



How Much is Contraband Tobacco Costing Taxpayers in Ontario?

A Look at the Cigarette Allocation System on Reserves and the Overall Contraband Problem in Ontario

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About the Canadian Taxpayers Federation

The Canadian Taxpayers Federation (CTF) is a federally incorporated, non-profit and non-partisan, advocacy organization dedicated to lower taxes, less waste and accountable government. The CTF was founded in 1990 when the *Association of Saskatchewan Taxpayers* and the *Resolution One Association of Alberta* joined forces to create a national taxpayers organization. Today, the CTF has more than 81,000 supporters from coast-to-coast.

The CTF maintains a federal office in Ottawa as well as provincial and regional offices in British Columbia, Alberta, the Prairies, Ontario and Atlantic Canada. Provincial and regional offices conduct research and advocacy activities specific to their provinces in addition to acting as local organizers of nation-wide initiatives.

CTF offices field hundreds of media interviews each month, hold press conferences, utilize social media like twitter, facebook, youtube and our own blog, as well as issuing regular news releases, commentaries and publications to advocate on behalf of CTF supporters. The CTF's flagship publication, *The Taxpayer* magazine, is published four times a year. *Action Update* e-mails on current issues are sent to CTF supporters regularly. CTF offices also send out weekly *Let's Talk Taxes* commentaries to more than 800 media outlets and personalities nationwide.

CTF representatives speak at functions, make presentations to government, meet with politicians and organize petition drives, events and campaigns to mobilize citizens to affect public policy change.

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I-Summary of Main Findings

CTF Finding: The *overall* contraband tobacco in trade in Ontario cost an estimated \$742 million to \$1.2 billion in lost tax revenue in 2011 to both the federal and provincial governments in Ontario. This adds up to an estimated \$3.7 billion to \$6 billion over the last five years.

CTF Finding: Last year between 53% and 79% of all reported sales of tax-exempt allocation tobacco on Ontario aboriginal reserves was made illegally to people who are not Status Indians. This has created an estimated tax hole of between \$244 million and \$370 million over the last five years, averaging \$49 to \$74 million per year. This has increased every year since 2008, spiking at \$53 million to \$80 million in 2011.

CTF Finding: If all recorded allocation tobacco sold on Ontario reserves was for personal, legal use, Status Indians who are smokers would need to consume an estimated equivalent of 32 to 70 cigarettes a day. At its high end, that is 466% of what the reported smoking rate is for aboriginals and just under three packs a day.

CTF Finding: An estimated 303 to 448 million grams of tax-exempt allocation tobacco were sold illegally from Ontario aboriginal reserves in 2011. Allocation contraband tobacco sales have increased every year since 2008, adding up to between 1.4 and 2.1 billion grams in just the last five years.

CTF Finding: Put another way, 364 to 539 million contraband allocation cigarettes were sold from Ontario reserves in 2011 and between 1.6 to 2.5 billion cigarettes over the last five years. At its high end that is 22 million packs in 2011 and nearly 100 million packs total in the last five years.

II-Introduction

Contraband tobacco

All tobacco sold in Canada is supposed to be sold from registered tobacco dealers, normal corner stores, grocery stores and tobacconists. Tobacco sold from these retailers are required by law to be marked with a stamp indicating that the wholesaler of that tobacco has paid the taxes and duties to the federal and provincial governments. This is known as 'marked tobacco.'

However, in some regions of the country - particularly in Ontario and Quebec - it's not uncommon for people to purchase 'unmarked tobacco' from an aboriginal reserve 'smoke shack' or from people working within the black market, selling bags of 'unmarked' cigarettes from the trunk of their car. While some contraband tobacco might still have a federal or provincial stamp on it, it is largely described as 'unmarked tobacco.' This means the tax has not been paid to the provincial and federal governments and as such, is usually significantly less expensive - hence its attractiveness.

On portion of 'unmarked' or 'contraband' tobacco that is sold in Canada comes from a government established system to provide cigarettes to aboriginal reserves. Aboriginal reserves are allotted a ration of unmarked cigarettes for personal consumption through the Cigarette Allocation System (CAS). Of course, outside of the CAS, large quantities of 'unmarked' cigarettes make their way into the black market from aboriginal reserves as well. Even within the CAS however, the majority of tobacco sold on reserve ends up in the black market, as this report will demonstrate.

It is legal to sell this allocation tobacco on aboriginal reserves to Status Indians. However, when this allocation tobacco is sold to those who are not Status Indians, it is considered 'contraband tobacco.'

