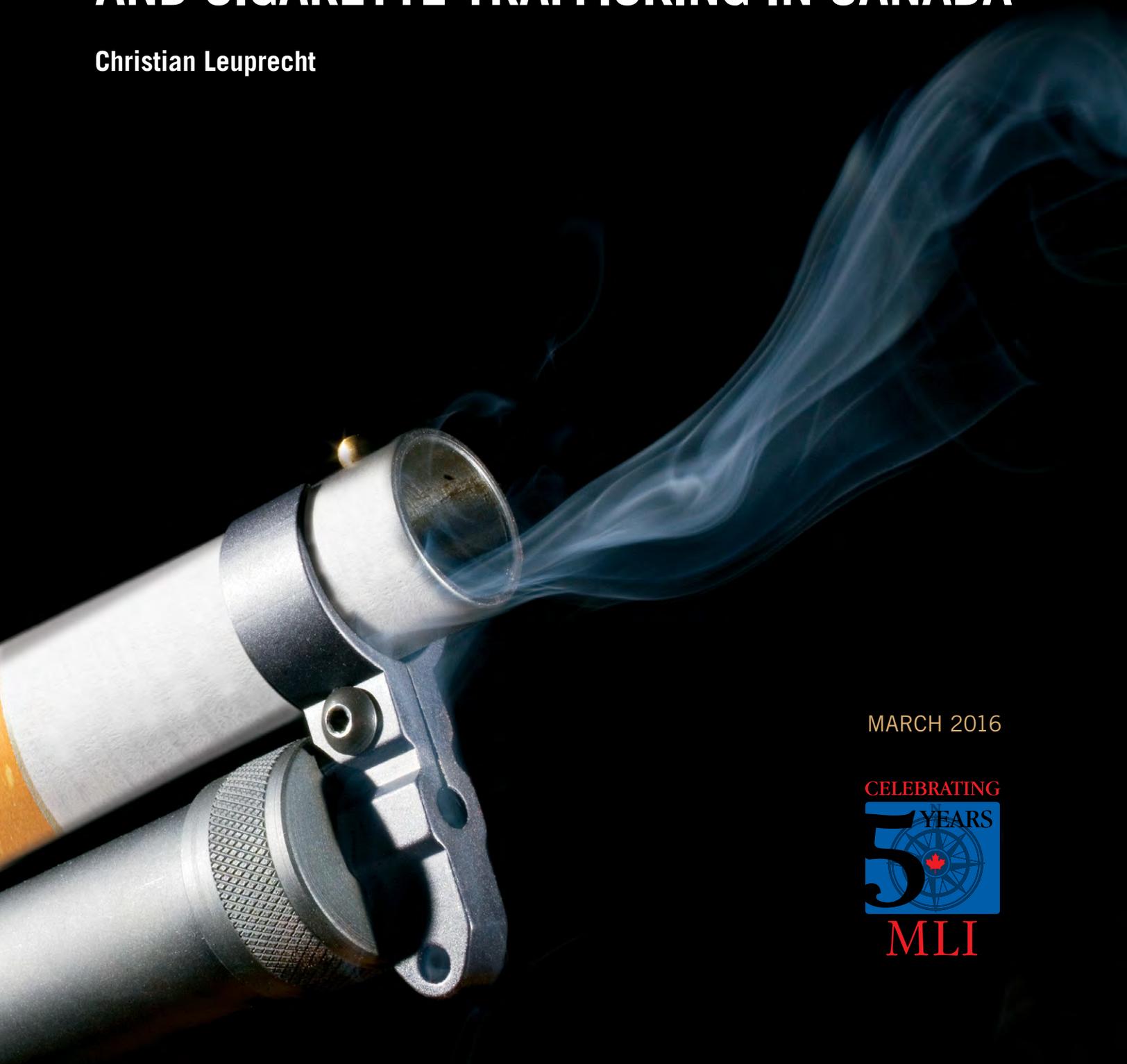


A Macdonald-Laurier Institute Publication

SMOKING GUN: STRATEGIC CONTAINMENT OF CONTRABAND TOBACCO AND CIGARETTE TRAFFICKING IN CANADA

Christian Leuprecht



MARCH 2016

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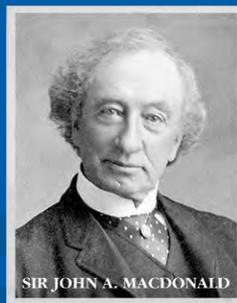
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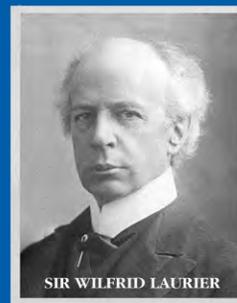


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EXECUTIVE SUMMARY*

Canadians think of contraband tobacco and cigarettes as a nuisance at best, or a tax-revenue problem at worst, not in terms of organized crime or terrorism.

This authoritative study of the size, scope, and operations of contraband tobacco and cigarettes in Canada reveals this to be a false dichotomy. Canadian law enforcement seizures of contraband tobacco routinely include high-powered weapons, hard and designer drugs, stolen vehicles and other merchandise, and lots of cash. Indeed the week this report was released, police in Quebec carried out 70 raids and made 60 arrests against an international criminal network involved in drug and contraband tobacco trafficking, and money laundering, in the largest anti-contraband operation to date.

Contraband tobacco is lucrative, it is produced and trafficked systematically alongside other illicit goods, and Canadian crime syndicates are heavily invested in its proceeds. Globally, money from contraband tobacco and cigarettes is a major source of revenue for the likes of ISIS, al-Qaeda, and Hezbollah, whose contraband fundraising activities in North America have been subject to indictments.

Producers and traffickers of contraband prey on the most vulnerable population groups in Canadian society. They brazenly flaunt restrictions on procurement, manufacturing, packaging, promotion, and

* This section has been revised. An earlier version of this paper conflated the provincial excise tax with the size of the illicit market and an Ontario tax loss figure with the national tax loss figure. These figures have also been adjusted on page 7.

sale of tobacco and cigarettes. Their ranks count hardened Mafioso and notorious criminal bikers who exploit Native communities. Tobacco farmers divert crops to the illicit market; some cooperate to reap higher profits, some uncooperative ones are coerced or have their tobacco stolen.

Compared to illicit drugs, materials and manufacture are readily accessible, and the market for contraband tobacco and cigarettes is huge, highly profitable and easy to reach. The loss factor is minimal because chances of detection are small, penalties lenient (if any are imposed at all), and social stigma less than for alternative illicit activities. Canada's contraband market in tobacco and cigarettes has been estimated at more than \$1.3 billion, which rivals the narcotics market and is likely an underestimate. In Ontario alone, roughly \$500 million in excise taxes are lost annually, and total forgone tax revenue has been estimated at over \$1 billion. Nationally the figure is as high as \$3 billion.

Enforcement is hampered by entangled jurisdictional issues, collective action problems within and across jurisdictions, scarce enforcement resources, legislative gaps, and, it seems, lack of a comprehensive plan, let alone strategy. There has been some institutional learning, and worthwhile innovations at different jurisdictional levels – federal, provincial, and First Nations. This study explores and compares some of these innovations to forge a comprehensive approach to contraband tobacco and cigarettes.

Although law enforcement has a role to play, like so much other criminal activity, we are clearly not going to arrest our way out of this problem. Ultimately, a comprehensive strategy needs to change the incentive structures in place on both the demand and supply sides, optimize legislative and regulatory frameworks, and improve inter-agency and inter-jurisdictional coordination. Key recommendations include:

Contraband tobacco is lucrative, produced and trafficked systematically alongside other illicit goods, and Canadian crime syndicates are heavily invested in its proceeds.

Revenue sharing with First Nations

The collection and administration of an excise tax by First Nations governments promises a sustained stream of revenue for community development and infrastructure projects and a significant incentive to reduce tax evasion in cigarette sales to non-Natives. In return for greater fiscal autonomy, sales to ineligible customers would be curbed by reducing the quota allocation to First Nations.

Halting diversion from legitimate growers in Ontario

Ontario is the only Canadian jurisdiction where tobacco is grown. Although the transition from the Ontario Flue-Cured Tobacco Growers' Marketing Board to the Ontario Ministry of Finance has tightened monitoring and enforcement of raw leaf tobacco, three changes will hamper the ability to investigate and interrupt diversion of tobacco to illicit markets: once harvested, growers no longer need to identify the source and the final destination of raw leaf; labelling information that tracks baled raw leaf tobacco is no longer required; and reporting frequency has been loosened from weekly to quarterly. Criminalizing the unlicensed growth, sale, purchase, and/or transport of raw leaf would acknowledge the serious consequences of diverted raw leaf and empower police to reinforce the licensing regime.

Federal coordination and a Tobacco Ombudsman

C-10 opens the opportunity for the federal government to facilitate coordination of a unified taxation structure for tobacco and cigarettes for all Canadian peoples, across

provinces and reserves. This authority could be administered and enforced by a Canadian Tobacco Ombudsman under the aegis of the Minister of Public Safety. An ombudsman could improve coordination and communication among law enforcement agencies and between law enforcement and other regulatory bodies.

Enforcement: Lessons learned

Ontario recently announced a Contraband Tobacco Enforcement Team that stands to draw lessons from Quebec, where Project ACCES has proven quite successful over more than a decade. Moreover, it and its outcomes come at no additional cost to government. In fact, it more than pays for itself: by reaping fines and seizures, and realizing a growing tax base due to deterring contraband without a change in smoking rates, the project has seen a return of *as much as 16 times* the investment.

Public awareness

Consumers of contraband tobacco are blissfully unaware of their habit's connection with organized crime; greater awareness might stem consumption, especially if on-reserve manufacturers associated with organized crime are clearly distinguished from those who are not.

Contraband has a more pervasive impact on the public safety of Canada, Canadians, and Canadian interests than terrorism has ever had. If Canadians only knew, they would demand that government act accordingly. Now they do. It is time to act to ensure the benefits of taxation accrue to all citizens instead of organized criminals and terrorists.

SOMMAIRE

Les Canadiens considèrent le tabac et les cigarettes de contrebande, au mieux, comme une nuisance, et au pire, comme un problème de recettes fiscales, mais non pas en termes de crime organisé ou de terrorisme.

La présente étude sur la taille, l'étendue et le fonctionnement des activités de contrebande de tabac et de cigarettes au Canada démontre qu'il s'agit d'une opposition trompeuse. Les opérations policières canadiennes qui mènent à la saisie de tabac de contrebande permettent de confisquer régulièrement des armes de grande puissance, des drogues dures et de synthèse, des véhicules volés et autres marchandises ainsi que de grandes quantités d'argent liquide. Ainsi, au cours de la semaine durant laquelle ce rapport a été publié, les corps policiers du Québec ont effectué 70 perquisitions et fait 60 arrestations au sein d'un réseau criminel international impliqué dans le trafic de drogue et de contrebande de tabac et le blanchiment d'argent, ce qui en a fait la plus grande opération anti-contrebande à ce jour.

La contrebande de tabac est rentable, sa production et son trafic côtoient de manière systématique le commerce d'autres produits illicites et les organisations criminelles canadiennes sont très présentes dans le produit de cette activité. À l'échelle mondiale, l'argent issu de la contrebande de tabac et de cigarettes constitue une source principale de revenu pour des organisations comme le groupe État islamique (EIIS), al-Qaida et le Hezbollah, dont les collectes de fonds tirés de la contrebande en Amérique du Nord ont donné lieu à divers actes d'accusation.

Les producteurs et les trafiquants ciblent les groupes les plus vulnérables de la société canadienne. Ils déjouent effrontément toutes les restrictions en matière d'approvisionnement, de fabrication,

d'emballage, de publicité et de vente de tabac et de cigarettes. Dans leurs rangs, on retrouve des mafiosos endurcis et des motards criminalisés notoires, lesquels exploitent les communautés autochtones. Des producteurs de tabac ont détourné leurs récoltes vers le marché illicite; certains ont collaboré de plein gré pour augmenter leurs profits, alors que d'autres y ont été forcés pour éviter de se faire voler leurs récoltes.

Contrairement aux drogues illicites, les matériaux et la fabrication sont facilement accessibles et le marché du tabac et des cigarettes de contrebande est vaste, très rentable et facile d'accès. Le facteur de perte est minime parce que le risque d'être incriminé est mince, les sanctions indulgentes (parfois, elles ne sont même pas imposées), et la stigmatisation sociale associée à ce type d'activité minimale. La contrebande de tabac et de cigarettes au Canada a été évaluée à plus de 1,3 milliard de dollars, un marché qui rivalise avec celui des narcotiques et est sans doute sous-estimé. En Ontario seulement, on évalue à environ 500 millions de dollars annuellement la perte en taxes d'accise et à plus de 1 milliard de dollars la perte totale en recettes fiscales. Dans l'ensemble du pays, ce chiffre est aussi élevé que 3 milliards de dollars.

La complexité des questions liées au partage des compétences, des problèmes d'action collective au sein des autorités concernées et entre elles, un manque des ressources nécessaires pour faire appliquer la réglementation, les lacunes législatives, et, semble-t-il, l'absence d'un plan d'ensemble ou même d'une stratégie entravent l'application de la loi. Toutefois, il y a eu un apprentissage institutionnel et des innovations intéressantes à divers paliers gouvernementaux : fédéral, provincial et autochtone. La présente étude explore quelques-unes de ces innovations et établit des comparaisons aux fins d'une stratégie globale en matière de contrebande de tabac et de cigarettes.

La contrebande de tabac est rentable, sa production et son trafic côtoient de manière systématique le commerce d'autres produits illicites et les organisations criminelles canadiennes sont très présentes dans le produit de cette activité.

Bien que les forces de l'ordre aient un rôle à jouer, comme dans le cas de bien d'autres activités criminelles, elles ne pourront pas régler le problème à elles seules. Ultimement, une stratégie globale doit prévoir de nouveaux mécanismes d'incitation tant du côté de la demande que de l'offre, l'optimisation des structures législatives et réglementaires et l'amélioration de la coordination gouvernementale et intergouvernementale. Des recommandations clés sont présentées ci-dessus :

Partage des recettes fiscales avec les Autochtones

La perception et l'administration d'une taxe d'accise par les gouvernements autochtones leur offriront une source stable de revenus pour le développement des collectivités et des projets d'infrastructures. Elles représenteront une mesure incitative importante pour réduire l'évasion fiscale issue de la vente de cigarettes aux non-Autochtones. En contrepartie de cette autonomie fiscale, les Premières Nations se verront attribuer des quotas qui auront pour effet de réduire les ventes destinées aux clients inadmissibles.

Entrave au détournement des producteurs légitimes en Ontario

Au Canada, seul l'Ontario produit du tabac. La transition effectuée entre la Commission ontarienne de commercialisation du tabac jaune et le ministère des Finances de l'Ontario a permis de renforcer la fonction de surveillance et l'application de la loi contre le tabac en feuilles. Cependant, trois changements entraveront le pouvoir de faire enquête et limiteront la possibilité de faire obstacle au détournement du tabac vers les marchés

illicites : une fois le tabac en feuilles récolté, les producteurs n'ont plus à identifier son origine ou sa destination finale; l'étiquetage qui retrace les ballots de tabac en feuilles n'est plus requis; et la fréquence pour soumettre des renseignements est assouplie, passant de rapports hebdomadaires à trimestriels. Criminaliser la croissance, la vente, l'achat ou le transport du tabac en feuilles sans permis accentuerait la gravité des conséquences de son détournement et permettrait aux forces policières de renforcer le régime de permis.

Coordination fédérale et ombudsman du tabac

Le projet de loi C-10 offre la possibilité au gouvernement fédéral de faciliter la coordination centralisée d'un régime d'imposition unifié pour tous les Canadiens en matière de tabac et de cigarettes, dans les provinces comme dans les réserves. Cette autorité pourrait être gérée et mise en œuvre par un ombudsman fédéral sous l'égide du ministère de la Sécurité publique. Cet ombudsman pourrait améliorer la coordination et la communication au sein des organismes d'application de la loi et entre les autres organismes réglementaires.

Application de la loi : leçons apprises

L'Ontario vient récemment d'annoncer la mise sur pied de son Équipe de lutte contre la contrebande de tabac, laquelle pourrait tirer profit de l'expérience du programme québécois Actions concertées pour contrer les économies souterraines (ACCES), qui affiche de bons résultats depuis maintenant plus d'une décennie. De surcroît, le programme a été mis en place sans supplément à payer pour le gouvernement. En fait, son taux d'autofinancement a été bien supérieur à 100 p. 100 : grâce aux profits tirés des amendes et des saisies et grâce à la croissance de l'assiette fiscale générée par la lutte contre la contrebande, et ce, sans modification des taux de tabagisme, il a offert un rendement atteignant *jusqu'à 16 fois* le montant investi.

Sensibilisation du public

Les consommateurs de tabac de contrebande ignorent que leurs habitudes sont liées au crime organisé. Une sensibilisation accrue endiguerait la consommation, surtout si les producteurs associés au crime organisé sur les réserves sont clairement identifiés par rapport à ceux qui ne le sont pas.

La contrebande a des incidences plus profondes que celles du terrorisme sur la sécurité publique du Canada, des Canadiens et des intérêts canadiens. Si les Canadiens seraient au courant ils exigeraient que le gouvernement agisse en conséquence. À présent, ils le savent. Il est temps d'agir afin que les avantages de la fiscalité reviennent à tous les citoyens plutôt qu'aux membres du crime organisé et aux groupes terroristes.

INTRODUCTION

Two loaded handguns, 17 rounds of ammunition, over 147 kilograms (kg) of illegal drugs including 95,635 kg of marijuana and 36,994 kg of cocaine, 198 cases of contraband tobacco, 128 cellular phones, high-end clothing, 832 purses, 51 wallets, and a stolen vehicle. Sounds like an organized crime adaptation of the *12 Days of Christmas*. In fact, those are the seizures by the Highway Enforcement Team as per the Ontario Provincial Police's Annual Report (2011, 10).

A case of contraband tobacco consists of 50 cartons. A carton (of 200 cigarettes) retails for upwards of \$80 but contraband goes for anywhere from \$8–\$50, depending on the quality of the cigarettes

and whether federal tax is applied. So, 198 cases will net anywhere between \$80,000 and \$500,000. Between January and October 2014, the RCMP alone – not counting seizures by other enforcement agencies – seized 12.4 million cigarettes in Ontario and Quebec, and a total of about 16.5 million cigarettes across the country. Contraband cigarettes and tobacco are big business.

As explained below, dark markets are notoriously difficult to estimate. One estimate puts the size of the national contraband tobacco market at \$1.3 billion although this is likely low given the overall market was \$17 billion in 2015 and conservative estimates of size the illicit market are in the neighbourhood of 20 percent of cigarettes sold. Provincial and federal tax losses in Ontario are conservatively estimated around \$1 billion annually, and are possibly as high as \$3 billion nationwide, depending on the estimate of the size of the illicit market, which taxes are taken into account, and whether partially-taxed cigarettes are factored in.

Worldwide, contraband tobacco accounts for an estimated 657 billion sticks, about 12 percent of the global market; an estimated \$40 billion to \$50 billion in government revenue is lost globally to contraband tobacco (Guevara 2008a). Tax revenue foregone by government is the illicit gain of those who sell illegal tobacco and the organized crime that enables it, enticed by the cost-benefit proposition of illicit cigarettes: profits are high, penalties the world over are lenient and rarely paid in full, and social stigma less than for alternative illicit activities.

The scale of seizures suggests an operation that is only possible by means of supply chains run by organized crime. Of course, seizures represent a mere fraction of actual production – and revenue. Beyond honing smuggling practices to avoid law enforcement, cigarette smuggling networks exploit geography, corruption, lax enforcement, and the collective-action problems imposed by different jurisdictions, to manufacture, distribute, and sell tobacco outside of government regulation and taxation.

There is a common reductionist perspective that contraband cigarettes and tobacco can be written off as a fiscal problem of lost tax revenue. It is, as this study endeavours to show, much more than that, including a matter of public safety. Criminal intelligence has identified 175 organized crime networks in Canada involved in producing, smuggling, and distributing contraband tobacco (Oliver 2010). However, that number is controversial. Section 476.1 of Canada's *Criminal Code* defines an organized crime group as (1) having three (or more) members for the purpose of (2) facilitating or committing a serious offence (3) from the proceeds of which they stand to benefit. In practice, it is rare for Crown prosecutors to lay that charge because it carries a mandatory five year minimum sentence upon conviction. That is, practice distinguishes between genuinely serious organized crime, such as a criminal biker gang, from a group of locals who commit an offence. That explains why the number of organized-crime charges laid in contraband cases dwarfs the number of organized crime groups the RCMP cites in association with contraband tobacco and cigarettes. A proliferation of new entrants suggests that business is booming, incentives to get into the business considerable, and sunk costs as well as deterrents relatively low.

