

December 2011

## Combating the Contraband Tobacco Trade in Canada

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### Key conclusions and findings

- Contraband tobacco has been a recurring problem in Canada, and one that has become noticeably worse over the past decade.
- The trade in contraband tobacco is enabled by several factors, especially relatively high tobacco taxes.
- Eliminating the contraband tobacco trade might be impossible. Nevertheless, abating the negative consequences of contraband tobacco is possible with a carefully crafted mix of the following policies:
  - 1 tax partnerships and agreements with Aboriginal communities;
  - 2 complete revocation of tobacco taxes;
  - 3 reduction of tobacco taxes to narrow price differences among jurisdictions;
  - 4 better record keeping by the RCMP;
  - 5 educational campaign to increase awareness of the dangers and costs linked to contraband tobacco;
  - 6 increased enforcement against contraband wholesalers and retailers.

## Summary

Contraband tobacco has been a recurring problem in Canada, and one that has become noticeably worse over the past decade. It has been estimated that contraband tobacco makes up roughly 30% of the total Canadian tobacco market. In 2009, the RCMP seized a record high of 975,000 cartons of contraband cigarettes. Key factors fueling the contraband trade include relatively high and rising tobacco excise taxes, the inability of law enforcement to impede tobacco smuggling, Aboriginal autonomy in taxation and on-reserve law enforcement, and the erroneous perception that lawful and contraband tobacco are close substitutes.

Health Canada contends that contraband tobacco undermines existent anti-smoking initiatives. Furthermore, the black market for tobacco deprives the private sector of business revenues and the public sector of excise tax receipts. Perhaps most alarming of all, the contraband tobacco trade has been linked by the RCMP and other law enforcement agencies to an assortment of related criminal activities.

This study proposes six policies for combatting the contraband tobacco trade:

- 1 tax agreements between Aboriginal communities and Canadian governments at both the federal and provincial level;
- 2 a complete revocation of tobacco excise taxes across Canada, including both the federal and provincial levies;
- 3 a partial tax reduction meant to bring the retail price of cigarettes in Canada in line with prices at which cigarettes are being sold in nearby jurisdictions with relatively low tobacco excise taxes;
- 4 improvement of the record-keeping procedures of Canadian law enforcement agencies and readily available statistics about the contraband tobacco trade;
- 5 campaign educating the public about the harm caused by the contraband tobacco trade;
- 6 greater efforts by law enforcement agencies to apprehend wholesalers and retailers of contraband tobacco

Contraband tobacco is an inherently difficult problem to address. It is unlikely that any anti-contraband policy will prove fruitful in isolation. However, adopting an assortment of policies that have been tailored to overcome the challenges imposed by specific aspects of the contraband tobacco market is a promising approach to fighting contraband tobacco in Canada.

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## Overview

Contraband tobacco has been a recurring problem in Canada, and one that has become noticeably worse over the past decade. The Canadian government has estimated that contraband tobacco makes up roughly 30% of the total Canadian tobacco market, that the contraband tobacco trade was worth nearly \$2.6 billion in 2008 and that the share of contraband tobacco in the overall underground economy has been rising since 2002. Key factors fueling the contraband trade include relatively high and rising tobacco excise taxes, the inability of law enforcement to impede tobacco smuggling, Aboriginal autonomy in taxation and on-reserve law enforcement, and the erroneous perception that lawful and contraband tobacco are close substitutes.

Health Canada has warned that contraband tobacco poses several unique risks for Canadian public health above the basic dangers associated with lawful tobacco consumption. Contraband tobacco undermines existing antismoking initiatives by creating a supply of relatively cheap and accessible tobacco, sold in packaging devoid of the warning labels that are clearly visible on lawful cigarette packs. Furthermore, the black market for tobacco deprives the private sector of business revenues and the public sector of excise tax receipts. Perhaps most alarming of all, the contraband tobacco trade has been linked by the RCMP and other law-enforcement agencies to an assortment of related delinquencies, including violent crimes, perpetrated by organized crime groups that dominate the contraband tobacco market. In light of the tremendous social costs attributable to the contraband tobacco trade, it is imperative that the contraband tobacco problem be addressed.

### **Policies for reducing the trade in contraband tobacco**

Devising effective policies for abating the contraband tobacco trade requires an in-depth understanding of the problem. Numerous reports and papers written over the past decade, including the Fraser Institute's *Contraband Tobacco in Canada: Tax Policies and Black Market Incentives* (Gabler and Katz, 2010), have described the mechanics of the contraband tobacco trade in Canada. Based on the findings of those earlier reports, this study will propose six policy options aimed at subduing the contraband tobacco trade. Each policy is evaluated and its advantages and drawbacks discussed.

1 Tax partnerships, agreements, and compacts with Aboriginal groups

The first proposal entails signing tax agreements between Aboriginal communities and Canadian governments at both the federal and provincial level. Individuals and groups based within Aboriginal communities are playing a leading role in producing and distributing contraband tobacco and obstructing them has proven nearly impossible. In light of this reality, Aboriginal tobacco distributors should be legally sanctioned and incorporated into the legitimate tobacco trade. To this effect, reserve-based tobacco merchants could be granted the authority to collect tobacco excise taxes, which would be kept in whole or in part within the reserve's coffers.

2 Complete revocation of taxes on tobacco products

The second policy suggested is a complete revocation of tobacco excise taxes across Canada, including both the federal and provincial levies. The link between excise taxes and contraband tobacco markets is well established. Though taxes are not the only factor enabling the black market for tobacco, the imposition of excessively high taxes on tobacco is likely the main factor encouraging the contraband trade. Policy makers should recognize the impact that eliminating taxes is likely to have on thwarting the contraband tobacco trade. It is possible that eliminating tobacco excise taxes might affect public health in Canada negatively but this effect would likely be modest and would be offset in part by the welfare gains from undermining the contraband tobacco trade.

3 Reduction in excise taxes and a narrowing of price differences among jurisdictions

The third policy is a partial tax reduction to bring the retail price of cigarettes in Canada in line with the prices at which cigarettes are being sold in nearby jurisdictions where tobacco excise taxes are relatively low. This policy is aimed at undermining the supply of contraband tobacco flowing from US states with low tobacco taxes.

4 Better record keeping by the Royal Canadian Mounted Police, Canadian Border Services Agency, and provincial policing authorities

Canadian law-enforcement agencies mandated with suppressing the contraband tobacco market need to improve their record keeping and to make useful statistics on the contraband tobacco trade readily available to the public. A comprehensive and rigorous analysis of the contraband tobacco trade requires detailed and rich data. In conducting research into the contraband tobacco trade, the author found that the Royal Canadian Mounted Police, Canadian Border Services Agency, and provincial policing authorities were not tracking several indicators that could have made clear the nature and extent of criminality linked to the contraband market.

**5 Educational campaign to increase public awareness of the dangers and costs associated with contraband**

Unlike the four previous proposals, the fifth policy recommended focuses on the demand side of the contraband market. Contraband tobacco markets are supported by price-sensitive smokers looking to buy discounted cigarettes. Consumers of contraband are typically unaware of the extensive social ills that accompany the black market for tobacco. Educating smokers who consume contraband tobacco about the true extent of the harm inflicted on the Canadian public by the contraband trade could decrease demand for contraband tobacco, if only by a small amount. Just as educating the Canadian public about the risks associated with tobacco consumption proved effective in reducing tobacco consumption generally, educating them about the specific harm attributable to the contraband trade could reduce the consumption of, and resultant demand for, contraband tobacco products.

**6 Increased enforcement against contraband wholesalers and retailers**

The law-enforcement agencies charged with interdicting the flow of contraband tobacco could bolster their efforts in apprehending contraband tobacco wholesalers and retailers. Obstructing the contraband tobacco trade at the point of production and sealing smuggling corridors has proven exceedingly difficult, producing mediocre results at best. Instead, law enforcement could focus its interdiction efforts on apprehending contraband tobacco wholesalers and retailers. Though the extent to which this strategy would lead to improved interdiction outcomes is uncertain, the option deserves to be explored.

## **Conclusion**

Contraband tobacco is an inherently difficult problem to address. It is unlikely that any single anti-contraband initiative will prove fruitful in isolation. However, adopting an assortment of policies tailored to overcome the challenges imposed by specific aspects of the contraband tobacco market is a promising approach to fighting contraband tobacco in Canada.

## Introduction

Contraband tobacco in Canada has been a recurring problem for Canadian policy makers since the mid-1980s. The Canadian federal government, in partnership with several provincial governments, made a concerted effort to suppress the contraband tobacco trade in 1994. A central component of this anti-contraband initiative was a reduction in the rate of tobacco excise taxation and these efforts proved largely successful (CRA, 1994; Cunningham, 1996; Dupuis, 1998; House of Commons Debates, 1994). However, a recent study by the Fraser Institute, *Contraband Tobacco in Canada: Tax Policies and Black Market Incentives*, has demonstrated that the problem of contraband tobacco has returned with a vengeance to Canada, becoming increasingly aggravated over the past decade (Gabler and Katz, 2010).

To address this growing problem, Canadian policy makers should develop robust strategies that use the right mix of policies. This publication describes the contraband tobacco market in Canada and considers several policy options for combatting it. The first section discusses the scope of the contraband trade in Canada; the second section, the negative impact the growing trade has on Canadians; and the third section, determinants of the contraband trade. Section four evaluates six policies for reducing the contraband tobacco trade in Canada.

# 1 The scope of the contraband tobacco market in Canada

Contraband tobacco is defined as any product that violates federal and provincial regulatory statutes pertaining to cigarette taxation, manufacturing, and distribution. Unfortunately, contraband tobacco markets have become increasingly common throughout the world over the past several decades, and Canada is no exception. Gabler and Katz (2010), in delineating the scope of the contraband tobacco market in Canada, noted five primary sources of contraband tobacco that have been identified by the RCMP and Criminal Intelligence Service Canada:

- 1 cigarettes unlawfully manufactured on Aboriginal territories in the United States that border Canada (primarily the Akwesasne reserve in the Cornwall region of south-central Ontario);
- 2 cigarettes lawfully manufactured in the United States, purchased primarily in states with relatively low tobacco excise taxes (such as North Carolina and West Virginia), and subsequently smuggled into Canada;
- 3 tobacco products manufactured under counterfeit brand names (primarily in China);
- 4 tobacco products designated for sale on Aboriginal reserves (and thus exempt from federal and provincial excise taxes) that are diverted into the black market;
- 5 tobacco products stolen from convenience stores or trucks carrying shipments of tobacco as freight (Criminal Intelligence Service Canada, 2005; RCMP, 2008a; Public Safety Canada, 2009).