Contraband tobacco can come in several forms. Broadly, it is defined as any product that violates federal and/or provincial laws relating to tobacco taxation, manufacturing and distribution. This includes tax-exempt allocation tobacco sold from reserves to those who are not Status Indians, the sale of illegally imported tobacco without duties, stolen tobacco, tobacco produced in clandestine tobacco factories, and tobacco produced during off-hours (and off the books) in otherwise legitimate factories.¹

The contraband tobacco trade has exploded over the last decade for several reasons. Chief among these are the incentives created by high tobacco excise taxes. As tobacco taxes have risen, so has the incentive to smuggle, produce and sell tobacco without the oversight of the government, and therefore taxes.

Contraband tobacco is a wide-ranging problem with many tentacles. Because most aspects of the trade operate underground - often involving organized crime - it is extremely difficult to quantify. One aspect of the trade however - the sale of tax-free allocation tobacco to aboriginal reserves - is tracked by the Ontario government. Through Freedom of Information laws, the Canadian Taxpayers Federation (CTF) has obtained

¹ Gabler, Nachum. "Combating the Contraband Tobacco Trade in Canada." Fraser Institute. December 2011.
<http://www.fraserinstitute.org/research-news/display.aspx?id=2147483963>

key Ontario government data that allows us to examine and estimate contraband allocation tobacco sold from reserves to those who are not Status Indians.

III-Why contraband tobacco matters

Tax evasion

Contraband tobacco is a major source of tax evasion in Canada. Despite the popularity of politicians cracking down on 'tax-cheats' and of being seen to 'fight smoking,' cracking down on contraband tobacco remains politically sensitive. This is likely attributable to the inconvenient fact that the sale of illegal, contraband tobacco is a major source of income for some on-reserve Status Indians. While making recommendations for improving the socio-economic lot of aboriginals is beyond the scope of this report, this report will discuss various options, including an innovative proposal for tax-sharing agreements with aboriginal governments in the *Options for Fighting Contraband Tobacco in Ontario* section.

As a member of the *National Coalition Against Contraband Tobacco* (NCACT), the CTF believes that taxation should be low, efficient, fair and equal. We believe tobacco taxes should apply to all Canadians equally.

Unfair to law-abiding merchants

The sale of contraband tobacco creates an unfair disadvantage for merchants. Convenience store and gas station owners are forced to compete on radically uneven grounds. According to the *Canadian Convenience Stores Association*, its members each lose an average of \$115,000 in sales every year due to contraband tobacco.² While the damage caused to law-abiding small businesses is beyond the scope of this report, it should be considered of equal importance to the damage done to taxpayers more broadly.

Unfair to law-abiding farmers

Law-abiding tobacco farmers are punished for their honesty. Cheap contraband tobacco products flood the market at prices honest farmers simply can't compete with, unless they break the law themselves. Many farmers believe that the political sensitivities of both the federal and provincial government towards aboriginals have led them to intentionally turn a blind eye to this major component of the contraband tobacco trade and have launched lawsuits as a result.³

² Benzie, Robert and Brennan, Richard. "\$2 billion in tax revenue up in smoke." November 15, 2009. *The Toronto Star*. <http://www.thestar.com/news/investigations/article/726038---2-billion-in-tax-revenue-up-in-smoke>. Accessed August 31, 2012

³ Babbage, Maria. "Ontario farmers suing federal, provincial governments over illegal smoke shacks." The Canadian Press. <http://www.680news.com/news/national/article/122743--ontario-farmers-suing-federal-provincial-governments-over-illegal-smoke-shacks> November 1, 2010. Accessed August 31, 2012

Evasion of anti-smoking efforts

Contraband tobacco evades not only the government's taxes, but also its anti-smoking campaigns. In many cases, contraband tobacco does not have warning labels affixed, which are designed to educate and repel smokers from the product. Instead, they often are sold in non-descript plastic bags without anything indicating the harmful effects of tobacco.

A tale of two cigarettes

Legal, marked cigarettes contain mandatory government warnings to discourage use.

Most tax-free cigarettes contain no warnings of any kind.



Warning label on legal, marked cigarettes. Photograph: Health Canada



Tax-Free cigarettes. Photograph: Niagrareregion.ca

The government of Ontario requires that merchants hide tobacco products behind a visual barrier. This is done so that the 'power wall' of tobacco products is not used as an effective advertising instrument to potential smokers - youth in particular. By contrast, tobacco products sold from on-reserve 'smoke shacks' are often not hidden behind visual barriers as they are in off-reserve vendors.