While a recent declaration by Ontario's Ministry of Community Safety and Correctional Services (2016) suggests that the paradigm may be changing, the order of priorities suggests that the criminal element remains an afterthought: "Low-cost, contraband tobacco undermines provincial health objectives under the Smoke-Free Ontario Strategy, results in less tobacco tax revenues for critical public services our communities and families rely on, and compromises public safety through links with organized crime."

Canada's contraband market is worth in excess of \$1.3 billion, which rivals that of the narcotics market.

First, this study attempts to explain the conditions that facilitate this permissive environment. Since there are smokers just about everywhere on the planet, contraband cigarettes and tobacco exist the world over. Yet, in Canada in general and Ontario in particular, by all accounts the contraband market appears to be disproportionately large – 40 percent of the overall Ontario cigarette market by one recent count (National Coalition Against Contraband Tobacco 2014) – by whatever metrics one might apply: seizures relative to resources, unaccounted-for tobacco, butt counts, lost tax revenue, and more.

Once we understand what drives the phenomenon, we can attempt to devise a strategy to contain it. One would think that “government” might have done this already. But this appears not to be

the case. For one thing, there are coordination challenges among agencies and departments of the same level of government, and coordination challenges among jurisdictions (Auditor General of Ontario 2008). This is not to say that there has not been some institutional learning, and worthwhile innovations at different jurisdictional levels – federal, provincial, and First Nations. This study explores some of these innovations in greater detail to suggest what a more comprehensive contraband tobacco and cigarette strategy might look like.

A comprehensive strategy needs to change the incentive structures, optimize legislative and regulatory frameworks, and improve inter-agency and inter-jurisdictional coordination.

The current approach relies heavily on enforcement of customs and excise, and of the *Criminal Code*: by police, by the Canada Border Services Agency, by ministries of finance, and by

the Canada Revenue Agency. Enforcement, as this study shows, is an important part of the effort, but the data suggest that its deterrent effect appears to be limited. Enforcement is currently hampered by entangled jurisdictional issues and failure to coordinate within and across jurisdictions, scarce enforcement resources, legislative gaps, and, it seems, lack of a comprehensive plan, let alone strategy. There is not even an intelligence estimate specific to contraband tobacco in Canada. This study tries to compensate by painting a comprehensive picture, data issues notwithstanding.

The market for contraband cigarettes and tobacco can be contained, but that entails shifting to a comprehensive strategy that overcomes the fallacy of composition inherent in the prevailing piecemeal approach to disrupting the supply chains of organized crime. A comprehensive strategy ultimately needs to change the incentive structures in place on both the demand and supply sides, optimize legislative and regulatory frameworks, and improve inter-agency and inter-jurisdictional coordination.

Given the complexities of this issue, this study should be read as an effort to convey a better picture of what ails the effort against contraband cigarettes and tobacco in this country, and to invigorate a conversation about what might be done. Criticism of all players notwithstanding, instead of pointing fingers this study tries to open up a conversation among the key players, which is clearly necessary given the general consensus that the current ways and means are not working all that well – except for the racketeers. This study tries to raise expectations.

This study consists of three principal sections. The first section explains the relationship between the commodification of tobacco and the rise of contraband, defines contraband tobacco in its various manifestations and the challenges inherent to measuring it, and estimates the scope of the problem in Canada and its fiscal implications. The second section explains the connection between three disparate communities and their relationship to smuggling raw and refined tobacco: First Nations, organized crime, and terrorists. The third section discusses policy options: changes to taxation, legislative changes, revenue-sharing with First Nations, tracking and tracing of stamped cigarettes, input controls, enhanced enforcement, and the creation of an office of a Canadian Tobacco Ombudsman.

PART 1: CONTRABAND TOBACCO

1.1. Commodification

Tobacco is among the most widely used recreational substances in the world. It comes in many forms: raw leaf, cigarettes, cigars, pipe (of various kinds), flavoured, chewing, snuff, and more. Each product is a function of plant genetics, climate, altitude, horticulture, drying, packing, and shipping methods. None, therefore, is readily attributable to natural, technological, or social practices but, rather, dissolves the distinctions among them (Bourne 2015). Likewise, the contemporary geographical concentration of almost all growers of raw leaf tobacco in Canada across a small patch of Southwestern Ontario and some adjacent manufacturing on the adjoining Six Nations Reserve is not merely a function of climate and nature but is inseparable from them.

To examine all the manifestations of tobacco is beyond the scope of this study. The study is confined to tobacco's most common form on the illicit market: cigarettes, which generate the bulk of taxes from tobacco. Nonetheless, its many other forms also have a significant contraband presence. Some of the lessons from raw leaf and cigarettes are transferrable to other manifestations of tobacco whereas others have a particular illicit economy of their own. Contraband flavoured tobacco in Canada, for instance, originates almost entirely in the United States and India; ethnic organized crime in the Greater Toronto Area (GTA), by contrast, appears to have cornered much of the market for contraband cigars, which syndicates manufacture locally.

Contraband tobacco is sourced either from Southwestern Ontario or shipped in from the US directly, or from other countries via the US. Contraband cigarettes made with that tobacco tend to be manufactured either on a small number of Native reserves or by ethnic organized criminal networks in the GTA; other products are manufactured offshore and shipped into Canada where it is distributed by organized crime through sophisticated networks. We know these networks to be sophisticated because of product being trucked into hubs of tiny rural communities – far beyond what that community could possibly smoke or even sell to outsiders itself. Product gets to market through on-reserve “smoke shacks”, sales through complicit stores often in specific ethnic neighbourhoods, and distribution by autonomous sellers often in high-demand neighbourhoods.

Demand tends to be concentrated among groups most sensitive to price by virtue of having the least disposable income: the relatively deprived and under-age smokers (Leatherdale et al. 2009). In a recent study by the Ontario Convenience Stores Association, up to 20.4 percent of Ontario students report smoking contraband in the last year (Ibbotson 2015; see also Ontario Tobacco Research Unit 2009). Producers, then, have a vested, long-standing interest in targeting this group as studies show that persons who have not started smoking by age 20 are unlikely ever to smoke (see, for instance, DoSomething.org 2014).

This of course is nothing new. James Madison, in his opposition to Alexander Hamilton's tax package of 1794, already observed: “As to the subject before the House, it was proper to choose

Tobacco was among the first consumer goods to be taxed.

taxes the least unequal. Tobacco excise was a burden the most unequal. It fell upon the poor, upon the sailors, day-laborers, and other people of these classes, while the rich will often escape it” (quoted in Robert 1949, 100).

Tobacco was among the first consumer goods to be taxed. In North America, it was first taxed by the British, then by the newly independent American republic. Iowa was the first US state to impose an excise tax on tobacco. Nowadays, all 50 US states, 10 provinces, and 440 municipalities in nine US states levy taxes on cigarettes, and most also impose taxes on tobacco products other than cigarettes. Due to tax differentials – often between tobacco-producing and non-tobacco producing jurisdictions – contraband legislation prohibits not only the sale of illicit product, but also the transportation, receipt, shipment, possession, distribution, or purchase of product between jurisdictions. The first such legislation affecting North America dates back as far as 1679. In other words, government has long had a hand in regulating and legislating the market

Untaxed tobacco has made a comeback in Canada in the past 10 years and ignited surveys and research.

for tobacco, thereby distinguishing legal from illicit product. However, government has an equally long a track record of inconsistent and irregular enforcement of such legislation.

1.2 Studying Contraband

Contraband refers to “any tobacco product that does not comply with the provisions of all applicable federal and provincial statutes. This includes importation, stamping, marking, manufacturing, distributing and payment of duties and taxes.” However, this definition is controversial insofar as it is not shared by First Nations (Lickers and Griffin 2016). There are five categories of contraband tobacco in Canada (RCMP 2008; see also Pelfrey 2015):

- unlawfully/lawfully manufactured in the United States and then smuggled into Canada – the practice of exploiting disparities in tax rates across jurisdictions to buy contraband product low and sell elsewhere at a profit is known as *smurfing*;
- unlawfully manufactured in Canada, mainly on First Nations reserves and territories;
- diverted tax-exempt products;
- counterfeit tobacco products and international brands entering Canada illegally via sea container; and,
- stolen tobacco products (such as convenience store and cargo thefts, truck hijackings).

Due to their clandestine nature, these categories of contraband are notoriously difficult to study. Ergo, there are necessarily methodological limitations associated with any study of illicit activity, and the data that do exist are often generated by stakeholders with a vested interest. As with most contraband goods that are trafficked, a series of indicators can be triangulated to paint a broader picture of the nature and extent of the challenge, but all those indicators have significant limitations; relying on any one indicator alone is likely to generate distortions, yet even triangulation falls short of capturing the full picture. There are at least five different key sources of data and evidence that can be considered together in an effort to get a better picture of the scale of the contraband market.

First, one can compare tax revenue data and/or reported legal sales to self-reported usage rates to estimate the size of the contraband market and losses in tax revenue.

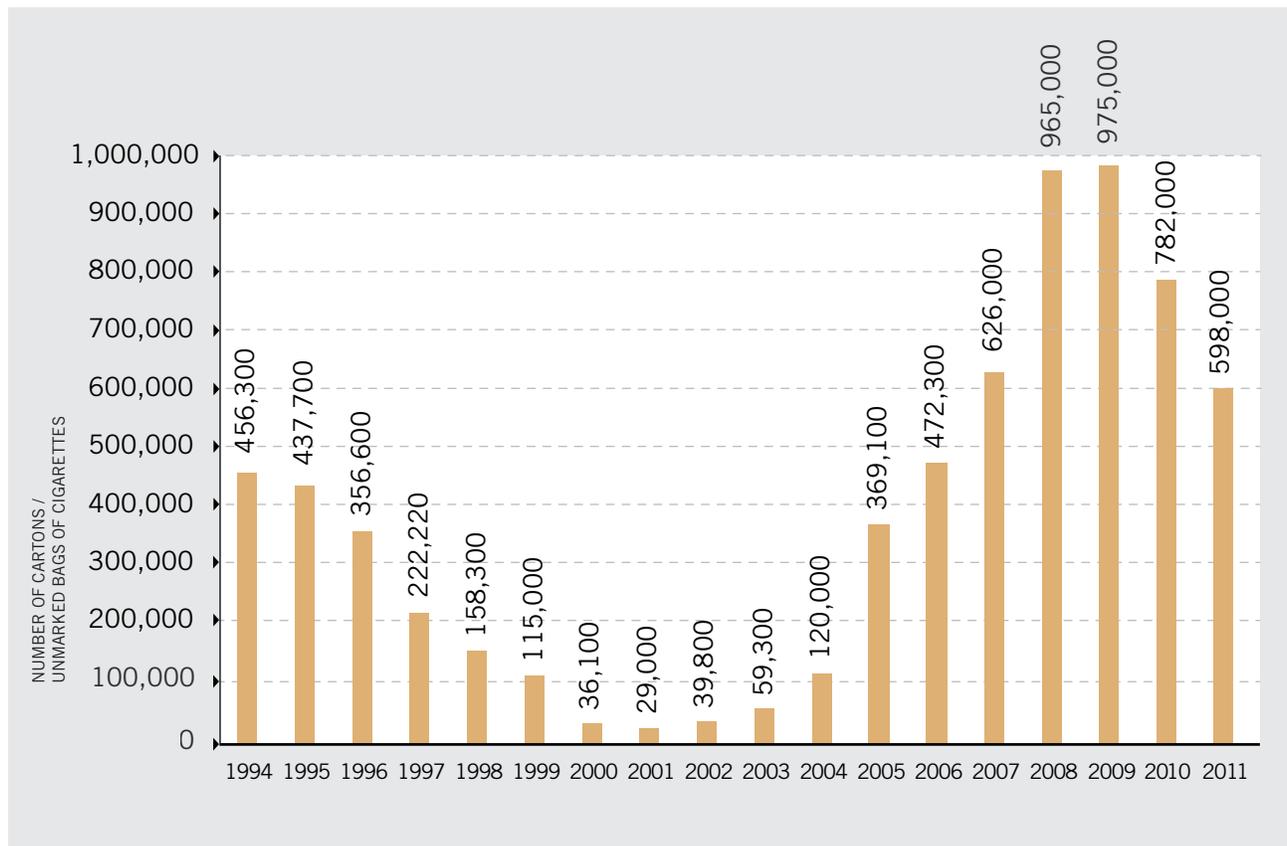
Second, one can conduct surveys of smokers as to whether they buy contraband and, if so, how often. The results are then extrapolated to the population as a whole. This method has the advantage of being able to distinguish between different forms of contraband, but self-reporting is notoriously unreliable.

Third, a cigarette butt filter analysis, commonly known as a “butt count” of discarded cigarette butts or packs, can provide some baselines. Collection is usually limited to select locations with high incidence rates, such as hospitals, schools, government offices, and casinos. The percentage of cigarette litter collected that is deemed to be contraband is held to be indicative of the contraband rates in surrounding areas. The method’s inherent limitations notwithstanding, it is one way of gauging youth tobacco use since 14–18 year olds overwhelmingly congregate around schools. However, given the discrepancy between butt counts and other forms of estimating the market, indications are that butt counts actually underestimate the size of the contraband market.

Fourth, this study draws on evidence from tobacco-smuggling networks dismantled by Canadian law enforcement agencies over the last 10 years. This timeframe is motivated both by available data and by the nature of untaxed tobacco in Canada in general. Untaxed tobacco has made a comeback in Canada in the past 10 years and ignited surveys and research into the issue that largely did not exist prior to the middle of the last decade. However, by virtue of the fact that the cases with the best data are the ones that have been prosecuted, there is an inherent selection effect at work.

Fifth, seizures are another indicator that can be triangulated. Since 2008, 252 million cigarettes, 4.1 million untaxed cigars, and 169 million grams of untaxed fine-cut tobacco have been seized in Ontario alone. In 2011, the RCMP seized 598,000 cartons and unmarked bags of illegal cigarettes, 38,000 kg of fine cut tobacco, 2200 kg of raw leaf tobacco, and over 1,164,000 illegal cigars. As chart 1 shows, between 2001 and 2006, for instance, seizures jumped 16-fold.

Chart 1: RCMP cigarette seizures, 1994–2011



Sources: RCMP 2011.

However, the Canadian government does not provide comprehensive data on contraband tobacco seizures. One of the reasons is that you cannot just add up seizures by different agencies. For example, Canada Border Services Agency (CBSA) can seize contraband but has no mandate to destroy it; so, CBSA passes seizures on to the RCMP – and the RCMP counts that same seizure as a seizure in its inventory. As a result, simply adding up seizures by different agencies would result in a larger figure than is actually the case and make the problem in some regions appear bigger than it actually is. Seizure rates are not necessarily a good indicator of the extent of activity that goes undetected. The networks that are detected may well be the most careless, and targeting and prosecution are a function of enforcement capacities, resources, and priorities. By way of example, the RCMP’s Cornwall detachment operates 24 hours; consequently, it also has more staff than RCMP detachments in Valleyfield or Kingston. The latter, however, operate on regular eight-hour shifts, Monday through Friday. One would thus expect the RCMP to seize more product around Akwesasne, but the commonly drawn inference that the Cornwall region thus sees more contraband product than Valleyfield or Kingston – with Akwesasne as the apparent source of the problem – does not immediately follow. In fact, comparing anecdotal accounts and annual seizures relative to staff resources, the relative magnitude of the contraband problem may be greater in Valleyfield than in Cornwall.

Contraband jargon can obscure the volume of trafficked contraband and associated profits. Table 1 demystifies the nomenclature and conversion metrics.

Table 1: Contraband tobacco nomenclature, revenue loss, and illicit gain

Amount	Number of Cigarettes	Potential Tax Revenue Loss	Potential Illicit Gain Value
Stick	1	\$0.33	\$0.18
Pack	20 (occasionally 25)	\$6.50	\$3.50
Carton	200 (usually 10 x 20, occasionally 8 x 25)	\$65	\$35
Master case (sometimes just “case”)	10,000 (50 cartons)	\$3250	\$1750
Truck or SUV	40,000 (4 master cases)	\$13,000	\$7000
A van	10 master cases	\$32,500	\$17,500
A cube van	20 master cases	\$65,000	\$35,000
40-foot tractor trailer	10,000,000 – 14,000,000 (1000–1400 master cases)	\$4,550,000	\$2,450,000

Source: Adapted from Myers 2012b, 9.

Production costs do not differ much between licit and illicit manufacturers; but illicit manufacturers sell to distributors for about \$5/carton, but as little as \$2–\$3/carton. A carton of contraband costs about \$5 to produce and nets between \$8–\$12 for one baggie – low-end, illicitly-produced cigarettes that are bundled and sold in transparent plastic bags of 200 – to about \$40 when federal taxes are applied. This is still less than half the cost of a regular carton of cigarettes. A small Aboriginal community in Northern Ontario processes two tractor trailers per week that supply 36 independent smoke shops between North Bay and Thunder Bay, and has branched out into supplying Winnipeg and other parts of Manitoba (Turner 2012). Depending on product sold, that operation generates about \$250 million annually in illicit gains from contraband cigarettes.

The recent prosecution in Alberta court of Robbie Dickson of Kahnawake’s Rainbow Tobacco shows that such locations also serve as a westward distribution hub to the Prairies (Myers 2013), which,

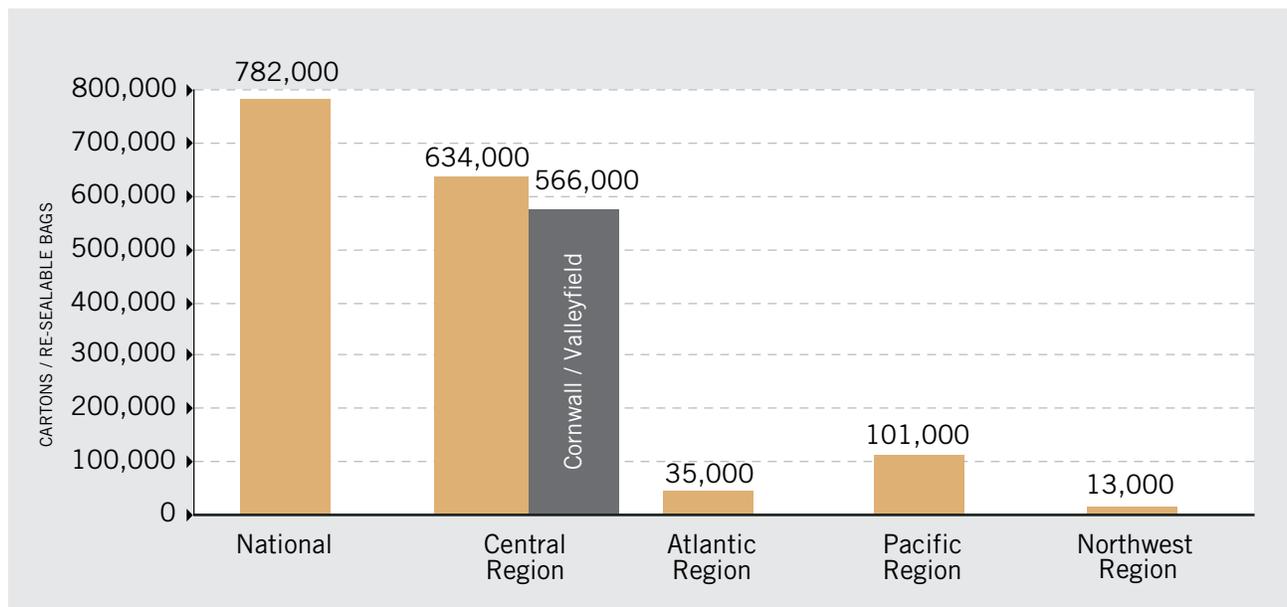
for instance, violates an agreement between the government of Manitoba and First Nations and contributes to the proliferation of contraband across Canada. Upon entering Manitoba from Ontario, a highway sign prods travellers to report contraband to the nearest RCMP detachment; there is no such sign in the other direction, which hints at the province of origin and the vector of contraband product. For Atlantic Canada and Northwest regions, the RCMP finds that their illicit tobacco markets “are almost entirely supplied by criminal organizations that obtain their products mainly from First Nations communities in Ontario and Quebec” (RCMP 2012b, 1).