After subsiding during the late 1990s and early 2000s, the underground market for cigarettes has experienced an alarming resurgence (Criminal Intelligence Service Canada, 2005; Sweeting et al., 2009).<sup>1</sup> Several federal agencies including the Royal Canadian Mounted Police, the Criminal Intelligence Service Canada, and the Ministry of Public Safety have expressed

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1 See Gabler and Katz, 2010 for a detailed analysis of the why the contraband tobacco trade expanded again in the early 2000s.



concern about the growing availability of contraband tobacco in Canada (RCMP 2008a, 2008b, 2009; Criminal Intelligence Service Canada, 2005; Public Safety Canada, 2008, 2009).

Though calculating precise estimates of the size of the contraband tobacco market is exceedingly difficult, one recent report by the federal Task Force on Illicit Tobacco Products estimated that 65 million cartons of contraband tobacco were bought nationwide by Canadian smokers in 2008, equal to approximately 30% of all tobacco bought across Canada (Public Safety Canada, 2009). A recent and informative report from Statistics Canada estimating the overall size of the Canadian underground economy found that personal expenditures on contraband tobacco in 2008 amounted to approximately \$2.6 billion and that the share of contraband tobacco within the overall underground economy in Canada has been rising since 2002 (Statistics Canada, 2011).

One important, though imperfect, proxy for activity in Canadian contraband tobacco markets that supports the notion of a growing trade in contraband tobacco is the number of nationwide contraband tobacco seizures made by law enforcement.<sup>2</sup> The amount of contraband tobacco seized increased consistently across Canada between 2000 and 2009. The RCMP confiscated approximately 25,000 cartons in 2000; in 2008, it confiscated 965,000 cartons of cigarettes, 820,000<sup>3</sup> of which were seized in Ontario and Quebec. The region around Cornwall, Ontario alone accounted for 368,000 of all the cartons seized across Canada in 2008 (RCMP, 2009, 2010). By 2009, the number of contraband tobacco cartons seized across Canada had risen further, reaching a record high, after the RCMP confiscated 975,000 cartons (RCMP, 2010).

The number of contraband cigarettes seized has recently started to decline, falling by approximately 20% between 2009 and 2010 to 782,000 cartons confiscated across Canada in 2010. Furthermore, the RCMP has reported that 362,000 cartons of contraband cigarettes were seized within the first six months of 2011 (RCMP, 2011). However, policy makers should not infer from this seemingly positive sign that Canada's contraband tobacco problem is abating. During the same period between 2009 and 2010, seizures of fine-cut and raw-leaf tobacco increased significantly: confiscations of fine cut tobacco increased from 34,000 kilograms to 43,000 kilograms and raw leaf tobacco seizures spiked from a mere 10 kilos in 2009 to a staggering 5,300 kilos in 2010.

2 It is difficult to determine whether the increase in contraband seizures can be attributed to increased black-market activity, to increased interdiction efforts by law enforcement, or both. As a result, contraband seizures are not a perfect reflection of the size of Canada's black market for tobacco. However, it seems likely that the increase in tobacco seizures is indicative, to some extent, of increased contraband trade.

3 Equivalent to 85% of the cross-Canada total (RCMP, 2009).

The RCMP has asserted that much of Canada's contraband market is located in Ontario and Quebec, where manufacturing, smuggling, and consumption of contraband tobacco are particularly acute. The RCMP also contends that more than half of all contraband cigarettes distributed in Canada are smuggled through Aboriginal territories in south-central Ontario and Quebec (RCMP, 2008a; Sweeting et al., 2009). The central St. Lawrence valley and, specifically, the region around Cornwall, Ontario has become "ground zero" in the contraband trade.<sup>4</sup> To deal with the acute problem of extensive contraband tobacco distribution in this region, the RCMP established the Combined Forces Special Enforcement Unit – Contraband Tobacco Initiative (CFSEU-CTI) in May 2010 to add cohesion and unity to the efforts of the various law-enforcement agencies involved in interdicting contraband tobacco in the St. Lawrence Valley region (RCMP, 2011).

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4 See Gabler and Katz, 2010 for a more detailed analysis of the contraband tobacco market in Ontario and Quebec.

## 2 The threat of contraband tobacco in Canada

Growth in the unlawful production, distribution, and sale of tobacco products throughout Canada in recent years is a primary concern for Canadian public health officials, law enforcement officers, tax authorities, policy makers, and the public (Health Canada, 2009; CRA, 2008, 2009; Criminal Intelligence Service Canada, 2005; RCMP, 2008a, 2008b, 2009; Marsden, 2009; Public Safety Canada, 2009). Contraband tobacco significantly harms the Canadian public in several ways. Foremost amongst the dangers posed by contraband tobacco is the undermining of anti-smoking initiatives meant to improve the state of public health, and especially the danger posed by the easy access to contraband tobacco enjoyed by young smokers. Though the chemical composition and carcinogenic properties of contraband tobacco smoke are similar to what is found in lawful tobacco, contraband tobacco packaging is typically not marked with any of the legally required warning labels that publicize the health risks associated with tobacco consumption (Health Canada, 2009).

Health Canada has also warned that the low cost and easy availability of contraband cigarettes constitutes a threat to Canadian public health beyond the threat posed by lawful tobacco (Health Canada, 2009). Trafficking in contraband tobacco has drawn in over 100 criminal organizations including the Hells Angels Motor Club (Centre for Public Integrity, 2008; RCMP, 2008a, 2009; Public Safety Canada, 2009). Furthermore, the contraband tobacco trade has also been linked to narcotics and firearms smuggling and the theft of lawful tobacco products from legitimate retail merchants (Criminal Intelligence Service Canada, 2005; RCMP 2008a, 2008b, 2009; Public Safety Canada, 2009).

Some other negative consequences associated with the contraband tobacco trade include the loss of market share for lawful tobacco merchants and declining federal and provincial tax revenues (CCSA, 2010; Canada Revenue Agency, 2008, 2009). Given the negative impact of the contraband tobacco trade, it is incumbent on Canadian policy makers and politicians to implement carefully crafted policies that will abate this flourishing underground market.

### **3 Determinants of the contraband tobacco trade**

Eliminating, or even abating, the trade in contraband tobacco will be difficult as there is no single factor solely to blame for fueling the trade (Sweeting et al., 2009; Gabler and Katz, 2010). Several factors that have precipitated the contraband tobacco trade include federal and provincial excise taxes, the difficulty of impeding contraband tobacco distribution, and the perceived substitutability between contraband and lawful tobacco from the perspective of budget-conscious smokers (Sweeting et al., 2009; Gabler and Katz, 2010; Public Safety Canada, 2009).

Tobacco excise taxes have long been regarded as a critical component of any anti-smoking initiative. Using taxes to discourage smoking follows from the basic economic principle that increasing the price of a good will reduce the amount of that good being consumed. As such, many proponents of using taxation to discourage smoking argue that imposing a high excise tax on tobacco will result in an increase in the retail price of tobacco products and a corresponding decline in demand (Health Canada, 2002; Chaloupka et al., 2000, 2002). Policy makers also impose tobacco taxes to generate revenue that can be used to finance fiscal expenditures (Chaloupka et al., 2000, 2002). Consequently, tobacco excise taxes have a dual—and conflicting—mandate: a reduction in smoking prevalence and an increase in tax receipts.

Unfortunately, taxing tobacco also leads to unintended and undesirable outcomes. Taxes have played an important role in fueling the contraband tobacco trade by creating an incentive to distribute and consume relatively cheap (“tax free”) black-market tobacco. The link between taxes and black markets has been extensively documented in earlier research. Taxes have been shown to increase the size of black markets and to cause economic activity to move underground, as price-sensitive individuals look for creative ways to evade taxation (Mirus and Smith, 1981, 1997; Mirus et al., 1994; Spiro 1993, 1997).

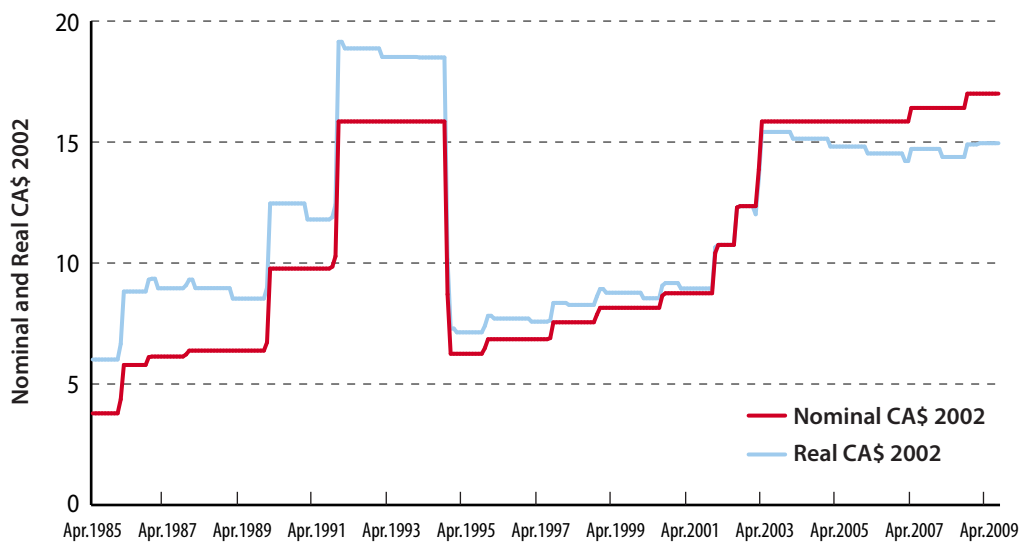
During the mid-1980s, Canadian lawmakers began to see tobacco taxation as an important source of revenue and an effective means to discourage smoking. Between early 1985 and late 1991, the federal excise tax per carton of cigarettes increased by 218%. As Gabler and Katz (2010) show, increased tobacco excise taxes have played an important role in the development and persistence of the contraband tobacco market in Canada. This dynamic was recognized by government officials in the mid-1990s and tobacco excise taxes were subsequently reduced in order to weaken the incentives to manufacture, smuggle, distribute, and purchase contraband tobacco products. Despite the

evident historical lessons, the federal and many provincial governments began to raise tobacco taxes again in the early 2000s as part of a reinvigorated effort to reduce tobacco consumption.