"Power Wall"



Covered Display

Most important, contraband tobacco is able to beat the market price of legal tobacco several times over. This makes it easily accessible and affordable for anyone, including children. Since one of the objectives of high tobacco taxes is to dissuade people from smoking through economic disincentives, contraband tobacco renders this tool weak and ineffective.

Supply to under-age smokers - cigarette butts don't lie

A 2009 study by the *National Coalition Against Contraband Tobacco* found that of 19,770 cigarette butts near 110 Ontario high schools, 30% were contraband. A separate 2009 study by the *Canadian Convenience Stores Association* found that of 14,064 butts taken from 75 Quebec high schools, 45% were contraband.⁴ These two data sets make a clear case that contraband tobacco is easily available to under-age smokers and is a major source of tobacco for young people.

Smoking rates for aboriginals

The tax-free status of tobacco on-reserve - including legal allocation tobacco for personal use by Status Indians - makes anti-smoking efforts extremely ineffective for aboriginals. According to a report by *Physicians for a*

⁴ Benzie, Robert and Brennan, Richard. "\$2 billion in tax revenue up in smoke." November 15, 2009. *The Toronto Star*. <http://www.thestar.com/news/investigations/article/726038---2-billion-in-tax-revenue-up-in-smoke>. Accessed August 31, 2012

Smoke-Free Canada, “already high rates of tobacco use in First Nation communities will increase further still and no credible anti-tobacco effort can be mounted as long as cigarettes are easily available at bargain-basement prices.”⁵

Organized crime

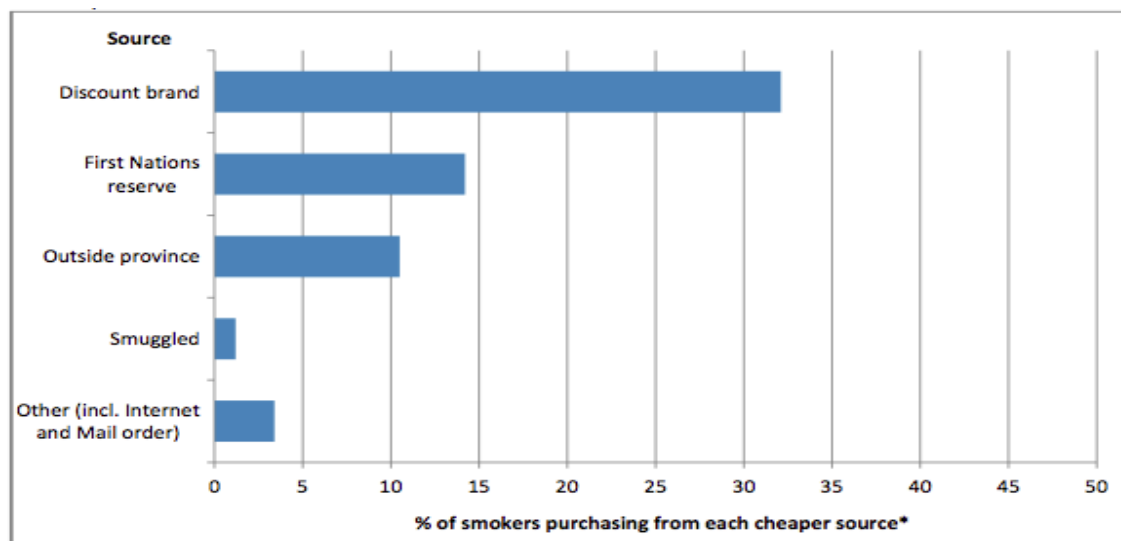
Contraband tobacco is also a major source of revenue for organized crime. According to the RCMP, trafficking in contraband tobacco has drawn over 175 criminal organizations, the Hells Angels among them.

The RCMP has made regular raids against illegal tobacco operations across Canada. As recently as February of 2012, the RCMP seized nearly 1.5 million contraband cigarettes, \$420,000 in cash and several loaded handguns in an operation outside of Winnipeg, Manitoba.⁶

By creating an incentive for the black market, government policy creates a large source of revenue for the worst elements of society.