1.3 The Market

Today’s overall rate of untaxed tobacco across Canada is on the rise. In 2015 it was estimated at over 20 percent. A study by the Western Convenience Store Association found that in British Columbia contraband cigarettes are about 17 percent of the market but as high as 51.6 percent in some locations, especially around universities (Union of BC Municipalities 2015). In the late 1990s deep cuts to cigarette taxes hollowed out the contraband market, but once tax rates started to climb again, so did contraband sales. A study by Physicians for a Smoke-Free Canada (2007) estimates that contraband tobacco made up 27 percent of the Canadian market in 2007. According to a study by the tobacco industry cited by the RCMP, between 2006 and 2008, the percentage of Canadians who had smoked contraband in the past year nearly doubled from 16.5 percent to 32.7 percent (RCMP 2011). The Non-Smokers’ Rights Association (NSRA) estimates that contraband represented 25 percent of the Canadian market in 2008 but declined to 12 percent by 2010 (Daudelin, Soiffer, and Willows 2013). Statistics Canada estimates that in 2008 Canadians spent a total of \$2.6 billion on partially or totally-untaxed tobacco (Gabler 2011).

Studies have repeatedly shown that Canadian contraband tobacco sales are overwhelmingly concentrated in Quebec and Ontario. In light of population (market) size and proximity to the source of tobacco, that is not all that surprising. RCMP seizures are in line with this observation, but subject to the aforementioned caveats that seizure rates can give misleading impressions due to differences in dedicated resources (see chart 2).

Chart 2: RCMP cigarette seizures by region, 2010



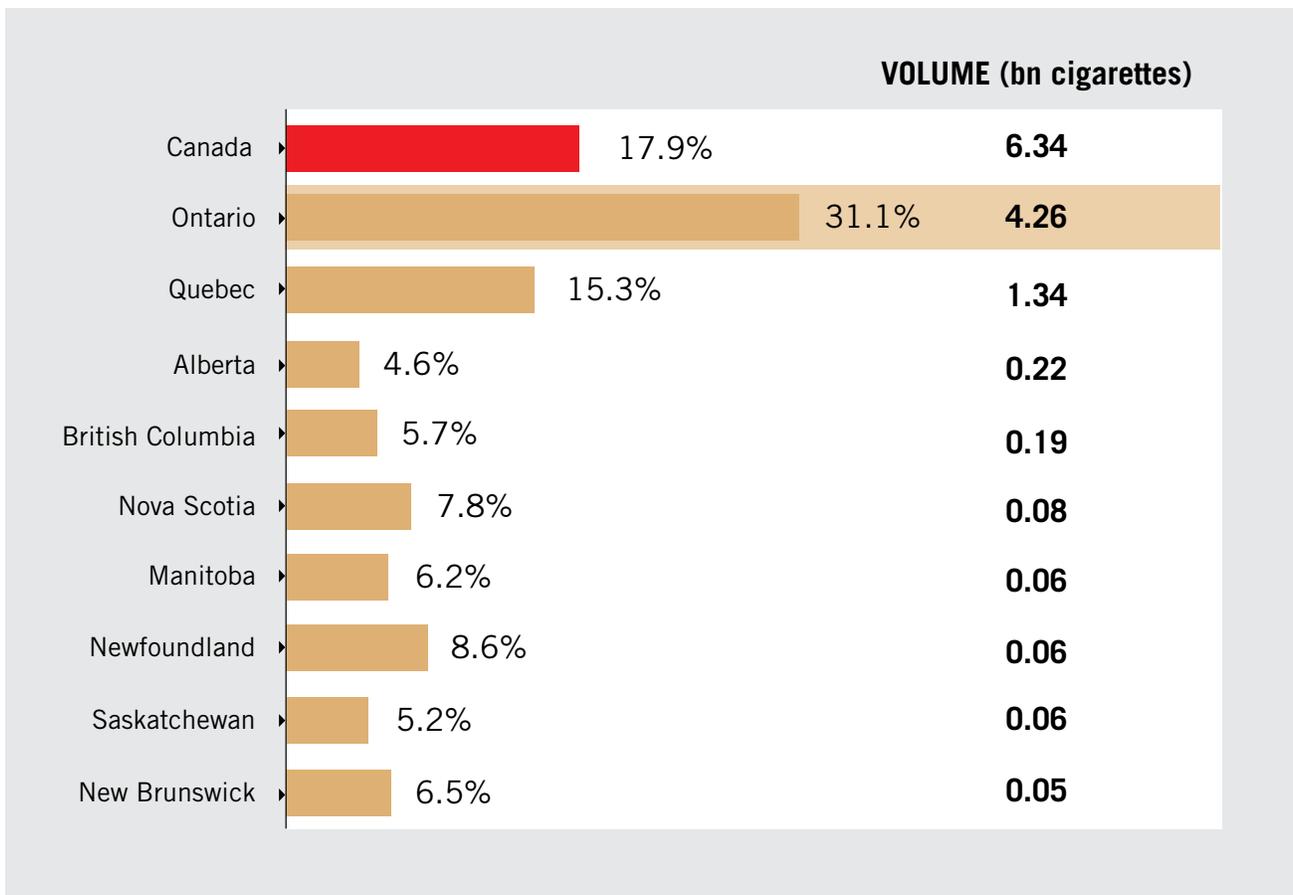
Source: RCMP 2012a.

The Gfk/BAT study found that 40.1 percent of cigarettes smoked in Quebec in 2008 were untaxed. In Ontario, an estimated 48.6 percent of all cigarettes smoked were at least partially untaxed, up

significantly from Imperial Tobacco’s estimate of around 30 percent in either province the year before (GfK Research Dynamics 2008).

In 2011, several years after other studies suggested that contraband levels had peaked, Imperial Tobacco estimated that 68.6 percent of all contraband tobacco in Canada was sold in Ontario (Legislative Assembly of Ontario 2011). This is corroborated by RCMP figures (2012b, 9): in 2010, 72 percent of contraband cigarettes and 84 percent of contraband tobacco were intercepted in the Cornwall-Valleyfield region. A 2009 study by the Canadian Convenience Stores Association (CCSA) found that 45 percent of butts collected from 75 sites in Quebec and 30 percent from 110 sites in Ontario were contraband. A 2013 study commissioned by the Ontario Convenience Stores Association (OCSA) collected cigarette butts across 12 Ontario cities. Sites averaged between 20 and 27 percent, and surged to between 30 and 45 percent around casinos, high schools, and hospitals (MacAlpine 2015). In the year to June 2014 legal domestic sales declined in Ontario while the overall market share was estimated to be 31.1 percent, or 4.3 billion cigarettes (see chart 3) (KPMG 2015, 10).

Chart 3: Domestic non-duty paid share of manufactured cigarette consumption, 2014



Source: KPMG 2015; data from “GfK Illicit Monitor” Q3 2013–Q2 2014.

The Ontario Convenience Stores Association pegs the province’s contraband market at 22.5 percent – up 1.5 percent from a year earlier (Market Wired 2015). Numbers correlate somewhat with distance from the main manufacture and distribution points of untaxed cigarettes located on First Nations reserves: Brantford near Ohsweken and Belleville near Tyendinaga had the first– and fourth-highest rates of contraband use (29.3 percent and 26.6 percent respectively). Some of the highest contraband rates were found around Sudbury, eight hours’ drive away from the Cornwall-Valleyfield region.

Evidently, the distribution of untaxed tobacco in Ontario relies on more than on-reserve retail shops, but also on networks and hubs that distribute and sell tobacco off reserve.

A report by the Canadian Taxpayer's Federation (CTF) suggests that a substantial portion of cigarettes sold untaxed on reserves as part of their allocation quota – which is designated solely for Native personal consumption – are in fact sold to non-Natives without collecting provincial taxes. Drawing on a comparison of allocation quota sales and smoking rates on reserves the study projects that as little as 21 percent of allocation cigarettes sold on Ontario reserves in 2011 were consumed legally. Smoking rates on reserves would have to be up to 466 percent of current estimates if Status Indians purchased all allocated cigarettes for personal use (Fildebrandt 2012). Similarly, an earlier study by the Canadian Tobacco Manufacturers' Council found that loose cigarettes (or baggies) purchased off-reserve accounted for 62 percent of illegal sales, while only 32 percent of untaxed cigarettes in Ontario were purchased by non-Natives from shops on-reserve (Sweeting, Johnson, and Schwartz 2009). Ergo, tobacco purchased by non-Natives without some or all applicable taxes *directly on reserves* accounts for a *substantial but not dominant* portion of tobacco-related tax evasion in Canada. A significant portion of untaxed tobacco in Canada also appears to be produced on reserves, but sold through off-reserve distribution networks.

If Status Indians purchased all allocated cigarettes for personal use, smoking rates would be up 466 percent on reserves.

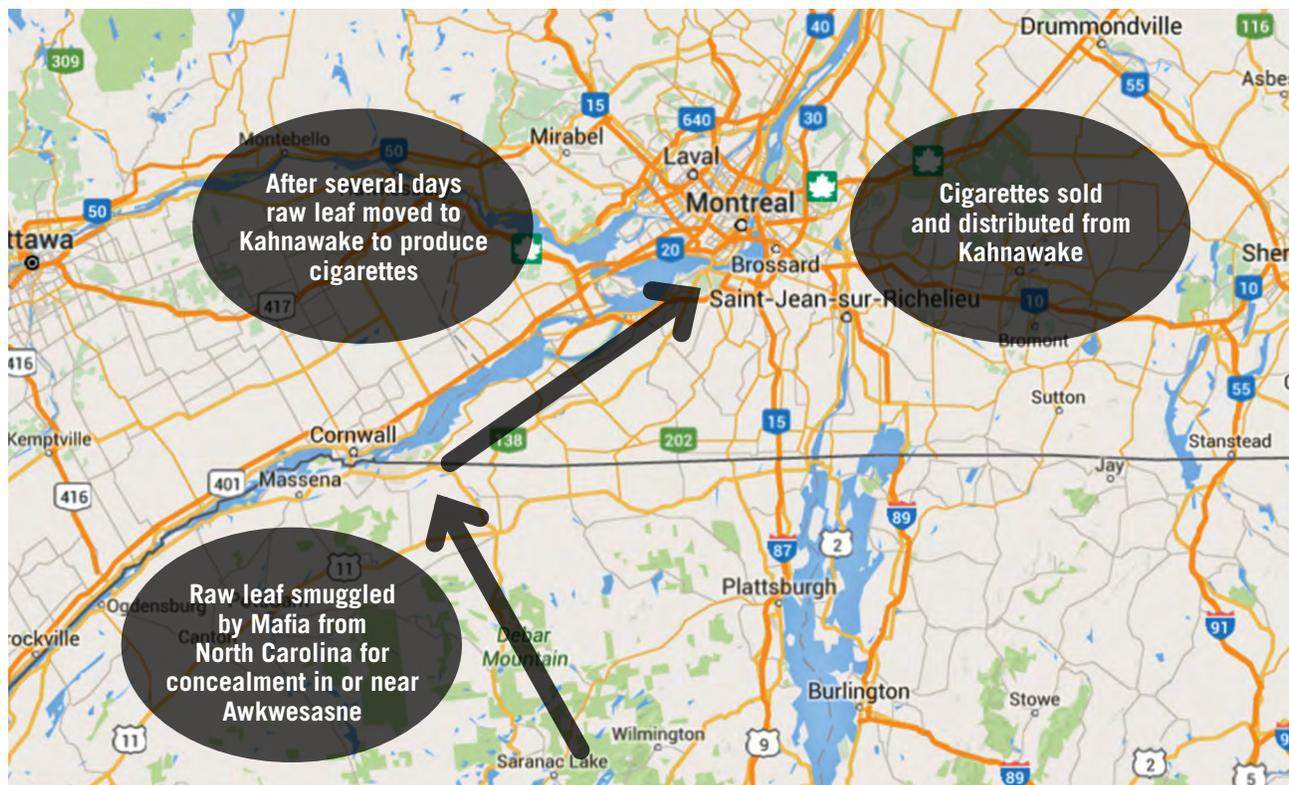
The untaxed tobacco market in Canada has resulted in significant tax revenue losses for both federal and provincial governments. An estimate by Ontario's Auditor General in 2008 suggested that \$500 million in provincial excise tax revenue was lost to the contraband market (Auditor General of Ontario 2008, sec 3.10). Between January 2007 and June 2008, the untaxed sales of cigarettes to non-Natives on reserves (not through informal distribution channels) is estimated to have resulted in \$286.4 million of lost federal and provincial tax revenue, including \$171.5 million lost by Ontario alone. Sales of untaxed tobacco in Ontario alone are estimated to have cost provincial and federal coffers tax losses of between \$689 million and \$1.1 billion in 2011, and a total of between \$3.4 and \$5.5 billion from 2007 to 2011 (Fildebrandt 2012). The CCSA, in cooperation with HEC Montreal, Pricewaterhouse Coopers, and Desjardins, estimates that untaxed tobacco cost convenience stores \$260 million in profit in 2009 (Canadian Press 2010).

To sum up, contraband tobacco rates fluctuate and estimates vary, but it is clear that contraband use in Canada is high, particularly in Ontario. For reasons discussed below, rates appear to be falling in Quebec.

1.4 The Supply Chain

Two major sources of contraband dominate the Canadian market. The first is tobacco smuggled through, and usually produced on, reserves in Ontario and Quebec. The RCMP have identified four such manufacturing or distribution hubs of untaxed tobacco: Akwesasne near Cornwall, Ontario; Kahnawake near Montreal, Quebec; Tyendinaga near Belleville, Ontario; and Ohsweken (Six Nations) near Brantford, Ontario (see map 1).

Map 1: Map depicting the organized crime supply chain through select Aboriginal reserves



Manufacturing sites in Akwesasne/Kahnawake are constantly seeking more raw inputs because dubious status (of not being registered with federal and provincial authorities) restricts their access to cut-rag – tobacco that has been cut into fine strips for use in cigarettes. So, US-based manufacturers in Akwesasne – who have easier access to cut-rag from US tobacco crops without having to cross an international border – often ship finished product to smoke shacks in Canada to avoid the supply/manufacturing step altogether. Nonetheless, cut-rag and manufacturing still exist on the Canadian side of the border because skipping the supply/manufacturing step altogether reduces profitability. By virtue of its location though, Six Nations manufacturing enjoys privileged access to the Canadian leaf market. The principal producer on the Six Nations reserve, Grand River Enterprises (GRE), is federally licensed, which ensures unfettered access to cut-rag and input materials, as the CRA allows federal licensees to purchase these from abroad. As a result, Six Nations does not struggle with “input” scarcity the way Akwesasne/Kahnawake do. This results in a finished product of better quality and substantially higher values of production.

The 2005/2006 Ontario Tobacco Survey reported that 26 percent of smokers had bought cigarettes on reserve, 12 percent reported usually buying cigarettes on reserve, and that 14 percent of all cigarettes were purchased on reserve (Luk et al. 2009). The same survey found that individuals who reported purchasing cigarettes on reserve were more likely to be heavy smokers, did not intend to quit, have lower educational attainment, and reside in Northern Ontario. But only so many people will drive onto a reserve to purchase cigarettes, and the ones who do are often locals anyway; so, manufacturing reserves have a distribution problem. “Wholesalers” are needed to bring large quantities of product to market in large population centres and other reserves. This distribution step is completely illegal and usually performed by organized crime, which isolates Aboriginal production from risk. Distribution and retail hubs include Kanasatake near Montreal, Wendake and Kitigan Zibi north of Gatineau, Quebec, and Listuguj on the New Brunswick/Quebec border. Between 2008 and 2012, 36.2 percent of all contraband tobacco seized in Canada was seized in Cornwall (Couture 2013).

Accordingly, officers in the RCMP's Central Region (encompassing Ontario and Quebec) seized 69.7 percent and 90.5 percent of untaxed cigarettes seized by the RCMP in 2011 and 2012, respectively. The Central Region also seized virtually all cigars, water pipe tobacco, raw leaf tobacco, and fine cut (processed but unrolled) tobacco in Canada in 2011 and 2012 (Health Canada 2012). That could be an indication of the scale of the contraband problem originating from reserves as opposed to abroad; or it could simply be a manifestation of better or more effective enforcement.

The second source is counterfeit cigarettes, usually arriving from overseas in shipping containers from China and Vietnam. A 2011 seizure in Vancouver (detailed below) netted 583,600 cartons of cigarettes that had been imported illegally. In 2010 CBSA seized 197,445 cartons of contraband tobacco from overseas containers, equal to only 55 percent of the tobacco seized by the Cornwall Regional Task Force alone that same year (Daudelin, Soiffer, and Willows 2013). But the seizures are too sporadic to gauge the magnitude of the challenge of imported cigarettes from Asia, even though China and North Korea are among the world's largest producers of counterfeit cigarettes. Nonetheless, pack swap data suggest that the domestic market for non-domestic legal and illicit cigarettes is relatively small; most contraband cigarettes in Canada are manufactured domestically (KPMG 2015).¹

Recent data suggest that most contraband cigarettes in Canada are manufactured domestically.

Contraband from First Nations and abroad notwithstanding, the fastest growing – albeit not the largest – part of the contraband cigarette market is mobile manufacturing where organized crime (usually non-Native) moves from warehouse to warehouse, setting up Mark-9 and better machines that are capable of producing 3500–5000 cigarettes a minute. The operations often specialize in counterfeiting cigarette brands that are not sold in Canada as well as importing such brands illegally, usually from the upwards of 300 tax-free jurisdictions in the United States that are found mainly, but not solely, on American Indian reservations. Transience reduces the risk of seizure or detection when product is moved along highways or across jurisdictions, but requires producers to keep moving operations to avoid detection. This mobile production is quickly emerging as one of the biggest challenges to cigarette enforcement.

Much of the tobacco used in these manufacturing operations comes from around Tillsonburg in Southwestern Ontario where over 90 percent of Canadian tobacco is grown; the rest is shipped in, often illegally, from the US, notably the Carolinas. Two 2014 seizures by the Canada Border Services Agency at the Stanstead-Derby Line port of entry (on the Quebec–Vermont border) netted 30,000 kg of tobacco, enough for 30,000,000 cigarettes that would have netted \$30–\$150 million. As of late, shipments of tobacco grown as far afield as India, Pakistan, and Afghanistan have also been seized; the study will return to implications for terrorism and public safety below. RCMP and CBSA threat assessments have long identified these as source countries of heroin making its way into Canada; that the same networks might be harnessed to traffic tobacco thus is not farfetched.

1.5 Legitimate Farmers and Contraband Tobacco

Legitimate tobacco farms are potentially a significant source of tobacco for illicit cigarettes. While the amount of tobacco produced is subject to licensing and production guidelines, it is not difficult to claim a smaller harvest and divert a portion to the contraband market. The latest official figures for Ontario from 2006 show tobacco being grown on 31,669 acres, less than half the 68,194 acres 10 years earlier (OMAFRA 2016). The decline may be partially due to a buy-out program, but it is likely largely a function of urbanization in Ontario's tobacco country.

The average tobacco grower in Southwestern Ontario tends 83 acres of field (Myers 2012b, 12). According to the guidelines of the regulatory Ontario Flue-Cured Tobacco Growers' Marketing Board, tobacco fields yield about 2750 lbs/acre (McGee 2009); so, a grower could divert up to 275 lbs/acre or 22,825 lbs total of tobacco without exceeding the 10 percent margin of error that may trigger an investigation. That is enough tobacco to produce over 11.5 million cigarettes – for a loss of \$1.21 million in federal excise taxes, and \$1.6 million in Ontario excise taxes. However, diversion is pretty easy because it is well-known in the community that neither the marketing board nor the Ministry of Finance has an accurate methodology to measure the group.

Tobacco sells for about \$2.25/lb on the legal market in Canada. Depending on the time of season and supply, growers can fetch up to \$8–10/lb if it is sold as contraband, although at off-peak times the price is closer to or even below the legal market rate. Even when prices are lower, the ad hoc, cash-

in-hand nature of these deals and demand from reserve manufacturers ensures outsized profits: A single grower can potentially make hundreds of thousands of dollars in net sales of illicit tobacco per season, without straying beyond the 10 percent margin of error.

Tobacco production increased by 144 percent in the three years after buyouts in Ontario.

The evidence of illegal diversion goes beyond anecdotes and the odd enforcement action. Growers are required to report their yields. *Frontline Security* learned that two farmers in Southwestern Ontario with adjacent plots reported discrepancies in yields of over 500 lbs/acre in the same season (Myers 2012b, 11). Similar to residents around Akwesasne and Kahnawake, some farmers report feeling unsafe after being repeatedly approached by

unlicensed buyers and pressured to sell illegally. A common tactic is for diverted raw leaf tobacco to be sold on the black market only to be reported as having been stolen (Myers 2012b, 11).