The first tax hike introduced as part of the Federal Tobacco Control Strategy in April 2001 raised the excise tax to \$10.65 per carton. The following month, the federal excise tax was raised further to \$10.99 per carton, and by the end of 2001 the tax rate had reached \$12.62 per carton. In June 2002, the federal tobacco excise tax was yet again raised, up to \$13.86 per carton and, a month later, to \$15.85 per carton. Since 2002, the federal government has continued to raise the nominal level of tobacco taxation incrementally to offset inflation and thus maintain the real level of federal excise taxes on cigarettes at about \$15 per carton (in real 2002 Canadian dollars) (Canada, Department of Finance, 2009). The levels of nominal and real federal excise tax per carton between 1985 and 2009 are shown in figure 1.

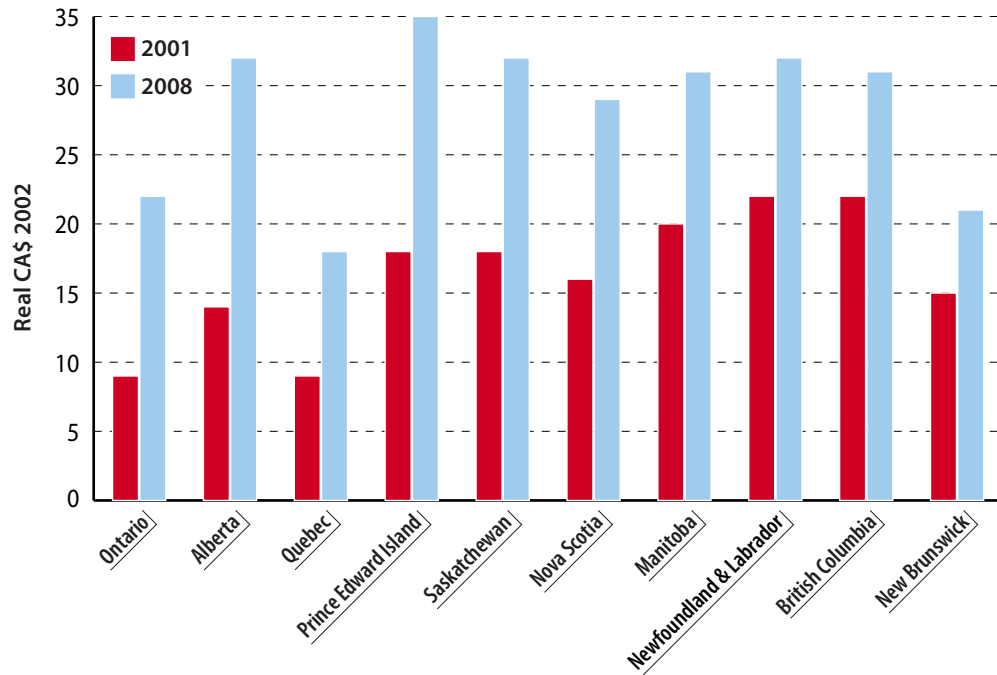
The provinces have also increased excise taxes on cigarettes. However, there was considerable interprovincial variation in the magnitude of the increases. The largest hike was adopted in Ontario, where taxes were raised from \$9.10 per carton to \$21.65 per carton (in real 2002 Canadian dollars) between 2001 and 2008, an increase of 137.9% (Ontario, Ministry of Finance, 2009a). The smallest increase occurred in New Brunswick, where the tax was raised from \$14.83 per carton to \$20.60 per carton (in real 2002 Canadian dollars) over the same period, an increase of 38.9% (New Brunswick, Department of Finance, 2009a). The absolute changes in (nominal dollar) tax rates for each province between 2001 and 2008 are shown in figure 2. Similarly, the percentage changes between 2001 and 2008 in the provincial tobacco excise tax rates per carton are given in figure 3.

**Figure 1: Federal tobacco excise tax per carton, 1985–2009**

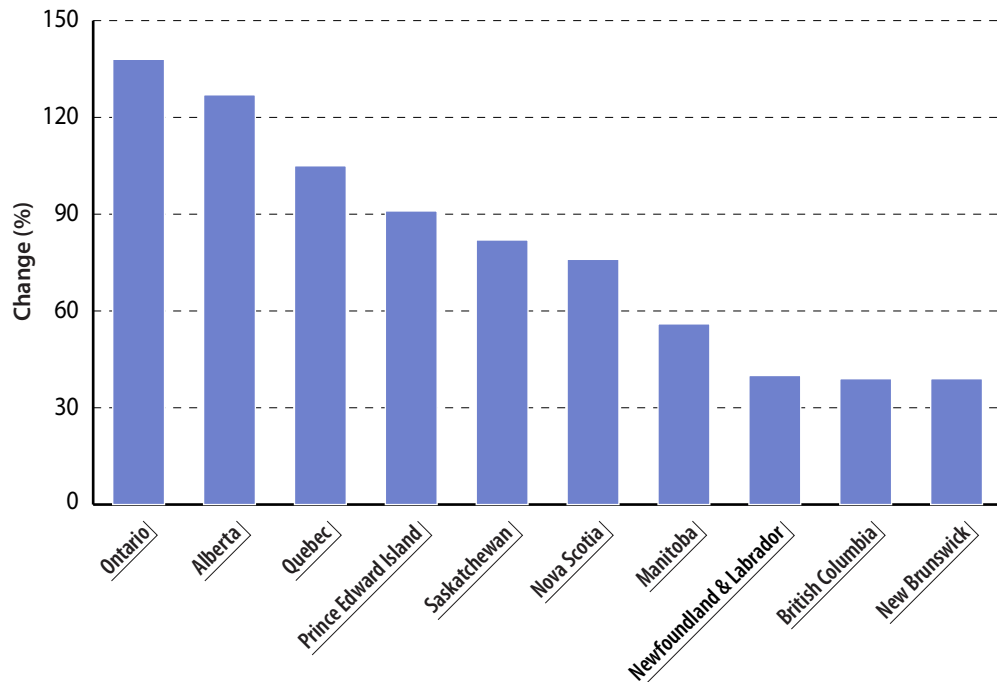


Sources: Canada, Dep't of Finance, 2009.

**Figure 2: Provincial excise-tax rates per carton, 2001 and 2008**



**Figure 3: Percentage increase in provincial excise-tax rates per carton between 2001 and 2008**



Sources: British Columbia, Ministry of Finance, 2009; Alberta, Ministry of Finance and Enterprise, 2009; Manitoba, Ministry of Finance, 2009; New Brunswick, Dep't of Finance, 2009; Newfoundland & Labrador, Dep't of Finance, 2009; Nova Scotia, Dep't of Finance, 2009; Ontario, Ministry of Finance, 2009; Prince Edward Island, Dep't of the Provincial Treasury, 2009; Quebec, Ministry of Finance, 2009; Saskatchewan, Ministry of Finance, 2009.

In addition to taxation, the ability to engage in smuggling and distribution with little threat of punishment is also important in explaining the growth of contraband tobacco markets in Canada. The efforts made by Canada's law-enforcement community to rein in contraband tobacco distribution have been frustrated by the difficulties involved in trying to seal the porous Canadian-American border and interdict black-market traffickers who take precautions to avoid police detection. The difficulty inherent in trying to interdict contraband tobacco flowing over the Canadian border with the United States implies that authorities are unable to stamp out the problem at its source, and can hope only to impede the flow of contraband once it is already available in Canada. Most of the geographic terrain that law enforcement has found difficult to police include semi-autonomous Aboriginal territories and reserves in close proximity to the US border, most notably the Akwesasne reservation located just outside of Cornwall, Ontario (Cunningham, 1996; RCMP, 2008a).

Despite the inherent difficulties in subduing contraband tobacco distribution, the RCMP has adopted a formal strategy intended to rein in the contraband tobacco trade. The centrepiece of the RCMP's anti-contraband efforts is the federal Contraband Tobacco Enforcement Strategy, a multi-faceted approach to fighting contraband tobacco. The Contraband Tobacco Enforcement Strategy aims to disrupt organized criminal activity, establish partnerships with various stakeholders with an interest in subduing the contraband trade, increase awareness through education and outreach about the dangers posed by contraband tobacco, develop further regulatory measures to facilitate the fight against contraband tobacco and conduct research that helps illuminate potential solutions to the contraband tobacco problem (RCMP, 2008a, 2008b, 2009).

Another key facilitator of the contraband tobacco trade is the ability of underground manufacturers to produce and sell cigarettes at exceptionally low costs. It has been reported that cigarettes are being sold for as little as \$6 a carton<sup>5</sup> through smoke shops on certain Aboriginal reserves in Ontario and Quebec. Because Aboriginal tobacco merchants are able to sell cigarettes for such astonishingly low prices, policy makers regulating tobacco distribution need to acknowledge that enticing Aboriginal tobacco merchants to opt out of the contraband tobacco trade voluntarily is crucial to subduing this flourishing component of Canada's underground economy (RCMP, 2008; *National Post*, 2008).

When devising policies to combat the contraband tobacco trade, considerations regarding tax policy and enforcement measures must figure prominently in the discussion. Contraband tobacco markets will not be hindered if the issues surrounding tobacco taxation, law-enforcement procedures, and the broader question of basic Aboriginal autonomies are not adequately addressed.

5 The figure of \$6 per carton is the lowest price reported by the RCMP. It should not be regarded as an average price or the price at which cartons of contraband tobacco are regularly sold.



## 4 Policies for reducing the trade in contraband tobacco

This section considers the merits and drawbacks of six policies as effective tactics in fighting contraband tobacco. The goal is to offer an objective and balanced analysis of each policy but no recommendations are made as to the right mix of policies. Instead, we evaluate the merits of each policy individually and leave the choice of a mix of policies up to the local experts and authorities who have first-hand knowledge of the particular characteristics of the contraband tobacco trade in their locales. Furthermore, the policies offered in this section are not being proposed in any particular order as all of the recommendations outlined below deserve serious consideration.