Unfair to law-abiding smokers

Figure 3.1: Percentage of smokers who purchased cigarettes from cheaper sources in the past six months, 2010 (National)



Source: Reid, Jessica. Hammond, David. “Tobacco Use in Canada: Patterns and Trends 2012 Edition with data from CTUMS, 2010.

Note: Smokers could indicate multiple sources, so these estimates should not be added

⁵ “Towards effective tobacco control in First Nations and Inuit communities.” *Physicians for a Smoke-Free Canada*. March 2007.

⁶ “Rosser Raid Just the Tip of the Iceberg.” Canada Newswire. February 9, 2012.

<http://www.newswire.ca/en/story/919255/rosser-raid-just-the-tip-of-the-iceberg-contraband-tobacco-is-a-growing-problem-in-western-canada-manitoba-specifically>. Accessed September 2012.

Finally, the sale of contraband tobacco is unfair to law-abiding smokers. Smokers who buy their tobacco from legitimate merchants make a substantial contribution to government revenues. In 2010, 45.2% of smokers reported purchasing cigarettes from cheaper sources within the last six months. After switching to discount brands, the most popular option was buying from an aboriginal reserve.⁷ The survey found that 14.5% of smokers even report using an aboriginal reserve as their primary source of cigarettes. It is simply unfair to those smokers who pay their taxes that others may choose to buy illegally from tax-exempt dealers.

⁷ Reid, Jessica. Hammond, David. "Tobacco Use in Canada: Patterns and Trends 2012 Edition." *Tobacco Report*. University of Waterloo, Propel Centre for Population Impact, 2012. Page 45. Web. 30 Jul 2012.
http://www.tobaccoreport.ca/2012/TobaccoUseinCanada_2012.pdf Accessed August 2012.

IV-Tobacco Taxes

Raison d'être

Tobacco taxes - like most 'sin taxes' - are generally imposed for the purposes of:

1. Raising revenue;
2. Cost externalization (such as health care); and
3. Discouraging consumption.⁸

While credible economic literature can be found to either support or refute these reasons for tobacco taxes, different governments place different degrees of emphasis on each of these justifications.

Regardless of the reasons used, high tobacco taxes are now the norm in the developed world.

How tobacco taxes work in Ontario

Canada's tobacco tax system varies by province. In addition to the federal tobacco tax of \$0.085 per gram of tobacco, each province has its own varying levels of a tobacco tax. In Ontario, the tobacco tax is \$0.1235 per gram for a combined federal-provincial tobacco tax of \$0.2085 per gram. This works out to \$0.166 per cigarette or \$4.15 per pack.⁹

The Harmonized Sales Tax (HST) of 13% is also charged on the combined price of the actual tobacco and the tobacco taxes, a tax-on-tax. Using the July 2010 average retail cost in Ontario of \$0.4008 per gram,¹⁰ this report uses an estimated HST of \$0.0545 per gram. Put another way; that is \$0.0435 per cigarette or \$1.09 per pack.

Using these estimates, this report uses a total combined tobacco and sales tax of \$0.263 per gram, which is the equivalent of \$0.21 per cigarette or \$5.24 per pack.¹¹

⁸ Trussler, Simon & Dr. Meschi, Meloria. *A review of the economic literature on tobacco taxation*. FTI Holdings Limited. March 2011. page 7.

⁹ A 'pack' of cigarettes in Canada usually contains 25 cigarettes. This report uses this measure.

¹⁰ *Pricing and Taxation: Increases in taxes on tobacco across Canada*. Coalition for a Smoke-Free Nova Scotia.
<http://www.smokefreens.ca/nova-scotia-tobacco-control/pricing-and-taxation/>

¹¹ Note: figures may not add up due to rounding

Tobacco taxes across Canada

Figure 4.1: Taxes on tobacco (per gram) by province, 2012

	NFLD	PEI	NS	NB	QC	ON	MB	SK	AB	BC
Provincial tobacco tax ¹²	\$0.1900	\$0.2540	\$0.2152	\$0.1700	\$0.1060	\$0.1235	\$0.2250	\$0.2100	\$0.2000	\$0.1850
Federal tobacco tax	\$0.0850	\$0.0850	\$0.0850	\$0.0850	\$0.0850	\$0.0850	\$0.0850	\$0.0850	\$0.0850	\$0.0850
Total tobacco taxes	\$0.2750	\$0.3390	\$0.3002	\$0.2550	\$0.1910	\$0.2085	\$0.3100	\$0.2950	\$0.2850	\$0.2700
Total sales taxes	13%	15.5%	15%	13%	14.975%	13%	12%	10%	5%	12%

¹² 'Tax Rates Across Canada.' Nova Scotia Department of Finance.