There is lingering resentment among Southwestern Ontario tobacco growers that stems from a change in tobacco agriculture regulations that complicates the implementation and enforcement of policy. The licensing system overseen by the Ontario Flue-Cured Tobacco Growers' Marketing Board controlling the amount of tobacco a given farmer can legally grow in a season was preceded by a quota system. In 2009, the Tobacco Transition Program bought out the 1083 quota holders in Ontario at a rate of \$1.05/lb at a cost of \$300 million. All but 18 tobacco farmers took the buyout. The average quota-holder received about \$275,000. But far from lowering yields as intended, tobacco production actually grew by 144 percent in Southwestern Ontario between the buyout and 2012 with a reported yield of 53 million pounds (Myers 2012b, 10).

In fact, the buy-out stimulated tobacco agriculture by providing an infusion of capital to farmers. A loophole in the regulations allows bought-out farms to rent their land and services to farmers who did not accept the buy-out. Pre-buyout they could transfer their quota to a relative and sell it informally, with the money split and reinvested into tobacco farming. Now, the original farmer was no longer encumbered by the conditions of the buyout or the now-defunct quota system. Regardless, many farmers in Southwestern Ontario feel no moral obligation to honour the buyout agreement because of unfulfilled promises made by the Ontario government to pay tobacco farmers 69 cents on each pound of surrendered quota (Helson 2009).

How much raw leaf is being diverted is difficult to tell. A source reported to *Frontline Security* that up to four million pounds of raw leaf tobacco, the yield of 100,000 acres at minimum, has been diverted to the illegal market by Southwestern Ontario farmers since the transition to the licensing system for regulating tobacco agriculture in 2009. Over the past decade, the RCMP published at least three reported seizures of thousands of kilograms of unstamped raw leaf tobacco smuggled east on Highway 401. Tobacco headed east, especially west of Cornwall, likely originated in Southwestern Ontario.

PART 2: FIRST NATIONS AND CONTRABAND

2.1 Tobacco and Cultural Heritage

First Nations insist that tobacco is part of their cultural heritage. Whether First Nations groups have the right to grow, manufacture, distribute, and/or sell tobacco without oversight or enforcement from Canadian government is controversial and a manifestation of broader issues of Aboriginal sovereignty and self-determination.

Cultural and historical roots are commonly used to justify the tax-free or tax-reduced Native trade and sale of tobacco to Natives. There is a broad consensus that tobacco was widely used by various First Nations peoples for different ceremonial and sacred purposes. But the Aboriginal right to pursue an economic, social, or cultural activity is different from a historic or cultural claim to usage, previous histories of harvesting a wild plant that in regions of North America eventually became a domesticated crop notwithstanding. Historically First Nations have no exclusive cultural claim to tobacco: For a while in the 17th and 18th centuries, for instance, tobacco quickly became the principal and, temporarily, sole, export product of the colonies of Virginia – “the colony founded on smoke” – Maryland, and, subsequently, the Carolinas. By 1621, England passed legislation that deliberately cultivated growing and import monopolies. So, for First Nations to stake a monopoly claim on tobacco as a cultural heritage is a weak argument. Tobacco is as much a part of the British North American and Canadian cultural heritage as of the Aboriginal one.

Aboriginals are not exempt from excise duty, but are exempt from sales tax when purchasing cigarettes on a reserve.

Aboriginals are not exempt from excise duty, but are exempt from sales tax when purchasing cigarettes on a reserve upon verification of their status. Yet, Section 87 of the federal *Indian Act* can be interpreted to exempt Status Indians from tax on the purchase of tobacco products in

Canada: “No Indian or band is subject to taxation in respect of the ownership, occupation, possession or use of any property mentioned in paragraph (1)(a) or (b) [‘the interest of an Indian or a band in reserve lands or surrendered lands’ and ‘the personal property of an Indian or a band situated on a reserve’] or is otherwise subject to taxation in respect of any such property”. By convention, tobacco has become one of the materials protected by the *Act*. Notwithstanding s. 87, by convention federal excise tax paid by cigarette manufacturers is applied to cigarettes sold to Status Indians on reserves.

2.2 Reserve Geography and Tobacco Smuggling

Mohawk communities, which include the main cigarette-producing reserves of Akwesasne, Tyendinaga, Ohsweken, and Kahnawake, were ideally located along the St. Lawrence River to trade with other Aboriginal groups and European settlers. In the early 20th century, men from both Akwesasne and Kahnawake began travelling to New York City for steelwork. This involved crossing the US-Canada border on a regular basis; the right for Mohawks to do so is enshrined in the 1794 Jay Treaty. The Treaty grants First Nations people the right to cross the border.² However, the legal weight of this treaty itself remains a source of contention between First Nations and Canadian governments (George-

Kanentio 2015). While some Mohawks claim that it gives them a right to trade over the Canada-US border without paying a duty or tax, such a right has not been formally recognized by Canada or past colonial governments, and courts in the US have ruled that this treaty does not justify the sale of tax-free tobacco to non-Native people (Physicians for a Smoke-Free Canada 2007). In 2001, the Supreme Court of Canada rejected the claim that the Treaty gave “Aboriginal rights to trade” to groups such as the Akwesasne Mohawks (*Mitchell v. M.N.R.*). The ruling had little discernible effect on the enforcement or conduct of the cigarette trade in Akwesasne or other reserves in Ontario and Quebec.

The return of Native-grown tobacco to Southwestern Ontario is part of a more general re-emergence of tobacco trade among Native people in North America beginning in the late 20th century. The

Akwesasne’s geography hinders enforcement and favours navigation by locals with intimate knowledge of the area and the ways across the river, especially in winter.

possibility of producing, shipping, and selling tobacco in Akwesasne emerged in the mid 1980s (George-Kanentio 2010). Attempts to regulate the fledgling tobacco business in Akwesasne in the late 1980s were largely ignored. By this time, rising domestic excise taxes in Canada coupled with the lack of export taxes created a substantial tax differential between Canada and the US, which precipitated large-scale smuggling with the cooperation of transnational cigarette companies back into Canada observed in Akwesasne in the late 1980s and early 1990s. Native-led manufacturing at this time appears to have been minimal, as transnational cigarette companies supplied ample cigarettes.

Natives were instrumentalized by export diversion schemes for their intimate knowledge of the intricate routes between the many islands in the St. Lawrence River in Akwesasne. This changed when the tax gap was closed by tax rollbacks and transnational companies were threatened and eventually punished with legal action. The years following the millennium have gradually given rise to a variety of manufacturing, wholesale, and retail operations on reserves along the St. Lawrence River that have varying degrees of licensing from federal and First Nations authorities. The share of the overall tobacco market in Canada held by these operations appears to have peaked around 2009 when contraband levels may have almost rivalled the boom of the early 1990s (Zhang and Schwartz 2015).

Akwesasne straddles the US-Canada border within a few hours’ drive of some of the largest cities in Canada and along the Eastern seaboard. In the past, Akwesasne served first as a nexus between the British and the French, then between the British and US markets, and honed a legacy of trade. This particular section of the border is shaped by the St. Lawrence River, which at Akwesasne is pockmarked by a complex maze of small islands.

This environment hinders enforcement and favours navigation by locals with intimate knowledge of the area and ways across the river, especially in winter. Akwesasne’s strategic position straddling international and provincial borders has made it a periodic hot spot for smuggled tobacco, alcohol, narcotics, and humans for over a century. Both Natives and non-Natives have historically been involved in smuggling at Akwesasne, but much of what was and is channeled through the reserve must be further distributed to their end markets, usually by non-Native criminal organizations.

For much of the 20th century, border control between Canada and the US at the Akwesasne crossing took place on Cornwall Island, which lies in the St. Lawrence River on the Canadian side of the border. Smugglers could easily circumnavigate the island and thus avoid the checkpoint. This checkpoint was moved to the Canadian mainland at the city of Cornwall in 2009 (Daudelin, Soiffer, and Willows 2013, 16). The relocation of this checkpoint has had no effect on the free movement across the border within Akwesasne, but it has forced smugglers to resort to shipping contraband in boats or snowmobiles rather than large trucks. Although that complicated life for smugglers, they still leverage their knowledge of the labyrinth along the islands of the St. Lawrence River and myriad

private docks and sheds to the east and west of Akwesasne along the Canadian shore, some of which are used without the owner's permission. Precious Blood Catholic Church near Cornwall has been particularly popular (Blackwell 2010). Complicating matters is the pace of operations; a shipment of cigarettes can be unloaded from a boat at shore in under a minute.

Court records on the RCMP-led Project O-Titan exemplify methods used. Cigarettes had been smuggled into Canada across the St. Lawrence, then further smuggled to Ottawa and the town of Prescott, approximately 60 km SW of Cornwall. In five incidents observed by police over eight days, cigarettes were delivered by boat from Akwesasne to one or two locations on the northern shore of the St. Lawrence. During the drop-off, two individuals roved the nearby roads in a truck, acting as a "mobile communications centre" for other group members. When the boat arrived from Akwesasne up to four people would conduct "static counter-surveillance" around the delivery site(s). After the group successfully transferred their cigarettes from the boat to a truck, they were delivered to either Prescott or Ottawa within 24 hours; in each case, the vehicle with the cigarettes was tailed by another car conducting counter-surveillance. On another night, police observed 37 cases (370,000 sticks) unloaded from a boat in under a minute. Police noted that the cigarette-smuggling boat was painted black and its occupants dressed in camouflage to avoid detection. It also navigated without the use of onboard lighting; the navigator appeared to rely on night-vision goggles.

Akwesasne has also come to be associated with smuggling for political reasons. Tensions between some First Nations groups and Canadian law enforcement were already high before a series of incidents in the 1990s, most notably the Ipperwash and Oka crises. Hitherto, in 1988 an RCMP raid on Kahnawake tobacco vendors led to 17 arrests and the seizure of \$450,000 worth of tobacco products. It also triggered a 29-hour armed standoff when, in retaliation, Mohawks blocked highways through Kahnawake. There has since been little enforcement of tobacco-related offences on reserves. Reserve police forces occasionally call on the RCMP for assistance, usually when a manufacturer or distributor has ties to organized and/or violent crime.

*A low-level smuggler
can earn up to \$7000 a day
in profits.*

2.3 The Business of Contraband on Reserve

Tobacco is thought to employ between 800 and 2000 of Kahnawake's 8000 residents and 2000 of Ohsweken's 11,600 residents in manufacturing, distribution, wholesale, and retail (Marsden 2009). Many workers are not Aboriginal. In 2014, the chief of the Kahnawake Peacekeepers police force claimed that the various tobacco factories and smoke shacks employed "thousands" of people on that reserve alone (Barrera 2011). Residents employed in cigarette factories make at least \$15/hour and between \$100–\$150 a day to bag cigarettes and \$175–\$200 per day or \$600–\$700/week (tax free) tending to machines (Marsden 2009).

Even more lucrative is the actual smuggling of relatively small shipments across the Canada-US border. This work is more irregular but the risks allow people to make a living wage working intermittent hours. In New York state, it has been reported that "a low-level smuggler can walk away with up to \$7000 a day" in profits (Guevara 2008b). Owners can make millions but, for obvious reasons, do not disclose profits: Indicted veteran cigarette smuggler Al Jacobs of Jacobs Tobacco on reserve is infamously known as the "40-million-dollar man". This has engendered a "narco-culture . . . in which the traditional values of humility, compassion, simplicity, generosity and communal service have been replaced by violence, intimidation, greed and death. . . . The easy money has led to corruption not only

at Akwesasne but throughout the region” (George-Kanentiio 2008). Its collective benefits, however, are disputed: the chiefs and a majority of members of the community oppose the criminality associated with illicit tobacco and cigarettes, see no future in it for their communities, and would rather have residents take up other, more legitimate, more sustainable work (George-Kanentiio 2010).

Aboriginals on reserves defend their right to manufacture, trade, and sell tobacco products and will likely continue to do so in defiance of federal and provincial governments, especially as long as Canadian law enforcement effectively shuns enforcement on reserves. On the one hand, legal conglomerates have their part to play to ensure acquisition, sale, distribution, and promotion of their product complies with their federal licence – and government has to be more vigorous in availing itself of its powers to sanction irregular activity under the licensing and legal regime.

On the other hand, the uneasy standoff between governments and Aboriginal peoples will continue as long as underlying grievances remain. Perpetual poverty on some reserves encourages desperate members (as well as some opportunistic ones) to consort with organized crime. These groups often rely on narcotics sourced from the Montreal area as well as cannabis grow operations off reserves to generate funds to purchase untaxed tobacco, which is often produced on reserves, such as Akwesasne and Kahnawake. Similarly Akwesasne residents generally do not venture far into the US with what they have smuggled over the border; while the destinations of these goods may be as distant as the southern United States, most movement within the US relies on the people to whom Akwesasne-based smugglers deliver, often located in New York State.

Natives tend to perform two functions: supplying cigarettes and smuggling tobacco and other goods over the St. Lawrence River. In some instances, the manufacturer of the cigarettes is knowingly involved in the purchase and smuggling of cannabis to the US. In other cases, it is less clear that the manufacturer of cigarettes has any stake in other smuggling activity. Some Akwesasne residents assist in smuggling narcotics through the reserve, but rely on Cornwall-area residents living and acting outside of the reserve to supply drugs from Montreal.

PART 3: ORGANIZED CRIME AND CONTRABAND

Not all cigarettes manufactured on reserves have connections to organized crime – reserve-based companies, despite their legal tensions with Canadian governments, are potential models for other Native businesses if Canada becomes more hospitable to the inter-reserve trade they advocate. However, it is clear that Akwesasne and to a lesser extent Kahnawake and other area reserves are serving as enclaves of crime and convenience for organized crime. They do not exploit these territories only for tobacco; were the North American Aboriginal tobacco industry to disappear tomorrow, these reserves would still be used by syndicates to smuggle and store illicit wares. Ergo, policies that are effective in combating organized crime more generally will be effective in curtailing cigarette smuggling. A recent report recommended that Canada develop “a strategic approach to illicit drugs and street gangs, implementing a coordinated and effective national fraud strategy, strengthening the witness protection program and facilitating the management of complex cases” (Public Safety Canada 2014). If organized criminal groups cannot grow, produce, and distribute illicit drugs, their ability to purchase cigarettes from reserves or more directly fund their manufacture will be hampered.

Organized crime is heavily invested in and/or operates manufacturing, distribution, and retail on and off reserve, and is often behind the baggies of totally untaxed cigarettes that are sold through informal channels but are also widely available through smoke shacks on reserves. So, containing organized crime off reserve would impede its reach on reserve. Investigations by the RCMP, Sûreté du Québec (SQ), and other law enforcement agencies unveil OC operations principally in the Cornwall-Valleyfield corridor and the GTA, although some rely on international suppliers and ship product across Canada. Some of these networks are highly localized around a particular reserve, while others are widely dispersed, often involving many non-Natives and established criminal organizations.

Surveillance and enforcement are focused on smugglers as they leave Akwesasne because jurisdictional disputes stifle enforcement on reserve and because interception becomes more difficult as distance from the reserve increases. As a result, demographic characteristics of those arrested may not be representative of the actual composition of contraband manufacturing, trafficking, and retail networks. Low-level mules may be more likely to be apprehended this way than managers and/or manufacturers. These mules are usually intimidated into being uncooperative with police if apprehended, frustrating attempts to link them to larger networks.

Table 2 below summarizes investigations involving contraband tobacco and cigarettes over the past 10 years. Despite potential selection bias in the way investigations are initiated by law enforcement (for instance, there is always the possibility that there are networks that do not involve Aboriginal reserves but are more professional and, therefore, have not been detected or prosecuted), in compiling the data below every effort was made to include the full universe of known cases. Certain trends emerge: they showcase “off-site” distribution, involve one or more Aboriginal reserves, trafficking is usually not limited to cigarettes, profits and tax losses are substantial, and seizures usually include firearms. What may at one point have been “mom & pop” operations have, over the past 15 years, been taken over by professional networks that generate significant profits while victimizing Aboriginals and reserves early in the supply chain or after manufacturing is complete as a (albeit often complicit) cog in the organized criminal machine.

Table 2: Sample investigations involving contraband tobacco and cigarettes in Ontario, 2006–2014

Project	Year	Arrests	Location	Seizures	Revenue and Organized Crime Involvement
Bluette	November 2006	26	Akwesasne, SW QC, E ON	435 cases (4.3 million cigarettes), 37 cars, \$600,000 real estate, \$700,000 cash, 9 firearms	300 million cigarettes, net sales \$53–\$67 million (May 2005–Apr 2006)
Crawler	November 2006	12	Akwesasne	\$650,000 cash, \$1.9 million laundered; cannabis	at least 13.2 million cigarettes/week, \$40 million in lost tax
Conquest	March 2008	20	Akwesasne, Kahnawake, Eastern Canada, Carolinas	21 million cigarettes, \$20,000 cash, 75 VLTs	\$5 million in lost provincial and federal tax

Project	Year	Arrests	Location	Seizures	Revenue and Organized Crime Involvement
Chateau	March 2009	22	Kahnawake, Quebec City, Wendake reservation (N of Quebec City)	300 cases of cigarettes, 20,000 methamphetamine pills, 3 guns, \$75,000 cash, property	Profits of \$2.5k/day; Hells Angels
Machine	March 2009	60 (only 4 charged)	Kahnawake, Akwesasne, Montreal	34,800 kg tobacco, 1 kg cocaine, 860 rocks of crack cocaine, 900 g cannabis, 4000 methamphetamine tablets, ecstasy, bulletproof vests, 12 firearms, 1 silencer, \$3.4 million cash	Hell's Angels, Rock Machine
	April 2009–October 2011	8	Vancouver & Toronto	11 cargo containers, 583,600 cartons of cigarettes, 6270 kg of P2P (used to manufacture methamphetamine and amphetamine)	1 Asian organized crime syndicate
LYNCH	March 2010 – April 2011	15	Prince Edward Island & Kahnawake	950 cartons of cigarettes, 6 vehicles	
	November 2010 – April 2011	29	Central St. Lawrence Valley	55,000 cartons, 5000 kg of tobacco, 20 vehicles, 1 assault rifle	1 organized crime group
	November 2010	13	Etrie	2050 cartons of cigarettes, 1 kg of marijuana, counterfeit movies and computer software, 8 vehicles, \$22,000 in cash	1 organized crime group
	December 2010	1	Calgary	300 cartons of cigarettes; an additional 1000 cartons of cigarettes seized by CBSA	1 Vietnamese organized crime group
	December 2010	3	South Glengarry	3500 baggies, 12 kg of marijuana	
	December 2010	4	St. Lawrence seaway	359 baggies, debt lists and ledgers, 22 firearms, 1 vehicle, \$35,000 in cash	
	February 2011	3	Moose Jaw & Akwesasne	1000 cartons of cigarettes, 1 fifth wheel travel trailer, 1 firearm, marijuana, drug paraphernalia	
	March 2011	2	Saint-Anicet	30,000 baggies, 1 semi-tractor, 1 trailer, 1 vehicle	Total estimated value \$850,000

Project	Year	Arrests	Location	Seizures	Revenue and Organized Crime Involvement
Chopper	March 2011	23, including 4 volunteer firefighters	Akwesasne; US	\$140,000 cash, 110 kg of cannabis, 2 bulletproof vests, 35 guns, 4 cars, property	\$2.5 million in lost tax to QC
H-TELEX	May 2011	5	Halifax	3500 cartons of cigarettes, 6 vehicles, 1 kg of marijuana	1 organized crime group
Castelnau	June 2011	6	Akwesasne, Kahnawake/Chateauguay, SW QC, Kitigan Zibi reserve (N of Ottawa), other reserves in QC and NB	10,500 cartons of cigarettes, 50 cars (40 luxury), 2 guns, \$300,000 in assets	1 organized crime group
Cinderford	July 2011	30 arrests + 8 additional warrants; over 300 charges	Cornwall, Ottawa, Gatineau, South Glengarry, Stormont, Oswego NY, Akwesasne, Montreal	8750 cartons of cigarettes, 259 kgs of cannabis, 1.75 kgs of cocaine, 2.5 kg of oxycodone, 4431 tablets of ecstasy, 12 firearms (including 2 AK-47 assault rifles), 1000 rounds of ammunition, a bulletproof vest, 4 cars, 1 snowmobile, 2 watercraft, 2 bulletproof vests, a police duty belt, 4 handgun holdsters, \$100,000 cash	1 organized crime group
Lycose (Sweet Dreams)	September 2012–April 2014	31	Akwesasne, Lacolle and Dundee (QC), Kahnawake, North Carolina	200,000 kg tobacco, \$450,000 cash, 1300 cannabis plants, 14 cars	Montreal Mafia
O-Stone	September 2012	12	Akwesasne, South Glengarry, Cornwall	401 cases, 11 kg cannabis	Smuggled assault rifles
O-Titan	2012–June 2013	37	Cornwall, Akwesasne, Ottawa, Prescott, South Stormont, Glengarry, and Dundas counties	11,615 cartons (2.3 million cigarettes), 100 lbs cannabis, 4 firearms, 4 cars, 2 boats	
London 9	May 2014	9	Cornwall-Valleyfield, SW ON	60 kg cannabis, 2 bricks of hashish, 950 cannabis plants, cocaine, ketamine, MDMA, \$85,000 cash, \$300,000 in raw leaf tobacco, 45 firearms	\$2.5 million lost tax

Sources: Multiple, including RCMP 2012a; Rakobowchuk 2014.