### 1 Tax-collecting partnerships, agreements, and compacts with Aboriginal groups

The active participation in the contraband tobacco trade of organized groups operating on certain Aboriginal reserves, primarily in south-central Ontario and Quebec is well documented (Cunningham, 1996; RCMP, 2008a, 2009). Without enticing Aboriginal groups to desist from engaging in the manufacturing and smuggling of contraband tobacco, other policy initiatives directed at combatting contraband tobacco are likely to flounder. The central role played by some Aboriginals in contraband tobacco markets is a result of unique Aboriginal autonomies, the historic involvement of Aboriginals in tobacco distribution, and the alleged centrality of tobacco in the economic development of impoverished reserve communities and Aboriginal culture. One of the important autonomies enjoyed by Status Indians<sup>6</sup> is an exemption from paying certain taxes at both the national and provincial level.

Tax policy as it pertains to Aboriginals is complex and comprises a myriad of laws. The exemption of Status Indians from paying certain taxes is based on Section 87 of the Indian Act (Canada, *Indian Act*, 1985). All personal property belonging to a Status Indian or Aboriginal community situated on

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6 Status Indian is a designation conferred on individuals of Aboriginal heritage who are privy to recognition under the Indian Registrar. The Indian Registrar is the framework that embodies all of the enactments and legislation that relate to the administration of any unique autonomies or treatment under the law that pertain to individuals of Aboriginal heritage and Aboriginal Communities living on reserve-designated territory.



a reserve is exempt from taxation according to Section 87. This exemption prevents all levels of government in Canada from levying most taxes, whether in the form of personal income, sales, or property tax on Status Indians who live and work on reserve lands. The exemption includes provincial excise taxes but notably excludes the payment of federal excise taxes, including federal tobacco excise taxes, both on and off a reserve. Conversely, reserve-based merchants are obligated to collect sales taxes when selling goods and services to Aboriginals without official Indian Status and all non-Aboriginals.

However, under Section 83 of the Indian Act and several other pieces of legislation, as well as within the framework of self-governing agreements signed between specific bands and their respective provincial governments (Canada, *Indian Act*, 1985), Aboriginal governments and band councils are vested with the authority and discretion to impose any form of direct taxation on the community members residing on their reserve land. These taxes may comprise levies on personal income, property, sales, and select goods that usually incur an excise tax. In accordance with this mandate, numerous individual tribal councils have instituted various taxes on reserves, often in coordination with relevant Canadian agencies including the federal Department of Finance, the Canada Revenue Agency, various provincial Finance Ministries, and the Ministry of Indian Affairs and Northern Development. The taxes currently being levied on select reserves are mainly composed of sales and excise taxes and, to a lesser extent, personal income tax (Canada, Ministry of Indian and Northern Affairs, 2002, 2010; Canada, *Indian Act*, 1985).

Several important types of taxes are currently in effect that can be adopted by Aboriginal governments interested in partnering with Canadian tax authorities in introducing specific tax levies within their jurisdiction. The First Nations Goods and Services Tax (FNGST) can be adopted and subsequently levied on the sale of all goods and services sold within a reserve, with the exceptions of alcohol, tobacco, and fuel. The FNGST is a substitute for the GST and the federal component of any HST on all goods and services sold, excluding alcohol, tobacco, and fuel. In place of the GST or the federal portion of an HST on alcohol, tobacco, and fuel, band councils can introduce the First Nations Tax (FNT). Furthermore, Section 83 of the Indian Act and the First Nations Fiscal and Statistical Management Act (FNSM) grant the right to band councils to levy property taxes. Income taxes can be enacted under the mandate of the First Nations Personal Income Tax (FNPIT) and can be levied against all personal income generated on a reserve by Status Indians and non-Status Indians alike.

It should be noted that the First Nations Tax, the First Nations Goods and Services Tax, and the First Nations Personal Income Tax are all negotiated and implemented in partnership with the Department of Finance and administered with the assistance of the Canada Revenue Agency. Moreover, there are two federal bodies that deal exclusively with taxation in Aboriginal communities: (1) the First Nation Tax Commission and (2) the Aboriginal Tax

Policy Section situated within the Department of Finance. Lastly, provincial excise tax levies on alcohol and tobacco have been adopted by Aboriginal governments in partnership with their respective provincial governments. A list of the key pieces of legislation for the tax levies to which Status Indians can be subjected and all the tax agreements adopted by Aboriginal governments as of July, 2010 are listed in the Appendix (p. 35).

Irrespective of any tax agreements, when reserve-based merchants sell tobacco to non-Status Indians or non-Aboriginal persons the appropriate taxes are supposed to be collected and forwarded to the designated government agency. That being said, Aboriginal tobacco merchants can earn a handsome profit by undercutting tax-inflated retail prices prevailing in lawful tobacco markets. Furthermore, it is imperative to recognize that Aboriginal manufacturers and distributors have shown a willingness to sell their tobacco products for prices that are often well below the tax-exclusive retail price of lawfully manufactured cigarettes. As such, it stands to reason that a tax reduction, or even a total tax repeal, may not suffice to deter Aboriginal contraband tobacco trafficking. The price differential could reach upwards of \$65 to \$80 per carton,<sup>7</sup> and perhaps slightly higher, given that cigarette prices at the retail level, and thus tax inclusive, across Canada are often between \$75 and \$90 per carton (tax inclusive), depending on the province (RCMP, 2008a).

By effectively undercutting the tax-inclusive retail price, Aboriginal merchants have been able to capture a significant share of the total Canadian tobacco market. The RCMP has alleged that upwards of 50% of all contraband tobacco confiscated in Canada flows from several key Aboriginal reserves situated in south-central Ontario and southwestern Quebec<sup>8</sup> (RCMP, 2008a).

Some Aboriginals have claimed that their tobacco production and distribution activities are lawful and vital to the economic development of impoverished reserve communities (Kahnawake Tobacco Association, 2010; Physicians for a Smoke Free Canada, 2007). While participation in the contraband tobacco trade is limited to individual operatives and organized groups, advocates who defend Aboriginal tobacco commerce claim that these tobacco entrepreneurs produce trickle-down benefits for the community at large. However, there is no evidence that any systematic efforts have ever

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7 The possible differential is based on the assumption that a typical carton of contraband tobacco can be bought for approximately \$10 on a Aboriginal reserve. As stated above, the RCMP has reported that a carton of contraband tobacco may be bought for as little as \$6 from some distributors. It is likely that \$6 is towards the low end of the price range and we do not know what quantity of tobacco is sold at this price. However, the existence of such a price underscores the difficulty faced by the tobacco industry and Canadian governments confronting manufacturers who can produce cigarettes for such a low price. Undercutting the \$6 per carton figure might not be attainable even if all tobacco excise taxes were repealed.

8 Most notably, the Akwesasne, Kahnawake, Tyendinaga and Six Nations reserves

been made to channel contraband tobacco revenues into a robust economic development strategy or initiative within a particular reserve community.

In an attempt to use economic incentives to confer legitimacy upon Aboriginal tobacco commerce, several Canadian provinces and US states have implemented tax-revenue agreements with Aboriginal communities. These states and provinces have signed tax compacts with their local Aboriginal communities that remunerate the band with the full or partial proceeds from the taxation of tobacco products sold on a reserve. Unfortunately, tax agreements can only reduce that portion of the contraband tobacco supply controlled by Aboriginal tobacco merchants. Nevertheless, recognizing the importance and prominence of this source of supply, it is imperative that a concerted effort be made to establish a stake for Aboriginal tobacco merchants in the lawful tobacco market.

Tax-revenue arrangements have been implemented in several localities within Canada and the United States, notably in Manitoba, New Brunswick, British Columbia, and the state of Washington (Sweating et al., 2009). It is possible that some Aboriginals may contend that collecting taxes, thereby equalizing the retail price for cigarettes on and off reserves, would eliminate their competitive advantage in dealing relatively cheap cigarettes and thus cause their market share to dwindle. In response, some governments have agreed to terms that allow Aboriginals to continue offering a discounted price relative to off-reserve prices by charging an excise tax rate that is slightly below the tax rate prevailing off-reserve. To date, tobacco taxation has netted tens of millions of dollars for participating tribal governments (Canada, Ministry of Indian and Northern Affairs, 2010).

Another beneficial aspect of tax agreements for Aboriginal tobacco merchants is the opportunity to bring their trade into the legitimate market. Though enforcement efforts against Aboriginal tobacco merchants have been obstructed or relaxed because of the Canadian government's wariness about contesting Aboriginal sovereignty claims, the RCMP and provincial police services will apprehend and incarcerate any contraband tobacco trafficker who can be apprehended outside autonomous Aboriginal territory. Regarding on-reserve enforcement, the RCMP and their provincial law enforcement counterparts will typically try to cooperate with reserve-based policing authorities to enforce the rule of law, though they do have the jurisdiction to operate independently. The RCMP has developed a special National Aboriginal Policing Strategy to address the distinctive needs of providing law enforcement services in Canada's Aboriginal communities (RCMP, 2007). It appears that the threat of law enforcement may not loom large in the minds of Aboriginal tobacco merchants and has not significantly deterred their contraband tobacco distribution activities; however, these threats cannot be totally ignored. Tax agreements remove the risks associated with operating underground and the threat of interdiction, apprehension, and incarceration by law enforcement.

Taxation also enhances the legitimacy of Aboriginal governance (Canada, Ministry of Indian and Northern Affairs, 2010; Graham and Bruhn, 2008). Collecting tobacco taxes in particular, and adopting other forms of taxation more generally, offers band councils a way to generate their own revenues, thereby reducing their reliance on federal transfers under the Indian Act (Canada, Ministry of Indian and Northern Affairs, 2010; Graham and Bruhn, 2008; Washington State, Department of Revenue, 2007, December 14). Furthermore, the decisions about how to spend the revenues generated through taxation would rest solely with the band council. As such, most tribal councils would likely be inclined to ensure that the revenues are used efficiently and not misappropriated. Similarly, reserve residents may exhibit deeper interest in the expenditure decisions of their tribal governments if revenues are generated within the community as opposed to being received via transfer from the federal government (Canada, Ministry of Indian and Northern Affairs, 2010; Graham and Bruhn, 2008).