<http://www.novascotia.ca/finance/en/home/taxation/taxratesacross.aspx> Accessed August 2012.

V-Legal Tobacco Sold on Reserves

Cigarette Allocation System (CAS)

The tobacco tax applies to all tobacco products sold in Ontario including cigarettes, cigars, loose tobacco and several other products. Every consumer who purchases tobacco products in Ontario must pay tobacco taxes through a registered tobacco retail dealer. Status Indians are exempt from provincial excise and both and the HST when purchasing products on-reserve upon presentation of a Certificate of Indian Status (CIS) card.¹³ Those without a CIS card are prohibited by law from purchasing tax-exempt tobacco from aboriginal reserve merchants. Status Indians still pay the federal tobacco excise tax since it is levied at the wholesale level.

This exemption flows from section 87 of the *Indian Act*, which exempts the personal property of a registered Status Indian situated on a reserve from taxation by the Crown.

However, while aboriginal reserve merchants can sell tax-exempt tobacco to Status Indians, the Ontario government limits the amount of tobacco these merchants can sell. They do so because they want “to prevent the purchase of excess quantities of unmarked cigarettes that could be resold to non-Indians.”¹⁴

Under the First Nations Cigarette Allocation System (CAS), the Province of Ontario allows wholesalers and retailers a quantity of tobacco based on:

- On-reserve and off-reserve adult populations,
- Smoking patterns of aboriginals; and
- Special events on the reserve.¹⁵

The CAS determines the weight of the factors above with this formula:

R = the number of individuals in the reserve community

OR = the number of individuals in the off-reserve community

A = annual allocation quantity

$$[(R \times 2.5 \times 0.423) + (OR \times 2.7 \times 0.423)] \times 12 = A^{16}$$

This annual amount can be increased by up to 30% if there are special events on reserve where Status Indians who are not members of the on or off-reserve community would be purchasing tobacco, and if the local band council has entered into a retail agreement with the Ontario government.

¹³ Elliott, William J.S.. Public Safety Canada. Royal Canadian Mounted Police. *2008 Contraband Tobacco Enforcement Strategy*. Ottawa: Her Majesty the Queen in Right of Canada, 2008. Web. <http://www.rcmp-grc.gc.ca/pubs/tobac-tabac/tobacco-tabac-strat-2008-eng.pdf>

¹⁴ Ontario Provincial Government. Ontario Ministry of Finance. *First Nations Cigarette Allocation System*. Toronto: Queen's Printer for Ontario, 2010. http://www.fin.gov.on.ca/en/bulletins/tt/2_2005.html Accessed November 2012.

¹⁵ Ontario Provincial Government. Ontario Ministry of Finance. *First Nations Cigarette Allocation System*. Toronto: Queen's Printer for Ontario, 2010. http://www.fin.gov.on.ca/en/bulletins/tt/2_2005.html Accessed August 2012.

¹⁶ “Ontario Regulation 649/94: Sales of Unmarked Cigarettes on Indian Reserves.” Tobacco Tax Act. *Government of Ontario*. http://www.e-laws.gov.on.ca/html/regis/english/elaws_regs_930649_e.htm

It's interesting to note that based on this formula, off-reserve Status Indians qualify for a greater cigarette allocation than on-reserve Status Indians.

According to *Physicians for a Smoke-Free Canada*, Ontario's quota system allocates about 3,000 tax-free cigarettes per person on the reserve per year.¹⁷

The Ontario Ministry of Finance requires by law that:

The on-reserve retailers must sell allocation cigarettes *only to First Nations individuals who are buying the allocation cigarettes on a reserve for their exclusive use.*¹⁸

According to the Auditor General of Ontario:

Manufacturers and wholesalers with operations on-reserve sold significantly more cigarettes to reserves than was reasonable. For instance, one of these manufacturers/wholesalers sold, to 16 reserves, an average of 27 cartons per month [5,400 cigarettes] for every adult band member who smoked, and to another reserve over 400 cartons per month. These quantities are well beyond what could be reasonably assumed to be for personal use and almost certainly included cigarettes destined for sale to non-band members.¹⁹

'Smoke shacks'

The loose enforcement of these laws results in so-called 'smoke shacks' located on aboriginal reserves illegally selling tax-exempt contraband tobacco to Canadians without Indian status on a mass scale. While those who are not Status Indians are, by law, to be turned away, it is a poorly kept secret they are in fact welcomed customers. According to the *Convenience Stores Association*, there are more than 350 on-reserve smoke shacks in Ontario and Quebec.²⁰

While the federal and Ontario governments have claimed to be cracking down on the contraband tobacco trade, they have demonstrated considerable timidity towards cracking down on smoke shacks directly.