In 2007 and 2008 alone, there were at least 480 seizures in the Akwesasne-Valleyfield region, netting 443 vehicles and firearms that included AK-47s and M-16 machine guns (Marsden 2009). Between 2008 and 2010, the RCMP (2012b) disrupted over 56 organized crime groups, laid over 2350 charges under the *Excise Act* (2001), and seized over 3.2 million cartons/unmarked bags of contraband cigarettes, 1600 vehicles, 70 vessels, and 7 other properties. From May 2010 until April 2011, at least 13 organized crime groups involved in contraband tobacco were disrupted, and over 1200 charges laid under the *Excise Act* (2001). From May 2008 until May 2011 a total of over 4200 charges were laid under the *Excise Act* (2001) in relation to contraband cigarettes and tobacco. Select seizures since about which additional information is known are listed in table 3.

Table 3: Additional contraband cigarette seizures, 2008–2014

Date	Arrests	Location	Seizures
5 June 2008	1	Akwesasne	360,000 cigarettes
17 June 2009	1	Kahnawake	200,000 cigarettes
31 August 2009	1	Kahnawake	1669 kgs of tobacco
5 January 2010	1	Kahnawake	200,000 cigarettes
5 May 2010	1	Akwesasne	800,000 cigarettes
8 July 2010	1	Pincourt	500,000 cigarettes
25 August 2010	1	Cornwall	160,000 cigarettes
23 November 2010	3	Cornwall, Akwesasne	500,000 cigarettes
24 January 2011	1	Cornwall	270,000 cigarettes
31 May 2011	1	Hogansburg, NY	220,000 cigarettes
1 June 2011	1	Cornwall	2203.2 kgs tobacco
27 June 2011	2	Hogansburg, NY; Akwesasne	200,000 cigarettes
18 October 2011	1	Hogansburg, NY	200,000 cigarettes
20 April 2014	3	Kanesatake, Oka	1230 million cigarettes

Source: Revenu Québec 2014.

Tobacco-smuggling networks in the Cornwall-Valleyfield region are involved with other illegal activities, especially other forms of smuggling. Over half the cases profiled in table 2 also trafficked in drugs, and 40 percent have confirmed links to organized crime. The Hells Angels, for instance, have floated several operations on Kahnawake. Tobacco and/or cigarettes tend to be imported from the US (including from the US side of Akwesasne), and cannabis tends to be exported to the US. While Akwesasne is undoubtedly a hotspot for cross-border smuggling, it is also a main source of cigarette production, with dozens of licensed and unlicensed operations: four of the aforementioned networks sourced cigarettes from Kahnawake, and seven from Akwesasne. In contrast to tobacco, drugs were not generally made or grown on reserves. In most cases cannabis and other drugs were sourced from the Montreal area, and these suppliers were not directly involved in cross-border smuggling. Several of these groups also traffic weapons, and 10 had weapons seized. In two cases they also laundered money. However, most often they just reinvest profits into other criminal enterprises, that is, to

“grow the business”: in several cases capital for Aboriginal producers to buy equipment and set up operations was fronted by organized crime (Marsden 2009).

In addition to similarities in function and location, most networks also have a similar structure: they rely on a central coordinating node, usually two or three people, to purchase drugs, re-sell them to dealers, arrange for specific smuggling events, and coordinate activities. This core is often located off-reserve, even in cases such as Castelnau where the mastermind was a former reserve resident. This core tends to be densely connected with one other, as opposed to the mules and pushers to whom they sell tobacco and drugs. The result is a hub pattern. In cases such as Cinderford, pre-existing relationships from legal and illegal activities enhanced communication between dealers, leading to an all-channel structure where dealers communicate informally about illegal activity. They may also compete for customers as well as limited resources from their seller.

Generally, smugglers are professionals who capitalize on their expertise to decrease the prospect of detection. In the aforementioned cases they tended to be composed of Akwesasne residents whose involvement is mostly limited to ferrying cigarettes and/or drugs across the St. Lawrence River and the international border. Overcoming this hurdle is indispensable for off-reserve organized crime syndicates to ensure business continuity in the supply chain.

Nonetheless, this table of major cases provides only a partial picture that could be misleading: It does not contain other seizures, such as incidental ones by the OPP's Highway Enforcement Team (HET), by the Cornwall Regional Task Force, the Valleyfield detachment, or by raids on mobile manufacturing in the GTA, mostly coordinated by the RCMP's Bowmanville detachment; but open source intelligence on seizures and raids is difficult to come by. Law enforcement wants to protect its containment and surveillance strategies; but absent systematic open source data, success (or failure) of their efforts is difficult to judge. As aggregate and anecdotal data in the introductory paragraph to this study suggest, the scale of these other seizures and raids is significant; but its extent is surprisingly difficult to ascertain, as is the type of organized crime involved. Once these seizures and raids are factored in, (1) the overall contraband market turns out to be much bigger than the cases listed imply and (2) it involves a diverse array of organized crime, including ethnic criminal gangs, and is not limited to Aboriginal sources as one might be tempted to infer from tables 2 and 3. Moreover, the phenomenon is much more dynamic than the table suggests. In an effort to avoid detection and disruption, smugglers adopt methods and tactics relative to enforcement; stepped up enforcement in Cornwall has a displacement and diffusion effect that sees more product seized in Valleyfield, for example (RCMP 2012a, 15).

PART 4: TERRORISM

An emerging literature posits a global convergence between organized crime and terrorism: terrorists are resorting to organized criminal operations to facilitate their activities, and organized crime is resorting to terrorist measures to support theirs (Leuprecht et al. 2015; Miklaucic and Brewer 2013; Clarke 2015; Mincheva and Gurr 2012; Williams 2008; Treverton et al. 2009; Hutchinson and O'Malley 2007; Roth and Sever 2007; Makarenko 2004; Alldridge 2003). In an age of globalization, the magnitude and velocity of terrorism and crime, driven by interconnected economies and advances in communication and technology, have resulted in unprecedented profits and violence (Realuyo 2015; Dishman 2001). The White House's 2011 *Strategy to Combat Transnational Organized Crime* (SCTOC) concludes that “criminal networks are not only expanding their operations, but

they are also diversifying their activities. The result is a convergence of threats that have evolved to become more complex, volatile, and destabilizing” (White House 2011). Convergence – defined as “the process of coming together and having a common interest, purpose, or goal” – has also improved groups’ ability to evade official countermeasures, overcome logistical challenges, identify and exploit weaknesses and opportunities in the state system, and attack that system (Australian Crime Commission 2014). Evidence from the US and abroad confirms that cigarette smuggling has been used to raise funds for foreign terrorist groups.

Mokhtar Bemokhtar was a military commander of al-Qaeda in the Islamic Maghreb from which he splintered his own organization, Al-Mulathameen (“Masked”) Brigade that was behind the 2013 terrorist assault on the Al-Amenas Tigantourine gas facility in Algeria. In 2008, he kidnapped and held Canadian diplomats Robert Fowler and Louis Guay for 130 days. The CIA dubbed him Mr. Marlboro for his frequent use of cigarette smuggling into Europe to fund his terrorist attacks.

Myriad terrorist organizations partially finance themselves by trafficking and selling contraband, including the PKK, Hamas, Hezbollah, and the Real Irish Republican Army.

ISIS has publicly burned shipments of cigarettes to enforce Sharia (smoking is prohibited) but continues to profit from smuggling the product into and through Iraq, Syria, and Turkey. ISIS controls the smuggling routes in their territory that are key to smuggling oil, cigarettes, and other profitable goods that, by all accounts, constitute the majority of their \$80 million in monthly revenue. The product and profit not only support ISIL and their organized crime network, but other al-Qaeda affiliates and foreign fighters drawn to the region (IHS 2015).

In 2013, 16 persons were arrested in operation “Tobacco Road.” This ring of wholesalers in low tax states and distributors including bodegas in

New York was found to have undertaken cigarette tax fraud against the State and city in excess of \$80 million and netted the group at least \$22 million. Only a fraction was recovered and there is good evidence that some of the money was sent back to Hezbollah as well as funding operations of terrorist mastermind Sheik Omar Abdel-Rahman, the “One-Eyed Sheik.” From 1995 until 2002, proceeds of “Operation Bathwater” and “Operation Smokescreen” partially financed Hezbollah (Leuprecht et al. 2015). Cigarettes were purchased in low tax states, trafficked to New York and Michigan, and sold to finance Hezbollah. Canada was a financial intermediary through which illicit funds were sent to Lebanon (Levitt 2012).

Recent seizures in North America of tobacco originating in Pakistan and Afghanistan are disconcerting because tobacco and contraband cigarettes have long been an important and stable source of revenue for listed terrorist entities. The Afghan and Pakistan Taliban collect taxes from legal and illegal producers in return for safe passage. In fact, these taxes reportedly account for as much as 20 percent of their revenue – second only to heroin (ICIJ 2009). Myriad terrorist organizations partially finance themselves by trafficking and selling contraband, including the Kurdistan Workers’ Party (PKK), Hamas, Hezbollah, and the Real Irish Republican Army (RIRA) (Rollins and Wyler 2013; Centre d’analyse du terrorisme 2015). It is estimated that the latter group was able to derive \$100 million USD in just five years from dealing in contraband tobacco (FATF 2012).

PART 5: POLICY OPTIONS

5.1 Taxation

Taxation is often held out to be the main driver of the contraband market. But as this section will detail, the optimum level of taxation with regard to reducing contraband is very hard to determine, and so the potential solutions to be found in adjusting federal or provincial tax rates are limited.

Taxes comprise about 75 percent of normal retail tobacco prices, and are largely responsible for the higher prices paid for legal tobacco off reserves, along with the generous profit margins for those who circumvent these taxes. Economists often posit lower or no tobacco taxes as a key tool in the fight against contraband tobacco. Conversely, public health advocates usually advocate holding the line or raising tobacco taxes as a way of curbing tobacco use. (These groups are not mutually exclusive, of course: some leading economists on tobacco, such as Frank Chaloupka at the University of Illinois' Institute for Health Research and Policy and Jonathan Gruber at MIT, place a greater emphasis on public health and support higher taxes). Research on the "price elasticity" of smoking, or how resistant the behaviour is to changing with higher costs, suggests that cigarettes sold legally and at lower prices will likely slow, halt – or even reverse – the general decline in smoking rates in Canada. That runs counter to the anti-smoking public health initiatives that at least partially motivate the heavy excise taxation of tobacco products (Zhang and Schwartz 2015).

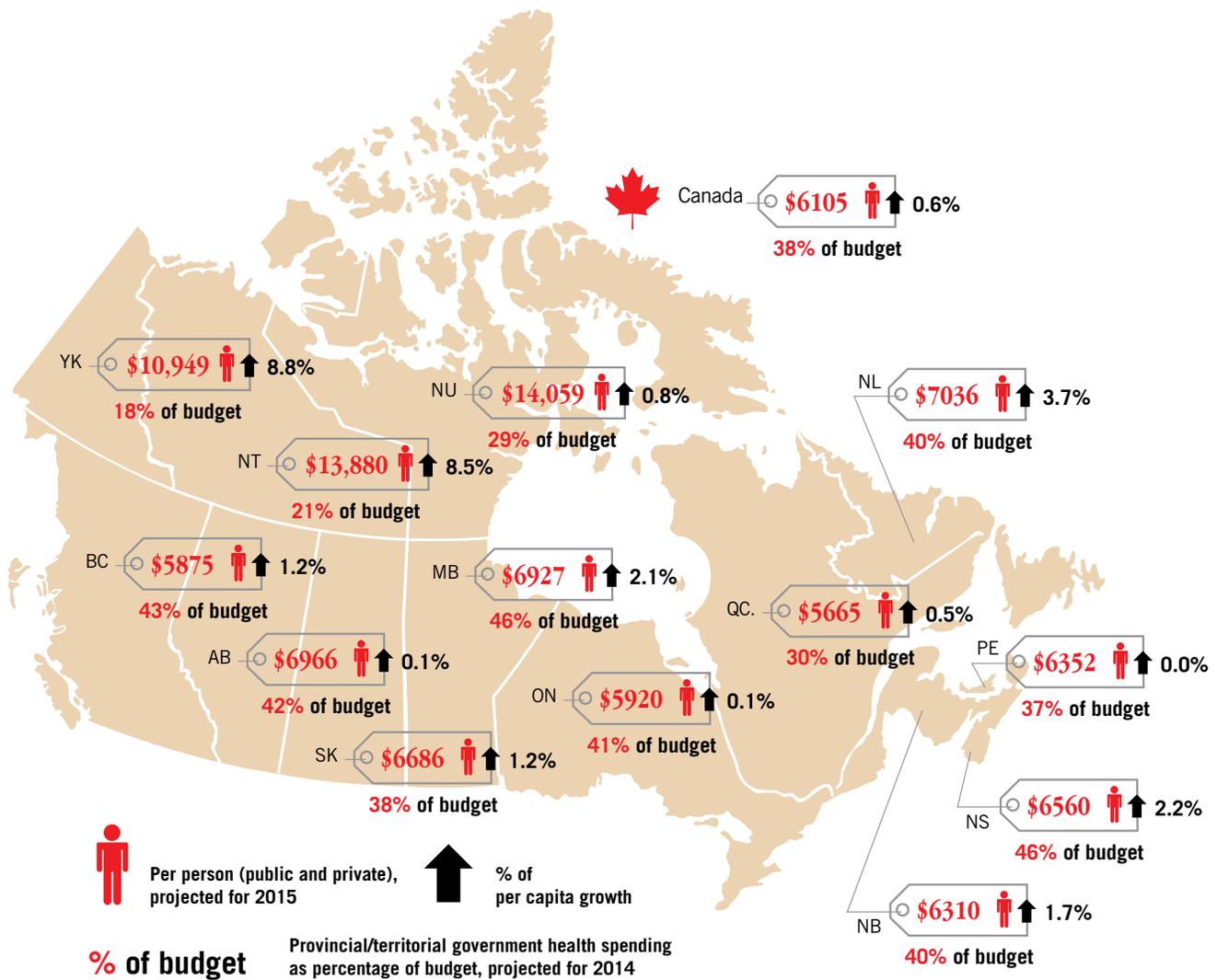
There are good reasons for taxing tobacco at rates higher than other retail products. First, even casual tobacco use has negative health consequences and undesirable "societal externalities", such as costs to a publicly-funded health care system. High tax rates partially monetize these costs at the point of purchase as a means of discouraging cigarette consumption and compensating for some of these costs. "Sin" taxes assume that tobacco

users (especially those addicted to nicotine) are likely to underestimate the risk the activity presents but are nonetheless responsive to price (Goel and Nelson 2006). Higher taxes may not cause a smoker to cease altogether, but they depress consumption, which is still beneficial to the smoker's health and the public health care system (Irvine and Sims 2012). Conversely, a ready supply of untaxed, cheaper tobacco undermines the economic disincentives of steep excise taxes to curtail the health consequences associated with tobacco.

Those who avail themselves of that ready supply of untaxed, cheaper tobacco also fail to pay their fair share of the estimated \$4.4 billion in direct medical costs and \$17 billion in health-related social costs associated with contraband tobacco alone (Reid et al. 2012). The following scenarios illustrate the point. Map 2 shows the average health care expenditures per capita across Canada (irrespective of whether someone smokes or not):

Higher taxes depress consumption, which is beneficial to the smoker's health and the public health care system.

Map 2: Projected provincial/territorial government health spending, 2012



Source: Canadian Institute for Health Information 2015.

Take the example of a smoker in table 4 who buys four packs a month for a total of 48 packs a year. At that rate, someone in Ontario who procures tobacco products from authorized retailers would spend about \$4254.72 on cigarettes a year, \$2840.64 in taxes. This smoker's tobacco taxes would cover 48 percent of the average \$5920 health care cost. An identical smoker who buys tobacco from a federal authorized legal Aboriginal manufacturer spends \$1729.44 on cigarettes, \$1009.44 of that in taxes. Tobacco taxes would cover 17 percent of that person's average health care bill. And an average smoker in Ontario who buys tobacco products from retailers who levy no tax would have contributed nothing.

Table 4: Evaded tax and health care costs of smoking contraband (48 packs/year)

	Total Price	Tax Price	% Tax	% of WHO FCTC Target	Health Care Deficit	% Health Care Recovered
Legitimate	4254.72	2840.64	67	-8	-2994.36	48
Fed Excise Only	1729.44	1009.44	58	-17	-4825.56	17
Contraband	960	0	0	-75	-5835	0

In short, those who smoke contraband end up not paying their fair share of health care costs, despite the fact that their higher risk for chronic illnesses and cancer is likely to cost the health care system more than the average Canadian (Martens et al. 2015).

The poor are disproportionately affected by higher tobacco taxes. They have less disposable income to begin with, and are more likely to smoke. If people do not stop or curtail smoking as taxes rise, they face a dilemma: either they remain in the legal market and spend a larger proportion of their meagre income on cigarettes; or they defect to the illicit market, and government foregoes the tax revenue (Gospodinov and Irvine 2009). With other taxes, such as income, research has shown that there is an optimal rate that maximizes revenue while minimizing the temptation to cheat. Rather than assuming that higher taxes will necessarily generate more revenue, reduce consumption, or both, it might be helpful to have more research on the optimal tax rates on cigarettes across Canadian jurisdictions. “Sin” taxes need to be punitively high to have any marked impact on behaviour; but just how high is controversial.

Higher taxes seem to lower demand, and evidence shows that lower tobacco tax rates will slow or even halt the decline in demand for tobacco.

Higher tobacco prices, for instance due to tax hikes, decrease legal tobacco consumption.

The WHO states that “raising the price of tobacco and tobacco products, primarily through tax increases, is the single most effective measure to reduce short-term consumption” (WHO 2004). However, a thorough analysis of Statistics Canada data suggests that higher taxes are ineffective at curbing tobacco consumption as they merely occasion a displacement effect from the legal to the contraband market (Ouellet 2010). But by how much, and how much of the consumption is displaced to the contraband market as a result of tax rates, is not clear.

Proponents and opponents commonly cite the same statistic: a 10 percent increase in tobacco taxes will generally result in a 3–4 percent decrease in consumption. Opponents hold that this demonstrates the relative inelasticity of tobacco demand to price and levels of taxation, while proponents believe that this drop in demand is sufficient to justify higher tax rates. One Canadian study found that a 10 percent tax increase would decrease demand for tobacco by between 4.5 and 4.7 percent (Gruber, Sen, and Stabile 2003). This study factored in Canada’s then-re-emerging contraband market, and warned that failure to account for the illicit market would cause price elasticity to be overestimated (it would overstate the potential effectiveness of a tax hike in decreasing smoking rates). Not only do higher taxes seem to lower demand, but there is also evidence that lower tobacco tax rates will slow or even halt the decline in demand for tobacco. Other studies focus on the effects of cuts to federal and provincial tobacco taxes in 1994 (Galbraith and Kaiserman 1997). They show that a reduction in tax rates reduces cessation rates and increases

initiation and consumption rates, especially amongst youth and males (Sen and Wirjanto 2010; Sen and Fatima 2011).

If taxes rise while the supply of cheap, untaxed tobacco (especially baggies) remains ample, the *de facto* price consumers pay does not necessarily rise with a tax increase. Conversely, a decrease in taxation might effectively cut out the contraband market by levelling its comparative advantage. This hypothesis was put to the test when Canadian tobacco taxes were rolled back in 1994. Yet, as table 5 and chart 4 show high tax rates do not necessarily correlate with large contraband markets. To the contrary, Pellegrini, Fry, and Aitken (2011) found that price is not a primary determinant of smoking behaviour. The World Bank found that intervening supply-side variables such as the level of corruption of government officials, the ease of cross-border smuggling, the prominence of organized crime, and proximity to the source all turn out to have a greater impact on the size of the contraband market than the level of taxation in and surrounding a jurisdiction (Joossens and Raw 2006).