Revenues collected by tribal councils could be used to finance various development projects that support, strengthen, and invigorate legitimate economic growth and development within Aboriginal communities across Canada. Development projects financed by tobacco-tax revenues could be used to help integrate burgeoning commercial activities on Aboriginal reserves within the wider Canadian economy. To date, no focused, concerted, or systematic efforts have been made to channel contraband tobacco revenues into robust development initiatives within reserve communities. However, after bestowing official sanction to distribute tobacco, coupled with the appropriate oversight and administration, such development efforts stemming from the tobacco trade could become a reality (Graham and Bruhn, 2008; Washington State, 2002).

From the point of view of the anti-smoking lobby, another benefit of tax agreements is that the deterrent effect of taxes on smoking would be bolstered. Because Aboriginal tobacco merchants would be collecting tobacco excise taxes at the same rate as, or slightly less than, all other retailers, one source from which smokers can readily procure markedly cheaper tobacco would be eliminated.

The agreements require provinces and states to relinquish revenues from tobacco taxes by abdicating tax-collecting authority to the signatory Aboriginal communities and granting those communities the right to keep all or most of the proceeds of the taxes they collect. However, the revenue to be generated by signatory Aboriginal communities was not revenue that would otherwise have been earned by any federal or provincial tax authority. Whatever tobacco was previously being sold by Aboriginal merchants would simply have constituted the proceeds from contraband tobacco distribution. In any case, any reduction in revenues due to the signing of a tax agreement should be offset somewhat by a reduced contraband tobacco market, as former distributors of contraband tobacco begin operating under the sanction and auspices of the signatory government.

Yet another benefit of tax agreements for Aboriginal communities is a reduction in the criminality associated with the contraband tobacco trade (RCMP, 2008). Respect for the rule of law might improve if the bulk of tobacco commerce on Aboriginal reserves is moved above ground and any links with non-Aboriginal organized crime groups are severed. More specifically, tax-revenue agreements can improve respect for the rule of law by reducing the exposure of reserve residents to many of the peripheral crimes associated with the contraband tobacco trade, including the sale of illicit firearms and narcotics. On the other hand, one arguable drawback of establishing tax compacts with former traffickers in contraband tobacco is the negative precedent that follows from rewarding criminal activity and the subsequent moral hazard these agreements may create. Rewarding criminal behaviour by giving validity to those perpetrating illegal activity could invite even more criminality in the future by other criminal elements also hoping to acquire the sanction of government.

Another major drawback of tax agreements is their limited focus on the contraband tobacco flowing from Aboriginal communities, to the neglect of other sources of contraband tobacco. Tax agreements will have no impact on contraband tobacco distributed by non-Aboriginals, including American cigarettes bought in states with relatively low taxes or counterfeit cigarettes that are smuggled into Canada via shipping freight. As such, tax agreements may simply result in contraband tobacco markets finding alternative sources of supply and not lead to the elimination of the Canadian contraband tobacco trade. Nevertheless, enticing contraband dealers identifying with Canada's Aboriginal communities to abandon their illicit tobacco distribution in favour of participating in the lawful tobacco trade, remains a desirable policy objective.

Tax agreements give Aboriginal communities a vested interest in the collection of tobacco excise taxes. Engaging Aboriginal tobacco merchants and offering them a stake in the legitimate tobacco trade would create an incentive for them to desist from contraband tobacco smuggling and distribution. Because some Aboriginals have played a pivotal role in the contraband tobacco trade, it is imperative to find solutions to the contraband tobacco problem that are supported by Aboriginal communities. This support will only be forthcoming if Aboriginal stakeholders feel that their interests in the tobacco trade have been safeguarded.

#### **Tobacco tax compacts in the State of Washington— a case in sanctioning the aboriginal tobacco trade**

Washington State requires all non-Aboriginals purchasing tobacco to pay the state's tobacco excise tax. Similarly, Aboriginal tobacco merchants selling to those who are not "qualified" purchasers are required to collect the state tobacco excise. "Qualified" buyers are Aboriginals purchasing tobacco for resale to other "qualified" buyers or for their own personal use. These general guidelines can be superseded if a tax compact or agreement has been signed and put into effect (Washington State, 2009a).



Over the past decade, Washington State has signed tax compacts with over a dozen of its Aboriginal bands. According to the Washington State Department of Revenue, most Aboriginal tribes are collecting cigarette taxes in accordance with the various agreements and compacts signed in partnership with the state. Buyers who are not qualified (non-Aboriginals) can only lawfully purchase tobacco from Aboriginal tobacco sellers who are party to a tax agreement. All cigarettes sold in Washington State, excluding those sold on military bases, must be affixed with a stamp indicating tax compliance. All cigarettes sold by tobacco merchants within Aboriginal territory where a tobacco-tax agreement is in place are marked with either a green compact stamp or a band-specific tax-compliance stamp. Aboriginal community members themselves continue to be exempt from any tobacco excise tax (Washington State, Department of Revenue, 2009b).

In April 2005, Washington State's revenue authorities signed an agreement with the Puyallup Aboriginal band that required reserve-based tobacco merchants to collect a tobacco excise tax equivalent to slightly above 80% of the off-reserve tax rate (Sweeting et al., 2009; Washington State Legislature, 2005). In December 2007, the state signed a tobacco tax agreement with the Yakama Nation that stipulated the imposition of a tobacco tax amounting to 80% of the off-reserve rate for the first six years, 84% in the seventh year and 87.5% of the state's rate thereafter (Washington State, Department of Revenue, 2007). Other agreements, like that signed with the Tulalip tribe, mandate that the rate of tobacco taxation levied on reserve equates to 100% of the state's off-reserve tobacco excise tax rate (Washington State, 2002). Thus, not every tax agreement over tobacco stipulates that the on-reserve tax rate must be lower than the state's rate prevailing off reserve. Agreements can be formulated where the on-reserve tobacco excise tax rate is either equal to, or below, the tobacco excise tax rate in effect off Aboriginal reserves.

If an agreement stipulated that Aboriginal tobacco merchants can levy an excise tax at a rate below that prevailing off reserves, the remaining tax discount would preserve the incentive of smokers to continue buying tobacco from Aboriginal merchants. Nevertheless, if Aboriginal tobacco merchants levy a tobacco excise tax, the price differential that previously existed between untaxed contraband tobacco and lawfully sold tobacco would likely shrink. The majority of Aboriginal bands who have entered into tobacco tax agreements with Washington States are entitled to keep all of the revenues they collect from the taxation of tobacco. However, there are several exceptions. The Puyallup compact, for example, calls for a remittance to the state's Department of Revenue on a quarterly basis of 30% of all tobacco taxes collected (Washington State Legislature, 2005; Washington State, Department of Revenue, 2007).

Tax agreements would allow Aboriginal tobacco sellers to raise the prices they charge for cigarettes and, consequently, the revenue they receive

from selling tobacco without having to sacrifice much market share. The reason that the market share of Aboriginal tobacco merchants would not fall significantly is that the tax-inclusive price charged on reserve for tobacco products following the signing of an agreement could remain lower than the prices charged for tobacco off reserve. Though the price differential would narrow, it would not be eliminated outright (Washington State, Department of Revenue, 2007) and Aboriginal tobacco merchants could continue to offer cigarettes at a relatively low price point.

### **Tax agreements in Canada**

Tax agreements with Aboriginal communities are a promising policy for reducing the volume of trade being transacted in Canada's contraband tobacco market. Unfortunately, it is not a policy that Canadian federal and provincial governments have tried systematically to implement. With the exception of Manitoba, no province has made a concerted effort to partner with all, or even a majority, of the Aboriginal communities that reside within its jurisdiction. The few existing agreements are limited to those in effect on scattered Aboriginal reserves, mostly in the Western and Prairie provinces. Moreover, there has been no concerted effort systematically to approach the Aboriginal communities in Ontario, Quebec, and the Maritime region that have been identified as key suppliers of the contraband tobacco available in those provinces and in those parts of Canada where contraband tobacco distribution and consumption is believed to be most pervasive. For the provincial governments in Ontario, Quebec, and the Maritimes forming partnerships with the Aboriginal communities within their jurisdictions to enact province-wide tobacco-excise tax agreements would be a feasible policy.

## **2 Complete revocation of taxes on tobacco products**

Tobacco taxation in Canada has a checkered past. Canadian policy makers sought to curb tobacco use through taxation in the late 1980s and early 1990s. By late 1991, tobacco taxes had risen to above \$19 per carton, up from \$6 per carton in early 1985 (in real 2002 Canadian dollars), a 218% increase in the rate of taxation in the span of six years. However, the rising rate of taxation on tobacco also spurred a booming black market for contraband tobacco (Cunningham, 1996; Dupuis, 1998). In an effort to curb the Canada-wide market for contraband tobacco as it thrived during the late 1980s and early 1990s, federal policy makers in conjunction with their counterparts from those provinces most adversely affected by the contraband tobacco trade joined in a major roll-back of tobacco excise taxes in October 1994. The tax reduction was an implicit acknowledgement by the Canadian federal government that

excessively high tax rates had fueled the contraband tobacco market and created a major criminal and public-safety issue. The federal government reduced its tobacco excise to just over \$7 per carton from \$18.5 per carton, a 60% reduction (Canada Revenue Agency, 1994; Cunningham, 1996; Dupuis, 1998; House of Commons Debates, 1994).