According to Ontario Conservative MPP, Toby Barrett, the government of Ontario is suing tobacco companies over the health-care costs of smoking while at the same time refusing to shut down two smoke shacks

¹⁷ "Towards effective tobacco control in First Nations and Inuit communities." *Physicians for a Smoke-Free Canada*. March 2007. http://www.smoke-free.ca/pdf_1/Effective%20tobacco%20control%203.pdf

¹⁸ Ontario Provincial Government. Ontario Ministry of Finance. *First Nations Cigarette Allocation System*. Toronto: Queen's Printer for Ontario, 2010. http://www.fin.gov.on.ca/en/bulletins/tt/2_2005.html

¹⁹ "2010 Annual Report of the Office of the Auditor General of Ontario." *Office of the Auditor General of Ontario*. http://www.auditor.on.ca/en/reports_en/en10/410en10.pdf Accessed August 31, 2012

²⁰ Babbage, Maria. "Ontario farmers suing federal, provincial governments over illegal smoke shacks." *The Canadian Press*. <http://www.680news.com/news/national/article/122743--ontario-farmers-suing-federal-provincial-governments-over-illegal-smoke-shacks> November 1, 2010. Accessed August 31, 2012

operating on government property in Caledonia.²¹ This hypocrisy has real consequences - especially on local residents and merchants.

Tax collecting

Registered importers and wholesalers designated by provincial authorities as collectors of tobacco tax report and remit the tax monthly. They reimburse themselves by collecting an amount equal to the tax when they sell tobacco products to non-collectors, such as retailers.

A 2008 review by the Auditor General of Ontario found that:

Although all seven of the large gasoline and diesel-fuel tax collectors had been audited every four years as planned, only a few of the 38 large tobacco tax collectors had been audited at least once every four years as planned.²²

While a follow up report by the auditor general found that improvement has been made, progress has been slow.

Although the Ontario government limits the number of untaxed allocation cigarettes that can be sold on reserve, they (along with Nunavut and the Yukon Territory) do not limit the sales of untaxed cigars on aboriginal reserves. As of 2010, the Ontario Ministry of Revenue was only considering options for reform, despite clear recommendations from the auditor general to establish an enforceable cigar allocation system.

Tax-exempt tobacco sales

This study's primary source of data is a table titled 'Exempt Tobacco Sales on First Nation reserves in Ontario' obtained by the Canadian Taxpayers Federation through the Freedom of Information (FOI) Act from the Ontario Ministry of Finance. This document details the total, recorded quantity of allocation cigarettes, cigars and other tobacco products sold on aboriginal reserves in Ontario. Of note, it also includes the provincial tobacco tax *value* of these tobacco products, rather than how much tax was actually collected, as that would be nil.

²¹ Babbage, Maria. "Ontario farmers suing federal, provincial governments over illegal smoke shacks." The Canadian Press. <http://www.680news.com/news/national/article/122743--ontario-farmers-suing-federal-provincial-governments-over-illegal-smoke-shacks> November 1, 2010. Accessed August 31, 2012

²² "2010 Annual Report of the Office of the Auditor General of Ontario." *Office of the Auditor General of Ontario*. http://www.auditor.on.ca/en/reports_en/en10/410en10.pdf Accessed August 31, 2012.