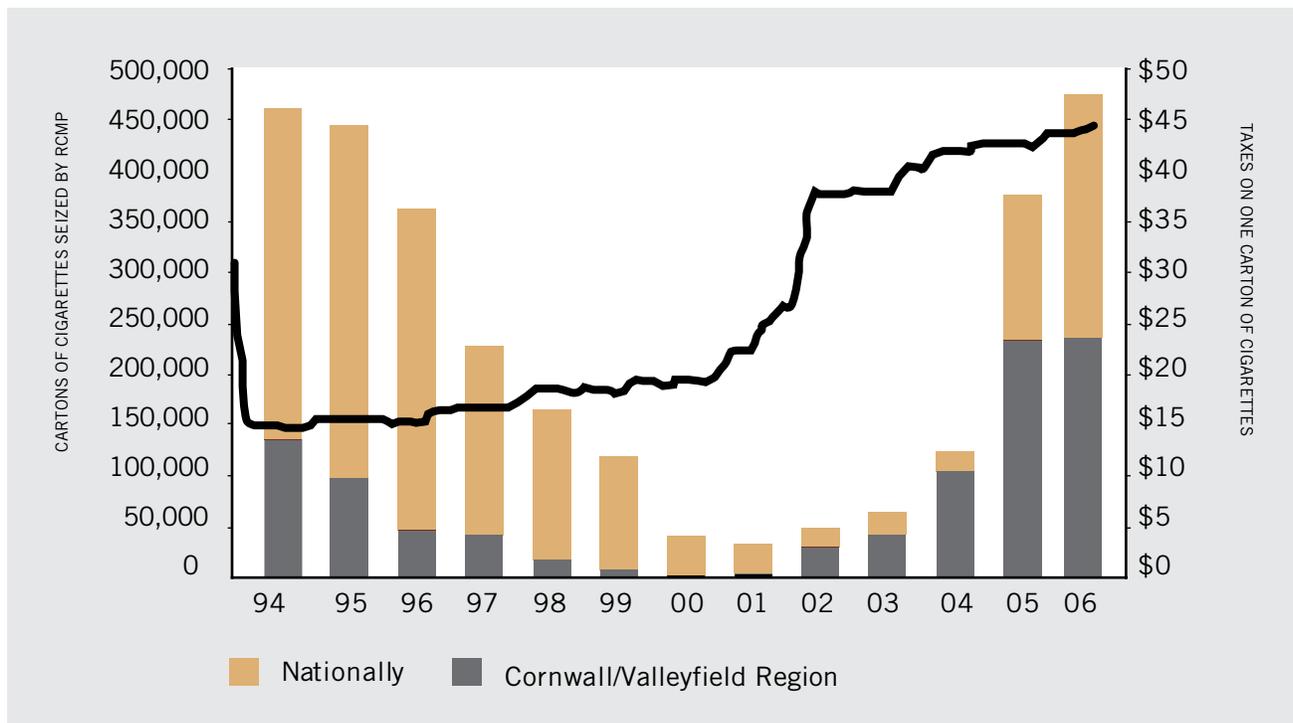
Canada's Western provinces tend to have the highest tax rates, but Ontario and Quebec have the largest untaxed tobacco market despite having the country's lowest provincial excise taxes (Dampousse 2005).

Table 5: Cost of a carton of cigarettes and tax rates across Canada's provinces and territories, February 2016

Province or Territory	Total Retail Price	Taxation Rates Per Carton
British Columbia	\$99.46	\$47.80
Alberta	\$104.92	\$50.00
Saskatchewan	\$117.79	\$50.00
Manitoba	\$133.25	\$59.00
Ontario	\$97.04	\$30.95
Quebec	\$84.01	\$29.80
New Brunswick	\$124.21	\$44.52
Nova Scotia	\$123.60	\$51.04
Newfoundland & Labrador	\$118.77	\$47.00
Prince Edward Island	\$118.78	\$50.00
Yukon	\$103.32	\$42.00
Nunavut	\$115.87	\$50.00
Northwest Territories	\$127.46	\$57.20

Source: Lickers and Griffin 2016

Chart 4: Average tax rates (black line) and contraband tobacco (bar graph), 1994–2006



Source: RCMP 2008, 8.

The history of tobacco taxation in Canada supports the World Bank’s findings. During the 1990s big tobacco enabled a “returning exports” scheme that saw product that had left Canada tax-free systematically returned to Canada without applicable taxes. The increase in export tax in 1992 temporarily choked off the contraband trade through a significant decrease in export product. With the exception of corruption amongst Canadian officials concerning the tobacco industry, just about all of the extenuating circumstances identified by the World Bank apply in Canada; therefore, it is highly unlikely that a reduction in tax levels would achieve desired policy outcomes unless the cut was so steep as to all but eliminate provincial excise tax in an attempt to equalize prices with tobacco sold without provincial excise taxes (but with federal excise taxes) sold on reserve. This would amount to a cut in excess of \$20 per carton in Ontario; to close the gap with totally untaxed baggies, taxes would have to be eliminated altogether. Neither is a realistic option, especially in fiscally austere times.

In Canada, substantial changes to federal or provincial tax rates in either direction are unlikely to achieve their policy goals as long as there is a robust and resilient supply of contraband. Complemented by other policies that curb contraband, including the proposals that follow below, higher taxes are preferable to lower ones because they help to compensate for the negative externalities of smoking and encourage the reduction or cessation of tobacco consumption. The solution in this situation is not to raise or lower existing taxes but rather to explore revenue sharing with First Nations, as detailed below.

5.2 Legislative Developments

5.2.1 FEDERAL LEGISLATION: C-10 (2014)

Municipal, provincial, and federal law enforcement have long had the power to charge tobacco smugglers (especially those linked with organized crime) with offences likely to have been committed

in the course of running a contraband tobacco operation. These include charges of fraud, conspiracy to commit criminal offences, participation in activities or the commission of an offence for a criminal organization, trafficking a controlled substance, laundering the proceeds of a crime, and possessing property obtained by crime (Bernal-Castillero and Nicol 2013). However, tobacco-related charges are usually brought under section 32.1 of the *Excise Act*, which makes it relatively easy to seize means of conveyance, such as cars. By contrast, charges under Canada's *Criminal Code* are relatively recent, and precedents to generate case law are still winding their way through the courts; so, it is too early to tell what the implication of the addition of this law enforcement tool will be.

Contraband tobacco had not been mentioned specifically in the *Criminal Code* prior to the passage of Bill C-10 in 2014. It adds a new section (121.1) to Part IV of the *Criminal Code* that "prohibits different steps involved in the selling of tobacco products that have not received an excise stamp or of raw leaf tobacco that is not packaged, unless it is stamped." This statute applies when tobacco is intended for resale (purchase of contraband tobacco for personal use is not punishable under the *Criminal Code*). The *Act* does not mention the manufacture or purchase of tobacco, which are addressed by the *Excise Act*. Changes thus address the sale of untaxed tobacco. However, an illegal manufacturing facility that sells tobacco without paying federal excise taxes and/or used unstamped raw leaf could be charged

under this *Act's* amendments, especially since federal excise taxes are paid by the manufacturer at the time of packaging. Bill C-10 also leaves open the potential of a major expansion of enforcement against contraband tobacco: All Canadian police forces can enforce the provisions of the *Criminal Code*; by convention, only the RCMP makes enforcement of the *Excise Act* a priority.

Contraventions of the section of the *Criminal Code* amended by Bill C-10 are a hybrid offence: Punishment can be by either an indictment or a summary offence. Maximum penalties of up to five years' imprisonment for an indictment or six months for a summary conviction can

be levied. Similarly, maximum penalties for contravening sections of the *Excise Act* concerning the possession and sale of unstamped raw leaf or processed tobacco products are five years' imprisonment for an indictment and 18 months' imprisonment for a summary conviction. Bill C-10 also institutes mandatory minimum sentences for repeat offenders. The *Excise Act* only stipulates mandatory minimum fines. In Ontario, for instance, fines range from \$108 for a single pack of contraband cigarettes to \$4693 for 50 cartons or baggies.

The problem with fines is that smugglers notoriously do not show up for court and fail to pay fines amounting to hundreds of thousands of dollars, yet are rarely if ever imprisoned for contempt or failure to pay. A retailer who the Government of Quebec assessed \$25 million in back taxes was offered an agreement to repay his debt – at a rate \$150 per month. At that rate, without interest and inflation, it would take him about 14,000 years to repay the total amount owing.

C-10 provides considerable opportunity for the federal government to show leadership. The legislation opens the opportunity for the federal government to emerge as the central coordination authority of a unified taxation structure for all Canadian peoples, across provinces and reserves. This could be administered and enforced by an Ombudsman or a new central tax authority where cooperation could be enticed through federal grants and other incentives. In other words, C-10 has the potential to turn a patchwork into a framework that will ensure the benefits of taxation accrue to all citizens instead of organized criminals and terrorists; but the legal structure still needs to be fleshed out, policies formulated, and implementation undertaken.

C-10 has the potential to ensure the benefits of taxation accrue to all citizens instead of organized criminals and terrorists.

5.2.2 QUEBEC LEGISLATION: BILLS 59 (2009) AND 44 (2015)

Quebec amended its *Tobacco Tax Act* in 2004 to make it illegal to sell or ship tobacco to a cigarette manufacturer not licensed by the province. For example in 2006, the Sûreté du Québec intercepted 250,000 kg of loose tobacco intended for provincially-unlicensed manufacturers in Kahnawake (NSRA 2007). Tobacco is illegal under Quebec law regardless of whether it is destined for a federally licensed manufacturer, such as Rainbow Tobacco on Kahnawake; consequently, enforcement of this law has the potential to antagonize conflict concerning provincial jurisdiction over reserves. Were Canadian and First Nations authorities to agree on the scope of provincial jurisdiction, analogous legislation in Ontario could improve the ability to intercept contraband tobacco before it is manufactured into cigarettes.

Quebec further amended its *Tobacco Tax Act* in 2009 when Bill 59 sought to limit the growth of the licensed tobacco industry by putting a moratorium on issuing licences to new manufacturers, shortening the validity period of existing certifications, and requiring permits for tobacco manufacturing equipment. To increase incentives for enforcement, fines levied under Quebec's *Tobacco Tax Act* are now remitted to a municipal government when the charges are heard in court. The Bill also increased fines, imposed maximum penalties of two years' imprisonment for infractions, and revoked driver's licences for some offenses. It allows the SQ to stop a vehicle on "reasonable grounds" of suspicion that it may be carrying contraband tobacco. However, these provisions will only allow provincial and municipal police to stop the suspect's vehicle and request a search warrant from a judge. Police cannot lay charges under the *Tobacco Tax Act*; that remains the purview of the responsible Ministry.

In November 2015, Quebec's Bill 44 *An Act to bolster tobacco control* went even further. Although much of the *Act* deals with electronic cigarettes, it also increases fines for selling to minors to up to \$125,000 for repeat offenders. As of 1 May 2016, flavoured tobacco will be disallowed altogether and restrictions on smoking in cars and public places will be tightened. Restrictions will be tightened further on 1 December 2016 and manufacturer discounts for retailers will be prohibited.

5.2.3 ONTARIO LEGISLATION: BILL 186 (2011)

In 2011 Ontario's Bill 186 intensified punishments for contraventions of the *Tobacco Tax Act*, while also delineating separate offences and punishments for simple possession of contraband on the one hand, and possession of contraband with intent to sell on the other hand. The first offence could result in imprisonment for repeat offenders, whereas a first offense of possession with intent to sell is punishable by fine or incarceration. The Bill has also empowered the Ontario Provincial Police and municipal police in Ontario to enforce the *Tobacco Tax Act* by granting them the power to seize tobacco products in plain view that are suspected of being contraband. It imposed possible fines for the possession of even one cigarette without the applicable taxes having been paid. These fines amount to "\$100 plus three times the tax for possessing up to 200 illegal cigarettes; \$250 plus three times the tax for possessing between 201 and 1,000 illegal cigarettes; and \$500 plus three times the tax for possessing between 1,001 and 10,000 illegal cigarettes."

The Ministry of Finance has some way to go to establish itself as a capable enforcement body.

Bill 186 also expands the scope of Ontario's *Tobacco Tax Act* by requiring the provincial registration of all who "produce, process, sell or distribute" raw leaf tobacco in Ontario. Only registered growers can grow tobacco on pre-determined plots of land and sell to licensed wholesalers, and then only in pre-determined amounts that are part of the licence application. Both licences for growers and buyers must be renewed annually, and the conditions of the licence are calibrated to the amount of

tobacco that the farmer projects to grow and the buyer expects to purchase. Under the old regulatory scheme administered by the Ontario Flue-Cured Tobacco Growers' Marketing Board, each spring registered farmers reported how many acres of their land will grow tobacco, and estimated their yield per acre. The guideline yield was 2750 lbs/acre. Reported yields of 2450 lbs/acre or less might be indicative of illegal diversion or inadequate agricultural ground that could cause the licence to be revoked. Once the total yield for that farmer is projected, it must be demonstrated that licensed buyers have already agreed to purchase the expected yield. The Marketing Board has stipulated that up to 10 percent of the farmer's yield can go unaccounted for upon harvest due to variations, such as adverse weather conditions.

Bill 186 had the Ministry of Finance take over the oversight of this regulatory framework from the Ontario Flue-Cured Tobacco Growers' Marketing Board. The Board had been responsible for granting, renewing, and revoking the licences of tobacco farmers since Ontario switched its management of tobacco farming from a quota-based system to a licence-based system of production in the spring of 2009. It is unclear what, if any, resources this Board has had at its disposal to enforce its licensing regime. The Ministry of Finance was slated to assume oversight in 2012, but this transition was delayed repeatedly until 2015. Bill 186 also bolsters enforcement powers for police by allowing for the seizure of raw leaf by Ministry-approved officials if there are reasonable and probable grounds to believe that it is being handled by unlicensed people.

Although the transition from the Ontario Flue-Cured Tobacco Growers' Marketing Board to the Ministry of Finance has tightened monitoring and enforcement, three changes will hamper the ability to investigate and interrupt diversion ("Contraband Tobacco and the Ministry of Finance: Two steps back" 2015):

1. once harvested, growers no longer need to identify the source and the final destination of raw leaf;
2. labelling information that tracks baled raw leaf tobacco has been dropped as a requirement; and
3. reporting frequency has been loosened from a weekly requirement to quarterly requirement.

Reversing these changes and adopting the licensing scheme developed by the Flue-Cured Tobacco Growers' Marketing Board would be an effective framework for managing the supply of raw leaf tobacco in Ontario *if* sufficient resources were devoted to enforcement. However, the Ministry of Finance has some way to go to establish itself as a capable enforcement body. In 2012/13, it seized \$8.72 million in illegal tobacco products; this figure fell to \$1.94 million in 2013/14 (DurhamRegion 2014).

Criminalizing the unlicensed growth, sale, purchase, and/or transport of raw leaf would enable local enforcement of this licensing regime.

Still, hampering the flow of raw leaf from Southwestern Ontario will not necessarily undercut the manufacture and smuggling of contraband cigarettes in Ontario and Quebec because raw tobacco is also available to manufacturers, sometimes at a better price, from North Carolina. Southwestern Ontario may be preferred by some manufacturers for its proximity to the reserves (especially Ohsweken), and by manufacturers on Canadian reserves to avoid having to traffic across

international borders. Furthermore, the raw leaf supply chain appears rife with diversion. Victor Osztrovics, president of now-defunct True Blend Tobacco Co, was selling the majority of his tobacco to Akwesasne and while not caught for the transport that was seized at Mirabel (200,000 lbs), the seizure left him without money to pay farmers over \$12 million he owed them and collapsed his company

(Re Osztrovics (No.2), 2014 ONSC 4405). About 20 percent of farmers were on his wholesaler list whose product – not necessarily known to them – was used pretty much solely for contraband production. By way of example, in 2009 he failed to disclose 15 acres of tobacco for which he did not have a purchase contract. His mother then applied for both farmer and wholesaler licences but her application was rejected (Mann 2012). As a result of this episode, in 2011 only 193 licences were granted to growers to produce 46.3 million pounds of tobacco instead of the 251 growers licensed and approved to produce more than 50 million pounds in 2010. It takes about 1.9 pounds to make 1000 cigarettes.

Ontario's Bill 186 stiffened fines and enabled provincial and municipal police or other Ministry-approved officials to seize unstamped raw leaf tobacco, if it is in "plain view". However, the powers of these police forces and their ability to investigate suspected diversion remain limited. Criminalizing the unlicensed growth, sale, purchase, and/or transport of raw leaf would acknowledge the serious consequences of diverted raw leaf and the revenue it strips from government coffers and places in the hands of criminal groups. Most importantly, it would enable the OPP and municipal police forces to assist in the enforcement of this licensing regime.

Section 25 of Bill 186 particularly has drawn the ire of First Nations. It empowers the provincial government to "enter into such arrangements and agreements with a council of the band as the Minister considers necessary for the purposes of the administration and enforcement of this Act on a reserve" and "authorize a system for the sale of unmarked cigarettes, cigars and other tobacco products to Indians who are exempt from the payment of the tax imposed by this Act, and the arrangement or agreement may provide for limits on the quantity of unmarked cigarettes, cigars and other tobacco products to be sold to retail dealers for resale to consumers who are Indians". This provision empowers First Nations governments to regulate their own tobacco market by encouraging partnerships with provincial bodies, such as the Ministry of Finance. However, some First Nations representatives contend that the wording of this section simply assumes provincial jurisdiction over reserves and the tobacco trade, and legalizes jurisdictional intrusion by the province into matters that should be regulated by treaties between the federal government and First Nations or by the autonomous decisions of First Nations governments. However, the \$225 million per year in potential additional revenue as a result of Bill 186 is enough money to change the incentive structures at work.

Agricultural regulations may be easier to control than manufacture or distribution since most (but not all) tobacco cultivation takes place outside of First Nations reserves; so, provincial law enforcement and ministry officials can be "hands-on" in upholding these regulations without political controversy. Moreover, tobacco is an easily identifiable plant that, unlike some crops such as marijuana, must be grown in large quantities to be profitable. As a result, tobacco-growing operations tend to be outdoors in plain view, which makes it easier to estimate yields or at least ensure that only approved plots are cultivated. The bulk of Ontario's 239 tobacco farms are concentrated in the Norfolk/Delhi/Tilsonburg area of Southwestern Ontario, which makes them readily identifiable. An increasing amount of tobacco (2500–3000 acres in 2014, increasing at a rate of about 500 acres/year) is grown within Ohsweken, which complicates enforcement: The RCMP reported at least 200 acres of tobacco and 113 tobacco kilns there. Growing tobacco was the only element missing in the Aboriginal supply chain to ensure that business is fully integrated. On-reserve farms have acquired the specialized equipment necessary to produce tobacco of comparable quality to off-reserve crop. Ergo, more capacity to monitor tobacco growth is necessary to curtail the diversion of raw leaf to illegal manufacturers, and cooperation with Ohsweken authorities will be inevitable as tobacco agriculture intensifies there.

5.3 Revenue Sharing

The RCMP (2012a, 2; 22) and the Auditor General of Ontario (2008) have long emphasized the need to work with First Nations communities and leadership. A First Nations Excise Tax (FNET) has the potential to alter the way that tobacco is sold on reserves, especially to non-Native customers. The profitability of the Native tobacco industry relies on selling tobacco to non-Natives – and doing so without leaving the reserve or relying on Internet sales – at a price lower than off-reserve retailers: 150

smoke shops crowd the 9 km of Highway 138 that runs through Kahnawake. This is why communities such as Kahnawake and Akwesasne are so resistant to a FNET, let alone one equal to the provincial excise tax: such a tax, especially if the HST were also diligently applied, would eliminate the incentive for non-Native customers to travel to a reserve to purchase cigarettes. The current flow of non-Native customers directly benefits some members of these communities, but some revenues end up with organized crime.

In Ontario, Akwesasne is moving towards a self-governing system for licensing and taxing tobacco manufacturing and sales. The Akwesasne Technical Table, made up of representatives of the Ontario government and the Mohawk Council of Akwesasne (MCA) initiated the Akwesasne Tobacco Pilot Project. This pilot has generated draft legislation to license tobacco manufacturers, wholesalers, and retailers on-reserve. This project's recognition of self-government in Akwesasne is indicative of improving relations between the governments of Ontario and Akwesasne. As of January 2015, the

Akwesasne Tobacco Manufacturing and Products Law had been put before the public in a series of meetings and was "accepted in principle" by the MCA. The approved legislation itself had not been made public yet. Part of Akwesasne is in Quebec, and an agreement between the province of Quebec and the Akwesasne band council has yet to be reached.

