more stringent anti-contraband measures” (Zhang and Schwartz).

The relationship between tax rates and contraband is a multivariate problem. To curb demand, governments impose restrictions on consumers and producers. Consumers are prohibited from smoking in public places, at outdoor venues, and in a car in Ontario and select other provincial jurisdictions when someone under the age of 16 is present. In accordance with, and even in excess of, the directives of the WHO’s FCTC, Canada’s three “Big Tobacco” producers must feature health warnings and gory images on all packaging, face restrictions on flavours such as menthol, are banned from advertising and event sponsorship, and retail outlets must hide all cigarette packaging behind paneled walls. In addition, the federal government has introduced legislation to mandate plain packaging. Analogous measures are already in place in Australia; yet, between 2016 and 2017 the proportion of consumption comprised by illicit tobacco still increased from 14.3 percent to 15 percent (KPMG 2018).

That is because contraband manufacturers adhere to none of these restrictions. However, by virtue of flouting regulations, their product poses greater health and safety hazards that expose low-income, unemployed, and other marginalized groups, which are more likely to avail themselves of such product, to disproportionate risk. This population is also showing itself to be increasingly resilient to cessation initiatives.

Economically disadvantaged citizens, who are more likely than any other demographic to smoke, basically have three options in response to the burgeoning tax burden on cigarettes: try to break their addiction to nicotine, an endeavour for which there is limited support within the health care system; spend a greater amount of their limited and often fixed income on highly taxed legitimate tobacco products, leaving them with fewer financial resources for necessities; or resort to illicit cigarettes. Returns on investment in smoking cessation are bound to diminish the easier it is and the readier the financial incentive for smokers to defect to the contraband market.

In this light, to comply with the spirit of the WHO’s FCTC framework and actually reduce demand sufficiently to meet the federal government’s stated goal of reducing smoking rates below 5 percent, federal and provincial governments will have to make a concerted effort to contain the supply of contraband.

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Data from Quebec's long-standing *ACCES Tabac* initiative show that concerted enforcement can achieve remarkable results in reducing demand for and supply of illicit tobacco: reduce the incidence of smoking, increase revenue from the tax haul on cigarettes, while raising the cost for organized crime trading in contraband. *ACCES Tabac* was implemented by the government of Quebec in 2001 with an initial funding envelope of \$1 million; in 2014/15, it was funded at \$19.4 million (Finances Quebec 2014).

The investment pays for itself: Provincial tax revenue from tobacco in Quebec rose about a third over just four years, from \$654 million in 2008 to \$1026 million in 2013/14 (Finances Quebec 2014), without an appreciable increase in smoking rates (Statistics Canada 2016). Deterring people from buying and distributing contraband has shown even greater residual benefit - about 16 times the return on investment (Finances et Économie Quebec 2012).

As detailed in my authoritative 2016 MLI study, *Smoking Gun: Strategic containment of contraband tobacco and cigarette trafficking in Canada*, Quebec's success is the result of a strategic alignment of multiple factors, including provincial legislation in the form of Bill 59, which enables municipal police and the *Sûreté du Québec* to conduct searches and seizures related to contraband tobacco. In Ontario, by contrast, contraband enforcement is the purview of the Ministry of Finance (MOF). A larger contraband market notwithstanding, at \$4 million, Ontario's MOF has been allocated a fraction of the resources Quebec has committed, but has to share them with the Ontario Provincial Police's (OPP) Contraband Tobacco Enforcement Team. Existing legislation allows the Minister to delegate powers to law enforcement agencies to help fight contraband, but this has not been done.

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About the Author



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In 2016, he was elected a member of the New College of the Royal Society of Canada; he is also a recipient of RMCC's Research Excellence Award. He holds a Governor-in-Council appointment to the governing Council of the Natural Sciences and Engineering Research Council of Canada, is president of the International Sociological Association's Research Committee 01: Armed Forces and Conflict Resolution, and a United Nations Security Structure Expert.

An expert on security and defence, political demography, and comparative federalism and multilevel governance, he is regularly called as an expert witness to testify before committees of Parliament.

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