Figure 5.1: Exempt Tobacco Sales on First Nation reserves in Ontario, 2005-2011

Fiscal Year	Cigarettes (millions of grams) ²³	Other (millions of grams)	Provincial Tobacco Tax Rate - Cigarettes & Others	Cigarette & Other Provincial Tobacco Tax Value (millions)	Cigars (millions)	Provincial Tobacco Tax Rate - Cigars	Cigar Provincial Tobacco Tax Value (millions)	Total Provincial Tobacco Tax Value (millions)
2005-2006	295	n/a	\$0.11725 per gm	\$34.63	83	\$0.33 per cigar	\$27.40	\$62.03
2006-2007	339	n/a	\$0.1235 per gm	\$41.85	80	\$0.33 per cigar	\$26.30	\$68.15
2007-2008	318	41	\$0.1235 per gm	\$44.37	89	\$0.33 per cigar	\$29.52	\$73.88
2008-2009	285	33	\$0.1235 per gm	\$39.30	92	\$0.33 per cigar	\$30.35	\$69.66
2009-2010	291	30	\$0.1235 per gm	\$39.68	85	\$0.33 per cigar	\$28.08	\$67.76
2010-2011	323	30	\$0.1235 per gm	\$43.63	76	\$0.33 per cigar	\$25.04	\$68.67
2011-2012	341	42	\$0.1235 per gm	\$47.34	70	\$0.33 per cigar	\$23.10	\$70.44

Source: Canadian Taxpayers Federation, 2012 with data from Ontario Ministry of Finance, 'Exempt Tobacco Sales on aboriginal reserves in Ontario, 2005-2011' released under the Freedom of Information (FOI) Act

Notes:

- Tobacco tax figures do not include HST
- Other = Grams
- Data for Foreign Tobacco Tax Revenue is not available

Run against other statistics, this report estimates the sale of legal allocation tobacco to Status Indians, and how much is sold illegally to Canadians without Indian status.

It should be noted that for data compatibility purposes this report divides the tobacco tax value of cigars by the per gram rate of cigarettes or other loose tobacco. This blends all tobacco products into a single per gram tobacco unit. Using 2011-12 as an example:

$$\begin{aligned}
 &TV = \text{tax value of cigars} \\
 &OT = \text{Ontario tobacco tax rate per gram} \\
 &CQ = \text{cigar quantity by gram (estimate)} \\
 &TV / OT = CQ
 \end{aligned}$$

²³ While the data provided by the Ontario Ministry of Finance uses the terms 'gram' and 'stick' interchangeably, Health Canada claims that the average discount brand cigarette contains 0.797 grams of tobacco. This report uses the tobacco content measure from Health Canada in its calculations.

TV = \$23.1 million (2011)

OT = \$0.1235 per gram

CQ = 187.1 million grams of cigar tobacco (estimate)

Taken together with reported sales of allocation loose tobacco and cigarettes, this report estimates total tax-exempt tobacco sales of approximately 570.4 million grams of tobacco in 2011. This is the equivalent of 715.7 million cigarettes.

Determining legal tax-exempt allocation tobacco sales on-reserve

In order to estimate the quantity of contraband allocation tobacco sold on-reserves to those who are not Status Indians, we must first determine how much is legally sold to Status Indian smokers. This estimate is made by using the aboriginal smoking rate, the population of Status Indians in Ontario and information on how many cigarettes (or grams of tobacco) the average Status Indian smoker would consume in a year.

This report uses two data points for Status Indian populations: the on-reserve population and the total Status Indian population. While all Status Indians are entitled to tax-free allocation tobacco, it is unlikely that these individuals living in urban centers like Toronto or Ottawa will travel long distances on a frequent basis in order to obtain allocation tobacco on any mass scale. As such, this report produces all of its figures using both the on-reserve Status Indian population, and the total Status Indian population in Ontario.

This report estimates the quantity of allocation tobacco *legally* sold on-reserve through a basic formula.

A = average grams of tobacco consumed per year by aboriginal smokers

P = population of Status Indians in Ontario who are ages 15 and older

S = percentage of aboriginal people who are smokers

L = legal allocation tobacco sold on aboriginal reserves in Ontario

$$A \times P \times S = L$$

A = 5,511.5 cigarettes (4,393 grams) smoked per year²⁴

P = 64,823 Status Indians on-reserve aged 15 and older (2011)²⁵

S = 43% of the on-reserve population smokes²⁶

L = 122 million grams of allocation tobacco are sold *legally* on Ontario reserves (2011)

²⁴ Reid, Jessica. Hammond, David. "Tobacco Use in Canada: Patterns and Trends 2012 Edition." *Tobacco Report*. University of Waterloo, Propel Centre for Population Impact, 2012. Page 45. Web. 30 Jul 2012.

http://www.tobaccoreport.ca/2012/TobaccoUseinCanada_2012.pdf

²⁵ Federal Department of Aboriginal Affairs and Northern Development Canada's Indian Registry System.