A First Nations Excise Tax would eliminate the incentive for non-Native customers to travel to a reserve to purchase cigarettes.

Quebec has negotiated an exempt status of Indians from provincial taxes with the Mohawk Council of Kahnawake, implemented "smart cards" that allow for tax-free cigarettes purchases off-reserve by Kahnawake residents, and established the remittance of provincial taxes collected from non-Native customers back to the band council. However, the Kahnawake Tobacco Association, a compact of different tobacco

manufacturers and wholesalers on the reserve, promptly ignored the deal, citing its Aboriginal right to defy the provincial government, as it is not a member to any treaty with the people of Kahnawake and thus has no jurisdiction on-reserve. This action effectively incapacitated the agreement, which federal, provincial, or on-reserve law enforcement have been unable to enforce.

There has since been a renewed attempt to regulate the tobacco industry on Kahnawake. It had the support of at least one of the major manufacturers on-reserve, Rainbow Tobacco – until Rainbow lost its excise licence for selling illegal product (Mire 2014). These regulations call for the establishment of a nine-member board made up of Kahnawake residents, including but not limited to the tobacco industry. This body would oversee the licensing of manufacturers, wholesalers, and retailers. Having no criminal record is a precondition for a licence – unless convictions stem solely from tobacco-related charges (Gabler 2011). This exception reflects the derisive attitude of Kahnawake leaders towards the legitimacy of federal and provincial tobacco laws. According to the draft legislation, those holding licences from any other governing body must relinquish them before being licensed by the Kahnawake Commission (section 8.2). This stipulation stands to exacerbate tensions with Canadian governments, as this seems to preclude a licence-holder in Kahnawake from also being licensed by the CRA or a provincial body. While self-regulation of a reserve's tobacco trade is integral to keeping organized crime out of the industry, smooth operation of the industry beyond the reserve's boundaries will necessitate negotiations with federal and provincial governments about licensing or at least import and distribution arrangements.

The implementation of taxes and fees on tobacco sales on-reserve has met with greater success in other parts of the country. Tobacco products purchased on the Cowichan Tribes reserve near Duncan, BC irrespective of status carry a tax equal to the provincial excise tax, to be collected at the point of purchase by the retailer. The revenue is divided into four streams. Three-eighths (37.5 percent)

is paid out as a dividend to all Cowichan Tribe members as a kick-back of sorts to compensate for ending the section 87 tax exemption for Cowichan members. In 2014, this dividend amounted to \$268.10 per band member (Cowichan Tribes 2014). In addition, one quarter of the tax revenue is devoted to renovating and rebuilding residences on reserve. Another quarter funds economic opportunities for the young and elderly, and the remaining eighth is earmarked for on-reserve job creation and training. The Cowichan case may be an exception because of Duncan's remoteness. Nonetheless, its longevity, success, and transparency have led to similar models being adopted in other provinces.

*Successfully implemented
FNETs distribute revenue back
to the bands.*

Manitoba has instituted a "Band Assessment Collection Agreement Program". It levies a tax on tobacco purchases by Natives on the concurring reserve that equals the provincial excise tax. This tax is administered through the refund system that is used to collect taxes for the province. It is paid by the wholesaler, who passes the costs on to the retailer, who, in turn, applies for a refund from the province. As of March 2007, 55 of the 74 reserves in Manitoba had signed to this agreement, although implementation appears to be lagging. Much like the tax in Cowichan that has generated about \$2 million a year in tax revenue since its inception, revenues directed to band councils by the Band Assessment Collection Agreement Program go towards community development and aim to reduce tobacco consumption on participating reserves.

In the Maritimes, Prince Edward Island remits provincial taxes from the sale of tobacco on the Lennox Island reserve for use in community development projects. New Brunswick has struck a similar agreement with 13 of the 15 reserves in that province; Status Indians are exempt from provincial tax as before, but 95 percent of tobacco taxes collected on-reserve from non-Natives is reimbursed to the band council. In Nova Scotia, as in several other provinces, such as Ontario, each reserve is assigned an allocation quota, – the number of reduced-tax cigarettes that can be legally sold on that reserve per year. Unlike other provinces, however, cigarettes allocated within this quota can legally be sold in Nova Scotia to non-Native customers at the reduced price, which provides a legal incentive for non-Natives to purchase cigarettes on-reserve. Alternatively, a band council can choose to apply a fee to cartons within the allocation quota, to be collected and used by the band council.

Yet, high quotas encourage sales by quota-bound retailers to ineligible customers. Retailers without enough money to buy their full quota at the beginning of the month may also end up relying on illicit cigarette supplies later in the month to maintain their stock. This, in turn, drives demand for the production of illicit cigarettes. One possibility is to preserve the integrity of the quota system by means of real-time electronic monitoring of purchases and discretionary licensing, as Alberta and British Columbia have attempted (Sweeting, Johnson, and Schwartz 2009). Another is for government to curtail abuse of the allocation quota altogether. In Ontario, the allocation quota is 2.7 cartons per month per on-reserve member and 2.5 cartons per month per off-reserve member. But with fewer than half those cigarettes consumed by Status Indians, the allocated amount far exceeds Native consumption (Review of the First Nations Cigarette Allocation System in Ontario 2015). Cutting the quota in about half thus seems sensible. In March 2016 Ontario completed a comprehensive review of the cigarette allocation quota system in a report that weighed different options moving forward (Lickers and Griffin 2016).

Albeit controversial among First Nations, a wholesale refund system for allocation cigarettes would provide a stronger incentive to enforce tax collection at the point of sale. Cigarettes allocated for tax-exempt sale on First Nations reserves should be distributed through a refund system that helps to ensure that only Status Indians purchase tax-exempt tobacco in accordance with s. 87 of the

Indian Act. The wholesaler pays the provincial excise tax on each carton that is incorporated into the price paid by the retailer. Upon proof of a legitimate sale of cigarettes to a Status Indian (ID required), the provincial government refunds the tax to the retailer.

The experiments described above suggest that revenue-sharing with First Nations is likely to be successful if it shores up the governmental autonomy of band councils while enhancing accountability and transparency (Lickers and Griffin 2016). Indeed, Ontario has initiated revenue-sharing pilots that are ongoing. Revenue-sharing needs to link tax revenue with identifiable projects that clearly benefit the community to make the benefits of taxation tangible (Graham and Bruhn 2009). First Nations communities also need to ensure fair and accountable representation on the band council that spends these tax dollars. Notwithstanding some positive philanthropic efforts

The success of revenue-sharing with First Nations depends on shoring up the autonomy of band councils while enhancing accountability and transparency.

from the tobacco industry on Quebec and Ontario reserves, notably GRE in Ohsweken, the collection and administration of a tax by First Nations governments promises a larger and more sustained stream of revenue for community development and infrastructure projects. Elected band councils that spend tax dollars are also more accountable to reserve members than private enterprise. Overall, this would enhance both governmental autonomy and accountability by band councils.

A FNET will need to set the fraction of the normal provincial excise tax rate to be levied on cigarettes sold by Natives to non-Natives. A low rate will give Native retailers an unfair advantage over large tobacco companies

and their conventional distribution channels. Additionally, too low a rate would further frustrate enforcement inside and outside the reserve, granting legitimacy but effectively maintaining the status quo of a low-regulation enclave for manufacturers. This is precisely the strategy that Kahnawake and Tyendinaga may be pursuing. Since 2014, Kahnawake's Tobacco Law requires a "Contribution Stamp" to be bought and affixed to all tobacco products imported, exported, or manufactured on the reserve. Similarly, Tyendinaga in Ontario collects a \$2 fee per carton on cigarettes sold on the reserve.

However, Native retailers are likely to balk at selling cigarettes to non-Natives at existing federal and provincial excise tax rates because many Native cigarette retailers, whether the cigarettes they currently sell have the federal excise tax paid or not, rely on non-Native consumers for a substantial portion of their market. Parity would cripple Native retailers as non-Native consumers would no longer have a financial incentive to travel to reserves to purchase Native cigarettes if only fully-taxed ones were for sale. Price matters more to consumers than taste or quality; so, it is unlikely that offering a superior product would attract customers. Moreover, cigarettes made by corporations both on and off reserves often use tobacco from the same sources and employ the same manufacturing equipment, which makes it unlikely that Native manufacturers will produce a noticeably superior product even under ideal conditions.³ While some on-reserve manufacturers fall short of health and safety standards, the production facilities and final-product quality of large Native manufacturers, such as GRE, are comparable to major corporate producers. The price point of Native products vs. non-Native products will be the most important determinant in their popularity with non-Native consumers.

The implementation of a tax that maintains a gap between Native and non-Native retailers will preserve the market for Native economic development by providing an economic incentive for non-Native consumers to purchase tobacco on reserves, while the tax revenue thus generated can be used at least in part to keep the tobacco industry free of violence and crime through better-funded police and other initiatives. However, the optimal differential is difficult to gauge since there is no large-scale research on how tax schemes on First Nations reserves change consumer behaviours and influence the contraband market. Still, limited anecdotal evidence and existing policies provide a baseline for best practices: While

many US tribes have implemented a tax equal to the state excise tax, a reduced tax rate may be more effective in maintaining a legal market for Native-made cigarettes in Quebec and Ontario. Many of the tribes that have instituted an excise tax equal to the state excise tax are close to large cities and lack a resilient illegal parallel market with manufacturing operations on those very reserves.

A Native-implemented taxation scheme would eliminate or (preferably) lower the price differential at the point of purchase to non-Natives on reserves. If on-reserve retailers diligently collect a FNET from the applicable customers and refuse to sell cigarettes that do not collect this tax, this will help thwart the illegal, untaxed mass-purchase of cigarettes from reserves. The fundamental difference between a FNET and the current excise taxes – that many Native retailers do not collect – is the government that administers and uses these taxes. The collection of taxes by the Native community for their own use on these sales encourages them to clamp down on those who purchase tobacco at the tax-exempt rate (if Status Indians are excluded from the FNET) for informal resale as well as on the criminal networks that undercut taxed tobacco with ultra-cheap baggies.

With over 600 communities to which such schemes can apply, a wide range of options for taxation is now available to First Nations communities. While the approach varies across Canada, the communities that tax tobacco are reaping substantial revenues. But First Nations leaders need to be transparent with their communities about how the taxes collected will be used, and how the tobacco trade as it currently stands enriches many non-Natives who exploit their territory as sanctuary. Cheap and widely available tobacco is a scourge for public health whatever its source, diminishes efforts to control tobacco, and tobacco-control targets cannot be met without curbing the use of contraband (Luk et al. 2009; Smoke-Free Ontario Scientific Advisory Committee 2010). Growing and manufacturing tobacco can bring money and jobs to some reserves. As a quid pro quo governments of these reserves have a moral obligation to collect taxes on tobacco sold there to help lower tobacco use and collect revenue for the benefit of local communities and enforcement of criminal activity.

The collection of taxes by the Native community for their own use encourages them to clamp down on those who purchase tobacco at the tax-exempt rate for resale.

5.4 Tracking and Tracing

A common method of accounting for legally produced cigarettes, tracking their location as they pass through jurisdictions, and determining when those cigarettes have had the appropriate taxes paid is to affix a mark or stamp to cigarette packages. Tracking and tracing technologies are internationally recognized as an important component of regulating the legal tobacco market.

Canada has used tax stamps to signal the payment of taxes and duties since the introduction of the federal excise duty in 1864. The most recent update to these stamps came into effect on cigarettes, cigars, and fine-cut tobacco products 1 July 2012 (Ryan 2002). This new stamp has several security features, mostly to enable tracing. Each stamp features anti-counterfeiting measures, such as anti-copy line-work, colour-shift ink, ultraviolet visible ink, and an intaglio latent image (Canada Revenue Agency 2010). It is also uniquely encoded so as to be traceable to its wholesale purchaser, who must be licensed to buy them from the Canada Revenue Agency (WHO 2014). In some provinces, including Ontario, a single stamp is placed on a pack to indicate that both federal and provincial excise taxes have been paid, replacing tear-tape and former paper stamps. Cigarettes falling within the quota allocation for First Nations reserves are stamped with a “blackstock” marking, indicating that federal excise tax has been paid and that provincial excise taxes are not applicable.

Canada has also taken recent measures through stamping not to prevent diversion, but to detect counterfeits. Counterfeit cigarettes from China are common in BC, and sometimes sold at legal retail

Tracking and tracing systems are only effective against counterfeit products and diverted legal products, not illicit whites or baggies.

establishments. In response to this market the CBSA signed a Memorandum of Understanding with Imperial Tobacco Canada Ltd. that led to more sophisticated tear-tapes on cigarette packages in that province that make it easier for law enforcement to identify contraband. This has apparently been quite successful; thus far there have not been any successful counterfeits of these tear-tapes (Sweeting, Johnson, and Schwartz 2009, 31–32). However, special markings or other tracking and tracing systems are only effective against counterfeit products and diverted legal products, not illicit whites or baggies.

5.5 Input Controls

In its 2015 budget, Ontario announced that it would be looking into input controls as a possible measure to contain contraband tobacco. The two primary materials used in manufacturing tobacco products are acetate tow and cigarette paper. Both are specialized products with few uses outside of the tobacco industry. *Acetate tow* is a form of densely pilled cellulose acetate fibre made from wood pulp, and it has become the industry-standard material for cigarette filters over the past 60 years. According to INTERPOL (2014, 67), “there is currently no acceptable and qualified alternative filtration technology for cigarettes that can fully or partially replace acetate tow.” There are other filtering technologies such as activated carbon, but it is unclear if this can be deployed on the scale of acetate tow, which, at any rate, is sometimes used to suspend activated carbon in an activated carbon filter. About 80 percent of all acetate tow made worldwide is used for cigarettes, and the other 20 percent is used for medical gauze, air filters, and other applications. It is unclear how to ensure that acetate tow filter is sold only to licit manufacturers without impairing the trade of acetate tow fibres for other applications. Cigarette paper is also a highly specialized product that is designed with specific porosities and burn rates. One advantage to controlling cigarette paper is that it is used solely for cigarettes, but production is more diffused than acetate tow, which complicates its regulation.

Although much more acetate tow and cigarette paper is produced and imported than the amount of cigarettes that eventually make it to the legal market, there is little research or effort put into controlling the trade in either product. Prospects are better for acetate tow. Barriers of entry into the acetate tow production market are high, due to the dominance of a few large, well-established competing manufacturers and the need for costly, sophisticated production facilities. As a result, there are few manufacturers of acetate tow. Most already belong to the seven-member Global Acetate Manufacturers Association (GAMA). GAMA has taken steps to implement a voluntary Know-Your-Customer (KYC) protocol. This initiative putatively stands to reduce contraband tobacco by ensuring that companies do their due diligence to ensure that the customers of acetate tow manufacturers are not linked with organized crime and/or illegal production. At present this protocol is non-binding and unenforced, and its effectiveness unclear (Neumann 2014).

5.6 Enforcement

Greater effort across the borders of the Cornwall-Valleyfield region, as well as the main ports (and points) of entry for loose tobacco on the New York/Vermont/Quebec border would likely put a significant dent in the supply of untaxed tobacco from these reserves. Yet, for complex legal, historical, and cultural reasons, enforcement of federal and provincial tobacco tax laws by the RCMP and provincial forces has been intermittent on Native reserves. In theory, nothing stops government from

encircling reserves and/or entering them to enforce the laws against the will of Native governments. The fundamental obstacle to such a crackdown are the ghosts of Gustavson Lake, Ipperwash, and Oka that haunt Native protestors and police alike. In practice, provincial and federal authorities find it difficult to enforce tobacco-related laws on reserves without the endorsement of Native leaders, reserve authorities, and local communities.

Since the 1970s First Nations have been able to set up their own police forces. Public Safety Canada is responsible for administering agreements between First Nations, provincial, and federal governments (Public Safety Canada 2012). Little research has been done on Native policing and peacekeeping forces in Canada. Similar to municipal law enforcement agencies – even the largest municipal forces lay no more than half a dozen charges a year under the Excise Act – and they are averse to confrontation with the very communities they serve because enforcing federal excise statutes is not a community-safety priority for them. Their mandate tends to be community stability (keep the peace), not full-spectrum law enforcement (the “white man’s” regulations and laws). Native law enforcement carries out raids and arrests related to tobacco on reserve, but only when community safety is at stake, that is, when organized or violent crime is demonstrably involved.

Provincial and federal enforcement of tobacco-related laws on reserves is difficult without the endorsement of Native leaders, reserve authorities, and local communities.

The Akwesasne Partnership Initiative was established in 2001 and finances a Joint Investigative Team within the Akwesasne Police Service that collaborates with US and Canadian law enforcement agencies on projects targeting organized crime on reserve (Public Safety Canada 2012). The 2006 federal budget allotted 71 new “resources” (personnel) to the RCMP’s Customs and Excise Program for tobacco-related enforcement and information gathering. Around the same time 10 police officers were added to various First Nations police forces to focus on contraband tobacco (Government of Canada 2014).

As part of its Contraband Tobacco Enforcement Strategy (CTES), the RCMP has also partnered with other Canadian and US law enforcement agencies. Beginning in 2008, the CTES was funded by the federal government for five years at \$368.5 million. The Strategy’s overall goal has been to combat the sale of federally and/or provincially untaxed tobacco in Canada, particularly when organized crime is involved. The Strategy emphasizes innovative enforcement techniques and ultimately hopes to inform front-line officers about contraband tobacco. The CTES is mandated to “increase dialogue” with First Nations governments and their law enforcement agencies to develop new enforcement initiatives. To this end, Public Safety Canada received additional funding to redirect to the Akwesasne Police Service to bolster communication and integration with the RCMP and CBSA. Similarly, Public Safety Canada has funded a “First Nations Organized Crime Initiative” to form taskforces between First Nations and provincial police in Ontario and Quebec to target organized criminals dealing in contraband of all sorts on reserves.

In Quebec, Project ACCES partners with an array of federal and provincial agencies and includes but is not limited to contraband tobacco. ACCES pays for itself. Quebec’s budget details three direct benefits: Value of Seizures, Tax Recover, and Fines. Fines and seizures alone amount to about \$10 million annually (Government of Quebec 2014, F.17). As table 6 shows, benefits have increased from about \$42 to about \$79 million. Yet, net financial benefits extend beyond enforcement. Quebec also quantifies the deterrence factor: after implementation in 2008 (when Quebec and Ontario had comparable contraband rates around 30–40 percent), provincial tax revenue in Quebec rose about a third, by \$210 million, over four years, from \$654 million in 2008 to \$864 million in 2012 and \$1026 million in 2013/14 (Government of Quebec 2014, A48) – without an appreciable increase in smoking rates (Statistics Canada 2015; Coalition québécoise pour le contrôle du tabac 2015). Revenue growth

due to deterrence has continued apace. These amounts are above and beyond the “tax recover” detailed in the Quebec budget.

Table 6: Quebec anti-contraband ACCES program return on investment (ROI) – amounts in \$million

	2010	2011	2012	2013
Seizure	22.6	20.3	20.8	19.1
Tax	8	8.6	4.7	22
Fines	11.2	30.8	34.7	37.1
Total ACCES Program Benefits	41.8	59.7	60.2	79.1
Tax Growth due to Deterrence	210	210	552	552
Net Positive Growth (Total Direct Benefit & Deterrence Tax Growth)	251.8	269.7	612.2	631.1
Cost of ACCES Program	15	16	17	18
Return on Investment (ROI) – Enforcement Benefit Only	2.79	3.73	3.54	4.39
Return on Investment (ROI) – Full benefits (+Deterrence Tax Growth)	16.79	16.86	36.01	35.06

Sources: Quebec 2013-2014 Budget Excerpt (2012, F17-F18) and Quebec Public Accounts consolidated financial statements.

Initial costs of Quebec’s ACCES program when it was established in 2001 were \$1 million. It has since grown by \$1–\$2 million a year. In 2014/15, Quebec spent \$19.4 million on combating contraband tobacco (Government of Quebec 2014, 34). The math that drives this growth is straightforward: ROI on direct seizures and related benefits alone is 2.7–4.3 times. The true benefit, however, amounts to 16 times ROI: the growth in tax base – growth due to deterrence from less activity that is attributable to the ACCES program as there were no net new smokers – as well as the Quebec government’s direct seizure benefits. Average benchmarks for good government programs have a payback over about eight years, great programs over three to four years. On ACCES, Quebec is receiving at least two to four times its money for every dollar spent; the residual benefit from deterrence – fewer people buying and distributing contraband – is about 16 times the money invested. The business case for such a program – let alone the ancillary benefits for public safety and public health – is obvious.

