

How the tobacco industry uses the threat of smuggling to keep taxes low

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Beirut
9 November 2018

Disclaimer

- My own views, not necessarily FCA positions.



Time to play a game

- For the purposes of this game, you work for a subsidiary of British American Tobacco.
- In the country in which you are working, there is a looming catastrophe due to a health fanatic having become president – more details in a minute. It could cost us tens of million of dollars!
- We are doing a brainstorming session to figure out how to prevent this catastrophe, or at least minimize its impact and try to fix the problem in the future.
- I'll be asking you to individually come up with three ideas on how to stop this catastrophe and to jot them down on a piece of paper.
- No idea is a bad idea. You can even suggest illegal things, as long as you can reassure me the risk of detection or the consequences of detection are low.

The situation

- As you know, our president-elect is an oncologist, and he's already said publicly that tobacco is the number one preventable health threat in our country.
- We hear that within two weeks, he will announce a plan to triple tobacco taxes (which would double cigarette prices) and to increase taxes by 10% every year till the end of his presidential mandate.
- The Ministers of Health and of Finance are onboard. However, in good news, the head of the Customs Service and the National Police are worried there will be an uncontrollable surge in smuggling.
- So, now write down three ideas – the more out-of-the-box, the better, on what we can do to either *stop* the decision outright or, if it is implemented, convince the government it was a terrible mistake.

Types of ideas I expected

- Attack the character of the president (e.g. claim he is getting bribes from an organized crime group that is involved in tobacco smuggling).
- Organize a sharp increase in illicit trade.
- Create observable facts that make illicit trade seem larger than it is:
 - Front-loading
 - Tipping off authorities to shipments of illegal cigarettes made by competitors
- Public relations efforts to make illicit trade seem like a growing and uncontrollable problem:
 - Hire academics and former police officers to discuss the problem.
 - Commission studies with biased methodology to exaggerate the problem.
 - Exaggerate links with the illicit drug trade and with terrorism.

Organizing a sharp increase in illicit trade

- It's not just a suspicion – the tobacco industry really has a history of doing this.

Example from Canada, about BAT subsidiary Imperial Tobacco Limited of Canada:

In February or March 1993... Imperial Tobacco abandoned any restraint with respect to supplying the black market. Here's how the decision was presented in May 1993, in a [“Summary of Competitive Environment” report to top BAT management](#):

Smuggling of exported Canadian cigarette back into the country continues in 1993... ITL's CTMC member competitors have been and continue to fully participate in this alternative distribution network. Due to the federal government's unwillingness to lower tobacco taxes as a means to discourage smuggling, ITL products, in February of 1993, were made available for full distribution... For the industry as a whole, ITL's 12 month share of the total tobacco industry is 55.0%, down 1.5 share points from the previous year. This is mainly due to our previous commitment not to supply smuggling channels...

Organizing a sharp increase in illicit trade (2)

- In the Canadian case, all three major manufacturers (subsidiaries of BAT, PMI and Japan Tobacco) eventually pleaded guilty to criminal charges relating to their direct involvement in the 1991-94 smuggling episode.
- BAT and PMI subsidiaries convicted in 2008; JTI subsidiary in 2010.



But most of the time, you'll only see the legal tactics – what is their basis?

- Bureaucrats are rarely punished for advising excessive caution. Because how can anyone know for sure they were being excessively cautious (e.g. in their evaluation of the risks of smuggling)?
- Bureaucrats and politicians are punished when an unlikely or unexpected risk materializes.
- So if the industry can simply create doubt about a possible though unlikely negative outcome, they may already have won.
- *Doubt and fear are the product the tobacco industry is selling with respect to illicit trade and tobacco taxes.*

Why illicit trade is such a great scare tactic

- Illicit markets are hard to measure. So you can make outrageous claims about levels and trends in illicit trade, and it's hard to be proven wrong.
- It completely distracts attention from the purpose of tobacco tax increases, i.e. the health benefits of reducing consumption.



Typical tobacco industry lines about taxes

- We already provide tremendous revenue to governments.
- We're in favour of 'reasonable' tobacco tax increases, in line with inflation.
- Avoid 'shock' increases in tobacco taxes, because they simply lead to smuggling.



Example: British American Tobacco

While some smokers may choose to quit, or smoke less, large and sudden tax rises may not always result in reduced overall tobacco consumption. In some developed countries we have seen tax rates raised to such a high level that tax revenue begins to fall, as smokers seek out cheaper, black market alternatives.

Hikes in excise tax may also lead to greater price differences between nearby countries, encouraging tobacco smuggling across borders.

It is clear that unusually high taxes on tobacco can create opportunities for criminals and potentially undermine governments' revenue and health objectives.

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Example: Imperial Tobacco Canada (BAT)

Imperial Tobacco Canada says tobacco tax increase will only fuel illegal market, and directly contradicts government policy for cannabis

TORONTO, March 28, 2018 /CNW Telbec/ - Today's tobacco tax hike will further entrench illegal traffickers as the dominant player in the Ontario tobacco market, says Imperial Tobacco Canada, the country's largest legal tobacco company.

“For the past few years, Ontario has sat at a crossroads between having a legal, regulated and taxed tobacco industry, or an illegal, untaxed and unregulated market,” said Eric Gagnon, Head of Corporate and Regulatory Affairs for Imperial Tobacco Canada. “Today's budget is evidence that this government is complacent to let illegal traffickers take over the market.”

It is estimated that approximately 1 in 3 cigarettes sold in Ontario is illegal and a March 2018 review of tobacco taxation in Ontario by Ernst & Young LLP (EY Canada) states that illegal tobacco has resulted in \$3.4 billion in lost tax revenue for Ontario since 2013. The report also predicts another \$1.6 billion in lost tax revenue by 2020.

Example: Imperial Tobacco Canada (BAT) (2)

“Illegal manufacturers and traffickers don't pay taxes and don't comply with a myriad of regulations applicable to legal tobacco products,” continued Gagnon. “Not only does this government do little to enforce the law, but they incentivize consumers to turn to illegal products through irresponsible tax hikes.”

Tobacco taxes account for roughly 70 per cent of the purchase price of cigarettes, which now sits at over \$100 per carton. A baggie of 200 illegal untaxed cigarettes can be purchased for a fraction of the price of legal products.

While anti-tobacco lobby groups continue to ignore the contraband problem in this province and advocate for irresponsible tax increases, law enforcement works hard to contain the growing trade of black market products in the province. Last week, police in Quebec and Ontario busted an illegal tobacco trafficking network worth hundreds of millions of dollars, and stated that smuggling tobacco is eight times more profitable than cocaine.

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