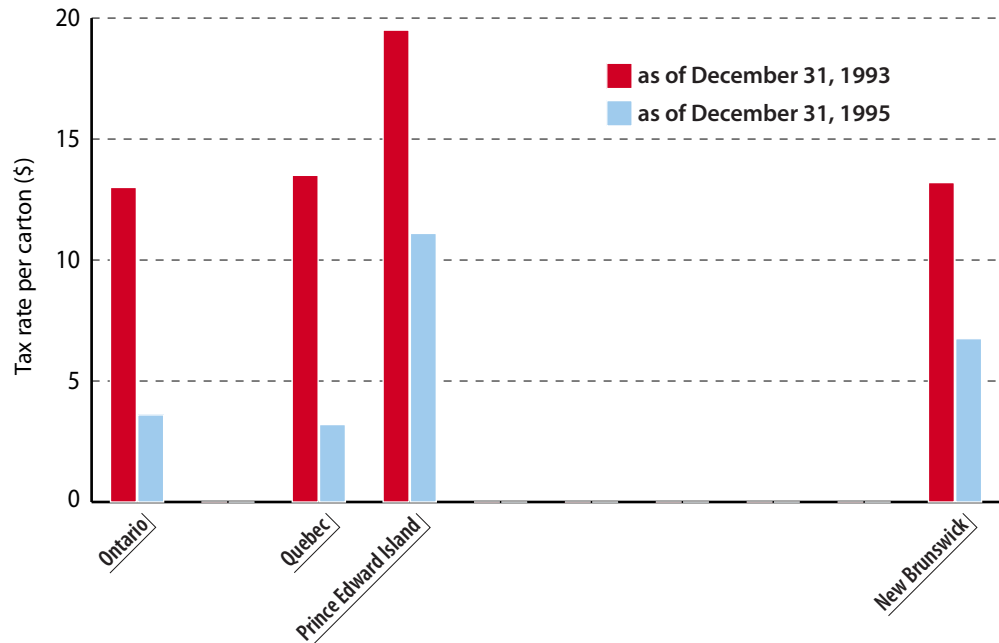
In addition, the provinces most acutely afflicted by the contraband tobacco trade—Ontario, Quebec, New Brunswick, and Prince Edward Island—followed the lead of the federal government and cut their tobacco excise taxes based on a commitment from the federal government to match any provincial cut in tobacco taxes up to \$5 per carton (on top of reductions to the federal levy). For example, the province of Quebec cut its provincial cigarette taxes by 77%, lowering the per-carton tax from over \$13 in 1993 to just over \$3 by the end of 1995 (figure 4) (Quebec, Ministry of Finance, 2009). Provinces other than Ontario, Quebec, New Brunswick, and Prince Edward Island were able to hold their provincial tobacco excise-tax levies in place.

The 1994 reduction in the rate of tobacco taxation proved remarkably effective in subverting the contraband tobacco trade. Nationwide seizures of contraband tobacco by the RCMP plummeted, falling from the previous record high of 456,333 cartons in 1994 to 28,966 by 2001 (RCMP, 2010). Furthermore, the tobacco tax reduction in 1994 had a positive impact on the market for lawfully sold Canadian tobacco products as well. The data for lawful cigarette sales reveal that the number of cigarettes sold by legitimate merchants clearly spiked in most Canadian provinces after tobacco taxes were reduced (Health Canada, 2010b; Statistics Canada, 2005, 2009). Nevertheless, the prevalence of smoking continued to decline for many demographic groups, the notable exceptions being male teenage smokers between the ages of 15 and 19 and adult male smokers at middle age (Stephens, 1988; Health and Welfare Canada, 1992, 1993; Health Canada, 2010a; Statistics Canada, 1994b, 1995a, 1995b, 1997, 1998a, 1998b).

One study found that the 1994 tobacco tax cut did not reverse the downward trend in tobacco use across Canada, but it did slow the pace of decline (Hamilton et al., 1997). The study also found that the incidence of smoking cessation was lower and the incidence of smoking initiation was higher in those provinces that significantly reduced their provincial tobacco taxes. However, a decline in the rate of cessation and an increase in smoking initiation may be offset somewhat by attrition resulting from the death of smokers from either natural causes and elderly age or smoking-related illnesses. Another recent analysis, by University of Waterloo economists Anindya Sen and Nafeez Fatima (2011), found that the 1994 reduction in the tobacco excise tax was correlated with increased daily tobacco consumption by adult and teenage males. While Sen and Fatima find that the effects of lower taxes were modest, nevertheless, they contend that a tax reduction could result in an uptick in tobacco consumption, especially for males. In



**Figure 4: Provincial excise-tax rates per carton, Ontario, Quebec, Prince Edward Island, and New Brunswick, 1993 and 1995**



Sources: New Brunswick, Dep't of Finance, 2009; Ontario, Ministry of Finance, 2009; Prince Edward Island, Dep't of the Provincial Treasury, 2009; Quebec, Ministry of Finance, 2009.

other words, lowering the tax-inclusive retail price of tobacco could induce more tobacco consumption. Conversely, increasing tobacco excise taxes can indeed reduce tobacco consumption: the law of demand holds for tobacco.

However, the earlier Canadian experience clearly demonstrates the effectiveness of tax reductions in abating the contraband tobacco trade. Moreover, a task-force on illicit tobacco products commissioned by the Canadian minister of Public Safety in 2009 found that activity in the contraband tobacco market during the early 1990s was indeed spurred on by increases in tobacco taxes through the latter half of the 1980s and early 1990s (Public Safety Canada, 2009).

Given the well-established link between tobacco taxes and the contraband tobacco trade, policy makers intent on fighting contraband tobacco distribution must give due consideration to the outright elimination of all excise taxes on tobacco, including both federal and provincial levies. A full revocation of taxes on tobacco products would abate the contraband tobacco trade as the profitability of selling contraband tobacco would be significantly reduced and budget-conscious smokers would have less reason to buy contraband tobacco. Contraband tobacco traffickers would find selling contraband tobacco much less lucrative after an outright elimination of excise taxes on tobacco. Similarly, smokers would likely feel less compelled to purchase tobacco in the black market.

A related benefit of eliminating tobacco excise taxes is that a large share of the total tobacco market that was previously held by contraband traffickers would then be restored to law-abiding merchants who sell tobacco within the framework of relevant Canadian laws. These lawful tobacco merchants have been significantly harmed by tobacco taxation as a result of market share lost to contraband tobacco dealers. Lawful tobacco merchants who carry other types of concessions are also hurt by the reduction in consumer traffic and the resultant loss of “add-on” concession sales (Canadian Convenience Store Association, 2010).

Earlier research has documented the perceived substitutability between contraband and licit tobacco products and the consequent displacement of lawful tobacco products by tobacco available in the contraband market (Gabler and Katz, 2010). With the return of smokers to the lawful tobacco market following a complete revocation of taxes on tobacco, law-abiding tobacco retailers can expect an associated increase in both tobacco and non-tobacco product sales. Due to increased customer traffic as smokers return to buying their cigarettes from these lawful merchants, merchants who also carry food, beverages, and other assorted convenience goods would likely enjoy the benefits of reinvigorated consumer traffic on concession sales.

Opponents of eliminating excise tobacco taxes argue that to do so would encourage smoking. However, recent research has found that the deterrent effect of higher tobacco taxation has waned in recent years. Recent estimates of the responsiveness of tobacco purchases in Canada to changes in price are now as low as a 3% decline in the number of cigarettes purchased in response to a 10% increase in the price of cigarettes (Gospodinov and Irvine, 2005). Several earlier estimates for Canada and other developed countries of the responsiveness of tobacco purchases to changes in price typically found that a 10% hike in the price of cigarettes would induce a decline of approximately 4% to 4.5% in the number of cigarettes purchased or consumed (Chaloupka et al., 2000; Chaloupka and Warner, 2000; Gruber et al., 2003). The declining responsiveness in the demand for tobacco to increases in price might indicate that the remainder of Canadian smokers are those with the most entrenched tobacco addiction and, as such, are the least likely to quit smoking in response to an increase in the rate of taxation.

Another possible explanation for the waning deterrent effect of tobacco taxation is that many of the smokers with the highest sensitivity to changes in price, principally young and lower-income smokers, have already stopped smoking or reduced their tobacco consumption. Those who continue to consume tobacco are those individuals who have shown themselves to be less responsive to changes in the price of tobacco, principally older and relatively high-income smokers with deeply entrenched tobacco addictions. The Canadian Tobacco Monitoring Use Survey indicates that the smallest reduction in smoking prevalence has been among smokers within the age bracket

of 45 to 55 years, the very cohort most likely able to resist tax-based anti-smoking initiatives (Health Canada, 2010a).<sup>9</sup> Conversely, there is reason to suspect that a constellation of anti-smoking initiatives, working in tandem, have collectively been responsible for reducing tobacco use across Canada. A whole array of anti-smoking education programs, restrictions on point of sales and restrictions on access have all had a significant role in lowering the prevalence of smoking among Canadians (Gospodinov and Irvine, 2005).

Opponents of revoking taxes on tobacco products also claim that federal and provincial governments would be forgoing a vital source of revenue. Between 2001 and 2008, a total of \$20.4 billion dollars was collected by the federal government through the taxation of tobacco. After reaching a peak of \$3.1 billion in 2005, revenues from tobacco taxation began to decline, falling to \$2.1 billion by 2008, a billion dollars in the span of just three years (Statistics Canada, 2010).<sup>10</sup> The \$2.1 billion collected from the taxation of tobacco made

9 It is important to note that most of these estimates are based on data about lawful cigarette sales and do not account for distortions caused by some smokers' use of contraband tobacco. Similarly, these estimates do not reflect the relatively high prevalence of contraband tobacco use among youth and lower-income smokers.

10 There are several seeming anomalies in the government's data on tobacco taxation, production, consumption, and trade. Similarly, the data used to deconstruct the dynamics of the Canadian contraband tobacco market is somewhat tangential and disparate when viewed as a whole. Owing to the nature of clandestine underground economies, there are no systematically tracked figures or statistics, recorded at regular time intervals, which can be easily scrutinized. Furthermore, any "back of the envelope" calculation is likely to contain more "wholes" than one would expect to find in a rigorous statistical analysis.

However, the data used to analyze the Canadian contraband tobacco market does not necessarily present an inconsistent picture. For example, Industry Canada reported that overall sales revenue for cigarette and tobacco wholesalers has increased over the past decade (Industry Canada, 2011). In contrast, the total revenue earned from excise taxes by the federal government declined between 2005 and 2008 (Statistics Canada, 2010). Furthermore, Health Canada simultaneously reported a decline in wholesale cigarette sales between 2005 and 2008, but a much smaller decline than the fall in tobacco excise-tax revenue (Health Canada, 2010b).

Taking these together, we see tobacco manufacturers' sales revenues rising, federal excise-tax revenues falling, and actual volumes of cigarettes sales also declining. Nevertheless, the seeming anomaly is explainable if there have been corresponding changes in the number of cigarettes actually sold, the final retail price of cigarettes, and the average unit price charged by manufacturers. More specifically, if the average price per unit (e.g., crate or carton of cigarettes) charged by tobacco manufacturers increased by a magnitude sufficiently high to offset the decline in sales volume, then aggregate industry revenues would rise. Conversely, if the volume of tobacco sold declines and the excise tax rate remains unchanged and does not increase to offset the decline in tobacco sales, then government tobacco-tax revenues would shrink. It is plausible, then, that government tax revenues could shrink while industry sales revenues increased as sales of lawful cigarettes declined. In sum, while the cigarette sales, manufacturer revenues, and government

up just under one percent of the \$233.3 billion aggregate of all federal government revenues in that year (Canada, Ministry of Public Works and Government Services, 2010; Statistics Canada, 2010). If the revenue generated from tobacco taxation was discontinued, governments could make up some of those lost revenues via the implementation of a more efficient tax structure targeting other tax bases or via reductions in less-than-necessary fiscal expenditures.