In March 2013 the Canadian government announced the creation of a 50-member RCMP Anti-Contraband Task Force. Its mandate was to have “a measurable impact on reducing the contraband tobacco market and on combating organized criminal networks” (Public Safety Canada 2014). Yet, it never materialized – the jobs were moved to other “codes”. In November 2014 the RCMP announced the Border Integrity Technology Enhancement Project, funding for which had been announced in the 2014 federal budget. Under this Project, video cameras, radar, ground sensors, licence plate readers, and thermal radiation detectors were to be installed along a 700 km stretch between Oakville west of Toronto and the Quebec-Maine border, and this equipment will be linked to a geospatial intelligence and automated dispatch centre. This surveillance network is to target high-incidence areas, such as Akwesasne. The budget announced this initiative as one solely targeting contraband tobacco, but it appears this system is to have wide-ranging surveillance capabilities, focusing on different types of cross-border crime. The project, expected to cost about \$92 million over five years, was to be fully implemented by 2017/18. In the meantime, funding for the project has been moved to 2017. It may not end up being funded at all, which is just as well since it was never particularly well thought through to begin with. Detecting someone crossing on the water has little impact since US boaters need not check in with CBSA until they reach the Canadian shore, cameras are easily defeated, and much of this technology has a hard time distinguishing between animals and humans.

As for the ineffectiveness of the current enforcement strategy, the Cornwall Regional Task Force (CRTF) is a good example. The task force is an important and valuable entity that is based on a unique geography that causes border security problems due to a porous terrain and cross-jurisdictional issues. Problems include a variety of crimes including drug smuggling, money laundering, gun running, and more. The CRTF thus plays an important role in the overall security framework. However, the term “task force” implies an end operational goal that likely cannot be achieved. Most of the contraband trade is outside of that one geography. In essence, all the eggs are being put in that one basket of policing pertaining to a small area when most of the activity of concern is outside of the CRTF’s scope and mandate. Enforcement off the reserves and Cornwall geography itself are only part of the larger puzzle of contraband that spans from tobacco farmer country and Six Nations to the East and West coasts.

Following past pilot projects in 2005 and 2007, the 2009 Shiprider agreement between the Canadian and US governments bolstered Integrated Border Enforcement Teams (IBET) to enforce Canadian and US customs, excise, and immigration laws. IBETs comprise the RCMP, CBSA, US Customs and Border Protection, US Coast Guard, and US Immigration and Customs Enforcement, and have been strategically deployed at areas of high contraband activity. Their remit goes beyond contraband tobacco to

enforce a range of smuggling and criminal activity across the border. Yet, Cornwall does not have Shiprider – only a small marine unit and a plan to introduce Shiprider in 2016. A 2007 Shiprider project dismantled a smuggling network of at least 18 individuals based in Nova Scotia. Forty thousand cartons of cigarettes were seized. In 2014 the Windsor IBET arrested two men smuggling water pipe tobacco across Lake St. Clair by boat and seized 115 cases of tobacco (RCMP 2014). Yet, under the RCMP’s recent reorganization, IBETs have been all but eliminated in the Ontario region, although there is an effort underway to reinvent them.

The latest volley comes from Ontario, which recently announced the creation of a new team dedicated to the smuggling and trafficking of contraband tobacco. The Contraband Tobacco Enforcement Team (CTET) is located within the OPP’s Organized Crime Enforcement Bureau and includes experienced investigative capabilities in organized crime and proceeds of crime. It is to work closely with Ontario’s Ministry of Finance, which will continue to provide enforcement through audits, inspections, and investigations.

*Enforcement strategies
are plagued by underfunding.*

5.7 Canadian Tobacco Ombudsman

Records of arrest over the past decade show that many contraband networks in Canada span multiple provincial and international jurisdictions – and sometimes multiple reserves. The flow of contraband cigarettes from China and other sources outside of North America aside, contraband is an intergovernmental issue that affects federal, provincial, and First Nations governments alike. What is more, Canada, and Ontario in particular, play host to the entire contraband tobacco supply chain, from raw leaf growth and diversion to illicit manufacture, distribution, sale, and money laundering. The range of tobacco production, distribution, and retail operations in Ontario gives rise to a complex regulatory framework that is enforced by a patchwork of different bodies at various levels of government. For example, while all provinces post tobacco registrants for excise, federally they do not. That makes correlation between provincial and federal lists far harder to verify and to flag problems internally before licences are granted on any level. This is emblematic of a lack of information sharing between the parties. Although this does not necessarily affect the federal government, it is detrimental to provincial efforts to stem contraband.

Constitutionally the provinces are unable to alter the federal framework and authorities and are unable to address some of the core systemic issues causing it. Similarly, the RCMP and the two major provinces do not readily exchange police information or coordinate efforts. For example, the SQ has its own fusion centre for contraband that is not linked to the RCMP (which has the mandate for most of the country as the force of jurisdiction). This enables a person who the SQ has flagged to operate with impunity in most of the country (perhaps with contraband in the vehicle(s)). The evident collective-action problem calls for central coordination to harmonize oversight, enforcement, and feedback across jurisdictions as well as up and down the tobacco supply chain.

A Canadian Tobacco Ombudsman (CTO) could be established under the purview of the Minister of Public Safety to ameliorate communication and coordination among law enforcement agencies, and between law enforcement and other regulatory bodies. For example, an Ombudsman could help

The CTO would bridge the administration of tobacco regulation and the investigation and enforcement of irregularities involving contraband tobacco.

liaise among the Ontario Ministry of Finance and law enforcement agencies as well as the former Flue-Cured Tobacco Growers' Marketing Board to develop and implement a strategic regulatory framework governing the growth, processing, and sale of raw leaf tobacco. Another example might be increased communication between the Canada Revenue Agency and the provinces, since they do not appear to coordinate well even though decisions the CRA makes can have significant second-order effects for provinces. Coordination among the CRA and law enforcement can help identify which manufacturing operations are adequately licensed: in the absence of timely access, the RCMP has admittedly had to rely on outdated information that may no longer be accurate

(Hamilton Spectator 2008). The CTO would be able to conduct systematic, methodical research and analysis with up-to-date data from which enforcement could benefit, and table an annual report to Parliament on both trends and containment efforts.

The Ombudsman's office would bridge the administration of tobacco regulation on the one hand and the investigation and enforcement of irregularities involving contraband tobacco on the other hand. This reflects the complex nature of contraband tobacco, whose supply chain relies on regulatory evasion and criminal activity, such as smuggling, narcotics, and money laundering. There is precedent for such an office: Established in 2003, the United States Alcohol and Tobacco Tax and Trade Bureau (TTB) is an inter-disciplinary, multi-tasking body that employs 470 people to ensure compliance with federal tax laws and "prevent unfair and unlawful market activity" concerning alcohol and tobacco (United States Alcohol and Tobacco Tax and Trade Bureau 2012).

By contrast, lack of a central coordinating authority for the tobacco trade has resulted in a widely disparate and diffuse mandate that has significant gaps in its capabilities. The RCMP is spread too thin to govern enforcement effectively. It may be able to stop some speedboats at Cornwall (although there is no evidence it even does that) but does not have the expertise to deal with farmers. The RCMP is focused on criminal violations while the administrative side of the industry is beyond its scope. In Canada, there is no TTB-like clearinghouse for the transit, sale, and transfer of cut-rag and finished tobacco products to avoid gray/black market influence. There is little to no correlation between finance ministries and federal government as manifest in wide variation in tax levels and approaches to Aboriginal tribes. In some provinces there are advanced agreements, others are devoid of any framework.

There is a lack of leadership and central mandate to cover everything from economic development grants for Aboriginal businesses, to excise permitting of manufacturers to regulating transport

companies moving tobacco products, to proper policy controls for local tobacco frameworks, such as ensuring compliance of Aboriginal laws with federal standards, as in the case of Kahnawake's tobacco laws. The Ombudsman should have access to records from the CRA, provincial revenue, and the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC), with possible cooperation from banks and other financial institutions. Such access is needed to ensure the meaningful and effective application of all provisions of the *Criminal Code* and criminal provisions in the *Tax Code*. Currently, the CRA has some staff as does CBSA but there is no central group, let alone coordination with the provinces, to regulate the industry and prosecute violations.

Borrowing from Quebec's Bill 59, the CTO could also be partially financed through fines and, similar to the TTB, other proceeds from investigations – at no additional cost to the taxpayer. The US's *PACT Act* remits a portion of the proceeds obtained through the liquidation of legal goods obtained with the proceeds of crime to the TTB, often called *churning*. This incentivizes strong enforcement, frees up tax dollars that would otherwise be used to fund the Ombudsman to other expenditures, and creates the potential for an upward spiral whereby more seizures lead to a larger budget, and, in turn, deterrence through more comprehensive enforcement.

The TTB is not responsible for enforcing laws concerning the retail sale of tobacco products. By contrast, the powers of the CTO could include enforcement of provincial *Tobacco Tax Acts* in addition to the *Excise Act* and other applicable laws concerning tobacco, especially given how entangled some manufacturers and retailers are on reserve. In light of the context of contraband tobacco in Canada, the Ombudsman should liaise and partner with First Nations and provincial police services.

The CTO, then, would be the central authority for tobacco enforcement in Canada with three main pillars of operations: (1) enforcement, seizure, and arrest powers of a peace officer under the *Criminal Code*; (2) regulatory oversight and compliance checks where it would serve as the equivalent of the US TTB that would have the clearinghouse of records to catch misrepresentation and fraud through complex “white-collar” crime systems; and (3) policy leadership in the form and deployment of tobacco enforcement across Canada. In particular, this would ensure compliance with federal standards (similar to the deployment of the *Canada Health Act* to which each province must conform). This is particularly important as only a federal body has direct authority (however disputed) over Aboriginal reserves. In light of C-10 and the range of stamping/regulatory regimes being proposed by First Nations bands, the Ombudsman would be the authority to review, modify, and, ultimately, approve, the stamping system within Canada.

There is a lack of leadership and central mandate to cover every aspect of contraband tobacco.

5.8 Public Awareness

Another strategy to combat contraband tobacco is to appeal to its consumer base as the National Coalition Against Contraband Tobacco (NCACT 2016) appears to have been doing as of late to deter consumers of contraband, especially casual ones. At present, many smokers may not realize that purchasing untaxed tobacco is illegal. One survey found much confusion over the legality of the purchase of provincially and/or federally untaxed cigarettes: over half of survey respondents thought that such a purchase was or might be legal (Pieters et al. 2006). Surveys from the UK and New York City confirm that consumers of contraband tobacco are ignorant, while others choose to purchase contraband willingly for economic reasons and/or because they view high tobacco taxes as punitive (Myers 2012b). A 2010 study of New Zealand's contraband market found that public opinion was an important driver of the contraband

market insofar as tobacco control policy that is seen as unreasonable may reduce the stigma around the consumption of untaxed tobacco (Edwards et al. 2010).

Tobacco control policy that is seen as unreasonable may reduce the stigma around the consumption of untaxed tobacco.

Furthermore, many consumers of contraband tobacco are unaware that their habits may be supporting organized crime; greater awareness might stem consumption, especially if on-reserve manufacturers associated with organized crime are clearly distinguished from those who are not. Consumers of contraband tobacco also seem blissfully unaware that their cigarettes – especially cheap baggies – have a much greater likelihood of having been produced in unprofessional facilities that are not inspected, many of which would not pass health or safety inspections, with mouldy and rodent-infested tobacco that is not stored and cured properly and is processed under filthy conditions (Health Canada 2011). Indications are that law enforcement is warming up to this

idea: mid-March 2016 the RCMP and SQ started a public awareness campaign in the Valleyfield and Ormstown areas.

5.9 Research and Data Analysis

The attentive reader will have noticed that nowhere in this study is there a reference to an official estimate of the size of the illicit contraband market for tobacco and cigarettes. That is because the government does not provide one; in 2012 the RCMP even stopped providing aggregate data on seizures. This may indicate that the government either has no idea how large that market is; or that it has no interest in knowing and publicizing such figures. As with any public policy issue, the absence of robust, reliable, replicable data thwarts evidence-based decision-making and public policy.

There is at least one internal audit that the RCMP conducted of its contraband effort: It consisted of qualitative interviews of those involved in the strategy. As is to be expected, the self-evaluation effort received glowing reviews from all involved. For any data collection to be perceived as objective, it would need to be arm's length, collecting data from government, industry, retailers and, quite possibly, Aboriginal partners. If we are to have a coherent strategy going forward, tasking an independent body with collecting and collating such data to produce an annual report may be a good starting point. That would also result in a more balanced picture to include ethnic organized criminal groups that are engaged in large-scale manufacturing, distribution, and retail in the GTA, but which elude much of the current discussion because little open-source intelligence is available about the nature and scale of their activities.

The lack of data leaves unanswered many interesting questions that could meaningfully inform public policy: What percentage of contraband originates from on-reserve manufacturers? If 20% of students report smoking contraband, are 80% of students smoking legit cigarettes? That in itself raises concerns about access. How many charges have been laid under C-10? How many of those have been prosecuted successfully? How many charges have been laid under provincial tax acts?

PART 6: CONCLUSION AND RECOMMENDATIONS

Effective enforcement and regulatory systems for contraband tobacco pay for themselves. Across Canada, governments collect a total of about \$8 billion a year in tobacco taxes and lose upwards of \$2 billion a year in revenue due to contraband tobacco (Imperial Tobacco Canada 2014). Removing the profits that organized crime and terrorist organizations derive from contraband tobacco benefits community safety as these profits cannot be reinvested in criminal operations, and do not wind up financing the smuggling of weapons, drugs, and human beings, or even acts of terror. As the source of funding is removed, the deleterious cost of combating organized crime and potential economic damage from a terrorist attack are negated, and funds can be redirected towards solving other crimes.

Effective enforcement and regulatory systems for contraband tobacco pay for themselves.

Canada's contraband regime has long suffered from a lack of strategy, coordination, and attention, and organized crime is thriving in this vacuum. Sure, select Aboriginal communities share a disproportionate burden, but is it any wonder when some stakeholders conveniently reduce the problem to a First Nations issue rather than making the effort to grasp the complexities of the contraband supply-chain ecosystem and devise a comprehensive strategy going forward? Not only do Aboriginal peoples need to be part of the solution; throughout interviews conducted for this study, it was obvious that they want to be. After all, would you want your community to stake its future on a product whose use is in decline and that is known to attract organized crime? At the same time, the legal production and sale of tobacco and cigarettes by Aboriginal communities can be regularized – but not at the expense of creating an uneven playing field with the “Big Three” regular manufacturers. The following key recommendations emerge from this study:

Taxation

In Canada, substantial changes to federal or provincial tax rates in either direction are unlikely to curtail the market for contraband tobacco and cigarettes as long as there is a robust and resilient supply of contraband. Complemented by other policies, including the proposals that follow below, higher taxes are preferable to lower ones because they help to compensate for the negative externalities of smoking and encourage the reduction or cessation of tobacco consumption. The solution in this situation is not to get bogged down in an argument over raising or lowering existing taxes but rather to explore revenue sharing with First Nations, as detailed below.

Revenue Sharing with First Nations

The collection and administration of a tax by First Nations governments promises a sustained stream of revenue for community development and infrastructure projects and a significant incentive to reduce tax evasion in cigarette sales to non-Natives. A reduction of quota for First Nations smokers on reserve by half, to a level that is more consistent with smoking rates, seems sensible and would also help to reduce sales to ineligible customers.

Halting Diversion from Legitimate Growers

Although the transition from the Ontario Flue-Cured Tobacco Growers' Marketing Board to the Ministry of Finance has tightened monitoring and enforcement, three changes will hamper the ability to investigate and interrupt diversion of tobacco to illicit markets: once harvested, growers no longer need to identify the source and the final destination of raw leaf; labelling information that tracks baled raw leaf tobacco has been dropped as a requirement; and reporting frequency has been loosened from a weekly requirement to quarterly requirement.

Canada's contraband regime has long suffered from a lack of strategy, coordination, and attention, and organized crime thrives in this vacuum.

Reversing these changes and adopting the licensing scheme developed by the Flue-Cured Tobacco Growers' Marketing Board would be an effective framework for managing the supply of raw leaf tobacco in Ontario if sufficient resources were devoted to enforcement. Also, criminalizing the unlicensed growth, sale,

purchase, and/or transport of raw leaf would acknowledge the serious consequences of diverted raw leaf and the revenue it strips from government coffers and places in the hands of criminal groups. Most importantly, it would buttress the OPP and municipal police forces in enhancing enforcement of this licensing regime.

Federal Coordination

C-10 provides considerable opportunity for the federal government to show leadership. The legislation opens the opportunity for the federal government to emerge as the central coordination authority of a unified taxation structure for all Canadian peoples, across provinces and reserves.

This authority could be administered and enforced by a Canadian Tobacco Ombudsman, which could be established under the purview of the Minister of Public Safety. An ombudsman could help address the lack of coordination and communication among law enforcement agencies and between law enforcement and other regulatory bodies that currently plagues contraband enforcement.

C-10 has the potential to turn a patchwork into a framework that will ensure the benefits of taxation accrue to all citizens instead of organized criminals and terrorists.

Input Controls

The two primary materials used in manufacturing tobacco products are acetate tow (industry-standard filters) and cigarette paper. Both are specialized products with few uses outside of the tobacco industry. Although much more acetate tow and cigarette paper is produced and imported than the amount of cigarettes that eventually make it to the legal market, there is little research into or effort to controlling the trade in either product.

Enforcement

With their recently announced Contraband Tobacco Enforcement teams, Ontario and New Brunswick should draw lessons from Quebec's Project ACCES. That province has established that by reaping fines and seizures, and realizing a growing tax base by deterring contraband

without a change in smoking rates, coordinated enforcement has seen a return of as much as 16 times the investment.

Public Awareness

Many consumers of contraband tobacco are unaware that their habits may be supporting organized crime; greater awareness might stem consumption, especially if licensed on-reserve manufacturers disassociate from illicit ones.

A tacit social agreement between illicit supply, manufacturing, distribution, and retail on the one hand, and government on the other appears to have emerged: as long as illicit activities do not occasion significant violence, government will not make it a priority. That tacit agreement is based on a fundamental fallacy: treating contraband tobacco and cigarettes as smuggling rather than trafficking. Smuggling tends to be understood as illicit activity on a small-scale; trafficking, by contrast, is the systematic, large-scale exploitation of vulnerabilities to criminal ends.

Ultimately, that is the conclusion to draw from this study: the evidence warrants a paradigm shift that treats contraband as the trafficking problem that it is, rather than the smuggling problem as it has thus far been perceived. In the aftermath of September 11, 2001 we realized that we had underestimated the threat terrorism poses to Canada, Canadians, and Canadian interests. Over roughly the same period of time, the trafficking of contraband tobacco and cigarettes has taken on similar urgency – but not received the attention it warrants, despite the fact that, unlike terrorism, it undermines public safety, subjects select Aboriginal communities to systematic exploitation by organized crime, and costs government billions in foregone tax and excise revenue at a time when all levels of government are struggling to make ends meet.

Contraband has a more pervasive impact on public safety in Canada than terrorism has ever had.

Contraband has a more pervasive impact on the public safety of Canada, Canadians, and Canadian interests than terrorism has ever had. If Canadians only knew, they would demand that government act accordingly. Now they do.

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Much work remains to be done on this topic. It is my intent to compile additional material including a criminal network analysis, and greater detail on terrorism and taxation than could be included in this study, in a book monograph. Indeed, part of the objective of this study is to generate broader interest and future scholarship. This study has no pretensions at being definitive, but it does aim at being sufficiently comprehensive to advance the understanding and conversation on this difficult and controversial topic and invigorate discussion with a collection of old, new, and innovative ideas.

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ENDNOTES

- 1 The converse, however, obtains in other jurisdictions, such as Mexico, where Seneca, a trademark owned by Canada's GRE, is among the most common illicit brands, and also has a presence elsewhere in the region, notably Costa Rica (KPMG 2015, 9; 56).
- 2 However, whether the rights to cross with "their own proper Goods and Effects of whatever nature" refers solely to belongings for personal use or also to possessions for the purpose of trade is contentious. *United States ex rel. Diablo vs. McCandless*, a 1927 US district court ruling, exempts Mohawk steelworkers from US immigration laws.
- 3 For example, both A1 (the main raw leaf wholesaler for large tobacco companies in Canada) and Norfolk Leaf (GRE's wholesaler) purchased large amounts of raw leaf tobacco from farmers in SW Ontario during the same season.

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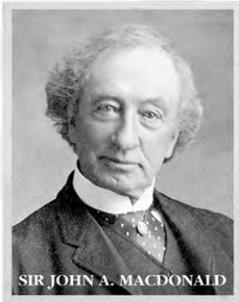
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