Another possible drawback of eliminating taxes is that it might still prove insufficient to deter the underground trade in tobacco. Aboriginal tobacco distributors and their affiliates have demonstrated that they are willing to accept exceptionally low prices for their tobacco, considerably below the price of legal tobacco that would prevail in the event of a complete revocation of tobacco excise taxes. The RCMP reports that in some locales a carton of cigarettes may sell for as little as \$6. It is unlikely that the tobacco industry will ever be willing to allow the price charged for a typical carton of tobacco (at either the wholesale or retail levels) to fall so low. Thus, even if tobacco excise taxes were eliminated outright, there is still reason to believe that Aboriginal tobacco merchants will manage to retain a part of their currently held market share.

The overall impact of a complete revocation, or partial reduction, of tobacco excise taxes in Canada is difficult to discern and there appear to be both positive and negative ramifications. Though reducing or eliminating tobacco taxes will not likely engender a major increase in general tobacco use across all demographic groups and cohorts within Canada, it might slow down the pace at which tobacco use is currently declining or even result in a slight increase in tobacco use. On the other hand, there is a considerable chance that a complete elimination of the federal (and provincial) excise taxes on tobacco products would shrink the profit margins of black-market merchants and squeeze the least efficient of them out of the trade. Unfortunately, the contraband market is unlikely to be suppressed completely even if the federal tobacco excise tax is entirely removed. Nonetheless, outright elimination of excise taxes on tobacco deserves serious consideration.

### **3 Reduction in excise taxes and a narrowing of price differences among jurisdictions**

The Royal Canadian Mounted Police (RCMP) has identified tobacco originally purchased in American states with relatively low excise taxes on tobacco as an important source of supply for the Canadian contraband tobacco market

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tax revenue data seems confusing, the data can be reconciled if the fluctuations in each respective variable were of a sufficient magnitude.

(RCMP, 2008, 2009). This being the case, another policy that could subvert a portion of the trade in contraband tobacco would be eliminating or narrowing any differences in the rate of tobacco taxation that currently exists between Canada and American states where the tobacco excise tax rates are relatively low.

The primary incentive driving the segment of the contraband market that procures relatively cheap cigarettes in the United States and smuggles them into Canada for sale in the black market is the existence of significant differentials between the retail prices for cigarettes in Canadian provinces and some US states. The differences in the retail prices for cigarettes sold in Canadian provinces and these US states are primarily a reflection of differences in the excise tax rates prevailing in these jurisdictions (Cunningham, 1996; Fleenor, 1998, 2003).<sup>11</sup> Patrick Fleenor (2003) found that jurisdictions with relatively high tobacco excise taxes inadvertently provide the necessary incentive that entices contraband tobacco dealers to buy tobacco in relatively low-tax jurisdictions for distribution in higher-taxed jurisdictions. Fleenor analyzed the effect of state and municipal tobacco taxes in New York and concluded that tobacco taxes fueled a massive, burgeoning black market for tobacco across New York State, and particularly within the municipal limits of New York City. Contraband cigarettes were being smuggled into New York State from other states with lower rates of tobacco taxation.

Reducing the price differentials that exist between the rate of tobacco taxation in Canada and the rates prevailing in those US states with relatively low tobacco taxes necessitates lowering taxes and bringing the tobacco-tax rates in Canada closer to the rates in those lower-tax jurisdictions; by default, Canadian federal and provincial governments would have to adopt the rates in those American states with the lowest tobacco taxation. It is possible that the amount of government revenue generated by taxes on tobacco sales could shrink on account of the lower rate of taxation but this decline may be partially offset by increased consumption of lawfully sold and taxed tobacco by smokers who may otherwise have purchased contraband tobacco. Another benefit, as described in the previous section on tax repeal, is that law-abiding merchants who sell tobacco within the framework of relevant Canadian laws should benefit not only by recovering a share of the total tobacco market that was previously held by contraband traffickers but also from increased consumer traffic that could lead to more concession sales.

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11 The jurisdiction from which tobacco can be smuggled need not be in close proximity. As long as the cost of transportation and other costs incurred in the smuggling effort can be recouped, the incentive to distribute cheap American cigarettes illegally in Canada will persist.

#### **4 Better record keeping by the Royal Canadian Mounted Police, Canadian Border Services Agency, and provincial policing authorities**

Good data is a prerequisite for any comprehensive, thorough, and detailed analysis of Canada's problem with contraband tobacco. Unfortunately, statistics that describe the extent of criminality linked to contraband tobacco markets are essentially non-existent. At the moment, the data being systematically tracked and publicly disseminated by the Royal Canadian Mounted Police (RCMP) is limited to the number of confiscated contraband cigarettes and the amount of raw tobacco leaf seized annually across Canada. It would be a great aid to policy makers if Canadian law-enforcement agencies would systematically record, compile, and organize more extensive data about Canada's contraband tobacco trade.

During the author's attempt to collect useful data about the efforts of law-enforcement agencies to suppress the trade in contraband tobacco, the public-relations departments at the Royal Canadian Mounted Police and Canadian Border Services Agency (CBSA) were unable to provide most of the information that was being requested. The information provided by the RCMP was disorganized and consisted of little more than old news highlights and releases as well as disparate information on tobacco seizures.<sup>12</sup> The author's public information request from the CBSA bore even less fruit. The public-relations office of the CBSA was unable to provide any of the data that was being sought.

The author requested data from both the CBSA and RCMP that documented what resources were being invested in the fight against contraband tobacco, including the budget devoted to fighting contraband tobacco and the number of law-enforcement personnel engaged on a full-time basis to thwarting contraband tobacco distribution. The author also requested a more detailed description of tobacco seizures that included: a provincial breakdown; the actual number of incidents in which illicit tobacco was seized; the number of arrests made in connection with contraband tobacco distribution; the number of successful incarcerations resulting from investigations of the contraband tobacco trade; and the number of charges for trafficking contraband tobacco laid alongside charges for narcotics or firearms distribution

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12 "Disparate" in the sense that, prior to 1994, in some years the RCMP recorded the number of cigarette cartons seized and in other years they recorded the total number of incidents in which tobacco was seized but failed to include the actual number of cigarette cartons confiscated in those incidents. As a result, the RCMP was unable to provide any data on the number of cigarettes seized across Canada prior to 1994.



and possession.<sup>13</sup> No information that could answer any of the above questions was available. Consequently, the author was unable to determine how much money is being expended by law enforcement agencies in suppressing contraband tobacco distribution. Similarly, the author was unable to determine clearly how successful the RCMP and CBSA have been in their interdiction efforts.<sup>14</sup>

Eradicating the market in contraband tobacco requires the collection of relevant data to deepen policy makers understanding of the problem and to aid the formation of effective counter measures. Similarly, it is important that policy makers are able to determine whether the costs associated with various interdiction strategies are commensurate with the extent of the contraband tobacco problem and the probability of a strategy's success. Without better record keeping and compilation of statistics, policy makers will be hindered in developing a clear understanding of the contraband tobacco trade and how it can be fought. This is especially true of data that would shed light on how much money and how many resources Canadian law enforcement is expending on fighting contraband tobacco, and how successful their efforts have been. Without reliable information, policy makers and analysts are unable to accurately assess the prospects of any anti-contraband tobacco strategy or the ability of various law enforcement agencies to subdue the Canadian contraband tobacco market.

Useful statistics that should be systematically tracked include: [1] provincial tobacco seizures compiled by the number of cartons seized and the number of incidents in which a seizure was made; [2] the number of individuals charged with offences related to contraband tobacco and the total number of charges laid against these individuals;<sup>15</sup> [3] the size of law-enforcement

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- 13 The RCMP were not able to provide information on the annual number of arrests and charges laid in connection to the contraband tobacco trade in response to the author's information request. However, information on the number of arrests made and charges laid in 2008 was made available in a policy document published by the RCMP detailing its progress in anti-contraband interdiction. The report specifies that 740 charges were laid for excise-tax evasion against 650 individuals in 2008. That is the extent of readily available public information on the success of the RCMP in laying charges against individuals engaged in contraband tobacco distribution (RCMP, 2009).
- 14 The public-relations officer at the Cornwall, Ontario regional division of the Ontario Provincial Police treated the author to a lengthy discussion of the difficulties involved in mitigating south-central Ontario's contraband tobacco problem but, like his federal counterparts, was unable to provide any useful information apart from some interesting anecdotes and news releases about large seizures of contraband tobacco. No other provincial law enforcement agencies were contacted after the fruitless information request to the OPP.
- 15 Individuals involved with the distribution of contraband tobacco are typically in violation of more than one law and may consequently face multiple charges.

budgets devoted to enforcing measures against contraband tobacco and how these budgets are being spent; [4] the number of charges laid against an alleged contraband-tobacco offender alongside charges pertaining to other criminal activities; [5] the number of people who were simultaneously charged both with trafficking contraband tobacco and an offence like drug or gun trafficking.

Though compiling this data would involve increased administrative costs, such costs would likely be small compared to the societal welfare losses and costs associated with the contraband tobacco trade. If reliable data is used to craft policies that prove more effective in abating the trade in contraband tobacco, the administrative costs will be justified. Without this information, policy makers and analysts are rendered incapable of accurately assessing the performance of various law enforcement agencies in tackling the contraband tobacco problem across Canada.

## **5 Campaign to increase public awareness of the dangers and costs associated with contraband tobacco**

One of the important factors allowing contraband tobacco markets to flourish is the commonly held perception among smokers that buying contraband tobacco has no consequences and that the only tangible difference between contraband tobacco and lawful cigarettes is the price (Health Canada, 2009). This insensitivity to the negative ramifications associated with the contraband tobacco trade follows from the relatively concentrated benefits that smokers receive by purchasing tobacco at a discount and the relatively dispersed negative impact of the contraband tobacco trade, which injures several other segments and stakeholders within Canadian civil society. This outlook leads smokers to believe that there is really not much in the way of added dangers or negative repercussions from purchasing and consuming contraband tobacco.

It would be useful if public-health officials developed a strategy to spread information about contraband tobacco products to counter the perception that substituting illegal for legal cigarettes is benign. Such a campaign could provide either information focused on contraband tobacco or information on contraband tobacco bundled together with other anti-smoking educational material. It should stress the harm and risks associated with contraband tobacco including [1] the lack of warning labels that have proven effective in reducing tobacco use, [2] the illegality of tax evasion, [3] the link to peripheral crimes and the domination of contraband markets by organized crime groups, [4] the damage to law-abiding tobacco retailers, and [5] the ease of access to contraband tobacco enjoyed by young smokers. Such information should also stress that the black market in tobacco undermines the most important objective of tobacco control policy, reducing tobacco use (Health Canada, 2009).



The RCMP has identified education and awareness campaigns that make use of the news media, television public-service announcements, and presentations to key stake holders as an important component of their Contraband Tobacco Enforcement Strategy (Canada Revenue Agency, 2005; RCMP, 2009). To this end, a joint effort by the RCMP, the Canada Revenue Agency, and Revenue Québec was undertaken to raise awareness of the harm caused by contraband tobacco in Quebec (Canada Revenue Agency, 2005). However, no formal analysis of the impact of this joint effort has been undertaken to date.

Unfortunately, stigmatizing contraband tobacco might come at a cost. By stigmatizing contraband tobacco, policy makers could inadvertently legitimize lawfully sold tobacco (Sweeting et al., 2009). Initiatives to combat contraband tobacco need to be tailored in such a way that the message exposes the dangers of purchasing contraband tobacco while avoiding the legitimization of over-the-counter cigarettes. Smokers need to recognize the distinct dangers associated with contraband tobacco but simultaneously be aware that consumption of tobacco, whether legal or illegal, always poses a health risk.

## **6 Increased enforcement against contraband wholesalers and retailers**

The main corridors for contraband tobacco smuggled into Canada pass through several Aboriginal reserves in south-central Ontario and Quebec, most situated in close proximity to, or straddling, the Canada-US border (RCMP, 2008a, 2008b, 2009; Gabler and Katz, 2010; Physicians for a Smoke Free Canada, 2007). There has also been a discernible increase in the amount of contraband tobacco entering Canada via freight shipment. A recent seizure of 50,000 cartons of contraband tobacco in British Columbia was the province's largest to date. The confiscated counterfeits of brand-named cigarettes arrived at Vancouver's commercial seaport in a freight container (RCMP, 2010, May 5; CBSA, 2010). Any attempt to cut off the supply of contraband tobacco at its points of entry into Canada will be very difficult as law-enforcement agencies simply do not have the resources to block smuggling routes running through Aboriginal territory or other remote parts of the porous Canada-US border. Similarly, it is impossible for customs officers to detect all of the contraband tobacco entering Canada in commercial shipping containers.

An alternative is for law enforcement to pursue contraband tobacco wholesalers and retailers with greater diligence. This implies increased interdiction against any parties engaged in the wholesale or retail distribution of tobacco who fail to comply with all of the restrictions governing tobacco control, including operating without a valid tobacco merchant's license or failing

to collect the required tobacco excise taxes. Wholesale distribution in the Canadian contraband-tobacco supply chain is dominated by some 100 organized crime groups. Retail distribution, on the other hand, is fairly dispersed amongst innumerable small-time, street-level traffickers (RCMP, 2006, 2008).

Criminals trafficking contraband tobacco have also been associated with other illegal activities such as armed robbery, money laundering, drugs and firearms trafficking (RCMP, 2008a). As such, focusing the attention of law enforcement on obstructing the contraband tobacco trade at the wholesale level, though still riddled with the logistical difficulties of surveillance and case building, offers a viable alternative to impeding contraband tobacco smuggling at its points of entry into Canada. Policing efforts will not eradicate the contraband tobacco trade in Canada as they have not eliminated illegal narcotic trafficking. At best, law enforcement efforts will be partially effective in suppressing the contraband tobacco trade. However, attractive illicit profits will likely entice new traffickers into the contraband tobacco racket as law enforcement works to apprehend already established dealers.

## Conclusions

Given the harm inflicted by contraband tobacco on the Canadian public, policy makers need to adopt effective anti-contraband measures that will eliminate, or at least reduce, the volume of contraband tobacco now available in Canada. Owing to the diversity of sources currently supplying the Canadian contraband tobacco market, it is unlikely that any one policy alone will prove able to eradicate Canada's contraband tobacco trade and an effective remedy to Canadian contraband tobacco woes will require a mixture of several measures that simultaneously address various facilitating aspects of the Canadian contraband tobacco trade and the varied supply sources supplying the black market.

Any attempt to resolve the Canadian contraband tobacco problem must address the central role played by some members of Canada's Aboriginal communities in the underground trade. Aboriginal tobacco smugglers are alleged to be responsible for supplying more than half of the contraband tobacco available on the Canadian black market. Considering that Aboriginal tobacco manufacturers have shown a willingness to accept prices for their tobacco products that are often well below the tax-exclusive price of lawfully manufactured cigarettes, it stands to reason that a total tax revocation would not be sufficient to deter Aboriginal contraband tobacco distribution. Tax agreements should be adopted alongside other anti-contraband policy initiatives. However, not bringing Aboriginal tobacco merchants into the fold of the lawful tobacco trade and ignoring their interests would likely prove to be the policy error that undermines any other individual or mix of anti-contraband tobacco measures.

There is a legitimate argument that rewarding Aboriginal contraband traffickers is rewarding criminal activity, a problem of moral hazard, especially since it might encourage further criminality. As valid as this argument may be, it is important to recognize that this perspective is rejected by those within Aboriginal communities who have ties to the tobacco trade. From the perspective of advocates of Aboriginal tobacco commerce, trading unlicensed tobacco is perfectly within the boundaries of their judicial autonomy and, thus, not criminal. However, there are amongst Aboriginal tobacco traffickers those who support trying to establish greater legitimacy for their product. This can be inferred by the willingness of some Aboriginal communities to enter into tax agreements that legitimize their commercial activities.

The primary motivation for distributing and purchasing contraband tobacco is to evade federal and provincial tobacco excise taxes. The raising of tobacco taxes over the past decade ignited a thriving trade in contraband

tobacco. Furthermore, the persistence of relatively high tobacco taxes continues to provide the fuel that keeps the contraband tobacco market burning. In recognition of the important role played by tobacco excise taxes in spurring the Canadian contraband tobacco trade, policy makers must give serious consideration to tax reforms that would repeal all tobacco excise taxes at both the federal and provincial levels. A complete elimination of tobacco excise taxes across Canada would deprive the contraband tobacco market of the fuel it needs to remain alight.

However, if implementing a repeal of tobacco excise taxes across Canada cannot be enacted by policy makers, an alternative would be a reduction in the average excise-tax levy on tobacco, by both the federal and provincial governments, that would bring the average tobacco excise-tax rates in Canada closer to those in those American states, where they are relatively low. Bringing tobacco excise-tax rates across Canada closer to the rates in these US states would undermine that portion of the Canadian contraband tobacco supply that flows from some of those states.

Some of the other anti-contraband measures that should be considered include correcting the serious deficiencies in the records and statistics kept by the RCMP and CBSA, educating the Canadian public about the explicit and implicit dangers of contraband tobacco, and allocating more resources for law enforcement efforts that focus on the criminal elements that dominate wholesale and retail contraband tobacco distribution.

Contraband tobacco is an inherently difficult problem to address. It is unlikely that any single anti-contraband initiative will prove fruitful in isolation. However, adopting an assortment of well-developed policies tailored to overcome the challenges posed by specific aspects of the contraband tobacco market is a promising approach to fighting the scourge of contraband tobacco in Canada.

## Appendix Tax legislation affecting aboriginal communities

### Legislation affecting aboriginal tax rights

- ◆ Indian Act (Sections 87 and 83)
- ◆ First Nations Fiscal and Statistical Management Act (FNSM)
- ◆ First Nations Goods and Services Tax (FNGST)
- ◆ Self-Government Treaties and Agreements.

Sources: Canada, Ministry of Aboriginal Affairs and Northern Development, 2002, 2010; Canada, Indian Act, 2011.

### Number of aboriginal band councils levying various taxes in conjunction with the federal or provincial governments

- ◆ First Nations Tax (FNT): 9 (Manitoba, 1; British Columbia, 8)
- ◆ FNGST: 22 (Newfoundland, 1; British Columbia, 8; Yukon, 11; Saskatchewan 1; Northwest Territories, 1)
- ◆ First Nations Personal Income Taxes: 12 (Newfoundland, 1; Yukon, 10; North West Territories, 1)
- ◆ First Nations Property Tax under Section 83 of the Indian Act: 102 (Newfoundland, 3; New Brunswick, 1; Nova Scotia, 3; Quebec, 3; Ontario, 12; Manitoba, 2; Saskatchewan, 7; Alberta, 19; British Columbia, 50; Northwest Territories, 2)
- ◆ First Nations Property Tax under the First Nations Fiscal and Statistical Management Act: 50 (Alberta, 1; British Columbia, 39; New Brunswick, 4; Ontario, 2; Saskatchewan, 4)
- ◆ Provincial Taxes (on Alcohol and Tobacco): 40 (British Columbia Tobacco, 1; Manitoba Tobacco, 34; Saskatchewan Alcohol, 5).

Source: Canada, Ministry of Aboriginal Affairs and Northern Development, 2010.

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## Acknowledgments

The author would like to thank the two external academic reviewers for their insightful comments and valuable suggestions on an earlier draft of this report. Special thanks are also due to Diane Katz for her diligent review and Niels Veldhuis for his guidance and many useful suggestions. The author also appreciates the advice and counsel of Dean Pelkey and Kendal Egli.

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## ISSN/ISBN

ISSN 1910-1945 / ISBN 978-0-88975-255-9 (2011 edition)

## Date of issue

December 2011

## Citation

Gabler, Nachum (2011). *Combatting the Contraband Tobacco Trade in Canada*. Fraser Institute. <<http://www.fraserinstitute.org>>.

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