²⁶ First Nations Information Governance Centre. "RHS Phase 2 (2008/2010) Preliminary Results." Socio-Economic and Demographic Statistics Section. Aboriginal Affairs and Northern Development Canada

CTF Finding: Based on known smoking rates for aboriginals and *only the on-reserve population*, this report estimates that 122 million grams of the 570 million grams of allocation tobacco, sold on reserves in 2011 was sold legally. This translates into 21% of total on-reserve allocation tobacco sales in 2011 being sold legally.

Put another way, of an estimated 716 million equivalent allocation cigarettes sold from reserves, just 154 million were legal. That works out to just six million of 29 million packs.

Including the *entire Status Indian population in Ontario*, this report estimates that 267 million grams of 570 grams of allocation tobacco was sold legally from Indian reserves, or 47%.

As an additional illustration, this report calculates the number of allocation cigarettes that would have to be consumed, both by those who are smokers on-reserve and off-reserve. As in, if it is claimed that every allocation cigarette purchased, is done so by a Status Indian for personal consumption, just how many allocation cigarettes would they have to consume each year?

Determining how much allocation tobacco Status Indian smokers would have to consume

To determine how much tobacco Status Indians who smoke would have to consume for all allocation sales on-reserve to be legal, this report uses the following formula:

T = total allocation tobacco sold on-reserve

S = percentage of aboriginal people who are smokers

P = population of Status Indians in Ontario who are ages 15 and older

W = amount of allocation tobacco (grams) Status Indians would have to consume

$$T / (S \times P) = W$$

T = 570.4 million grams of tobacco (2011)²⁷

P = 64,823 Status Indians (on-reserve) aged 15 and older (2011)²⁸

²⁷ Canadian Taxpayers Federation, 2012 with data from Ontario Ministry of Finance, 'Exempt Tobacco Sales on Indian Reserves in Ontario, 2005-2011' released under the Freedom of Information (FOI) Act. Calculated by author, Derek Fildebrandt.

²⁸ Federal Department of Aboriginal Affairs and Northern Development Canada's Indian Registry System.

S = 43% of the on-reserve population smokes²⁹

W = an estimated 20,463 grams would have to be consumed by smokers annually who are Status Indians living on-reserve (2011).

CTF Finding: Using just the *on-reserve population*, aboriginal smokers would need to consume an estimated equivalent of 70 cigarettes a day for all allocation sales to be legal. This would be 466% higher than the reported smoking rate is for First Nations. Put another way, that is just under three packs a day each, every day, for the entire year.

Including the *entire Status Indian population in Ontario*, aboriginal smokers would need consume the equivalent of 32 cigarettes a day – not including any tobacco purchased off-reserve.

²⁹ First Nations Information Governance Centre. "RHS Phase 2 (2008/2010) Preliminary Results." Socio-Economic and Demographic Statistics Section. Aboriginal Affairs and Northern Development Canada

VI-Contraband Allocation Tobacco

Determining tax exempt contraband allocation tobacco sales on-reserve

Now that we've illustrated that it's virtually impossible that all the allocation tobacco sold on-reserve is sold legally to Status Indians, we can estimate how much is sold illegally on-reserve.

This portion of the report estimates the quantity of *illegal, contraband allocation tobacco* sold on-reserve through a similarly basic formula.

T = total allocation tobacco sold on Ontario reserves (calculated in section IV)

L = legal allocation tobacco sold on Ontario reserves (calculated in section V)

C = contraband allocation tobacco sold on Ontario reserves

$$T - L = C$$

T = 570 million grams of allocation tobacco (2011)

L = 122 million grams of allocation tobacco are sold legally on Ontario reserves (2011, using on-reserve population)

C = 448 million grams of allocation tobacco are illegally sold as contraband (2011)

Figure 6.1: Allocation tobacco sold on Ontario reserves, 2007-2011

	2007		2008		2009		2010		2011	
	Res.	Total	Res. Pop.	Total Pop.	Res. Pop.	Total Pop.	Res. Pop.	Total Pop.	Res. Pop.	Total Pop.
Total grams (millions)	546	546	505	505	508	508	540	540	570	570
Legal grams (millions)	113	245	115	250	132	281	120	262	122	268
Contraband grams (millions)	434	301	391	255	376	228	420	279	448	303
Legal (% of total)	21%	45%	23%	50%	26%	55%	22%	48%	21%	47%
Contraband (% of total)	79%	55%	77%	50%	74%	45%	78%	52%	79%	53%

Figure 6.2: Contraband tobacco as a % of total recorded allocation sales from Ontario reserves, 2007-2011 (using on-reserve population)

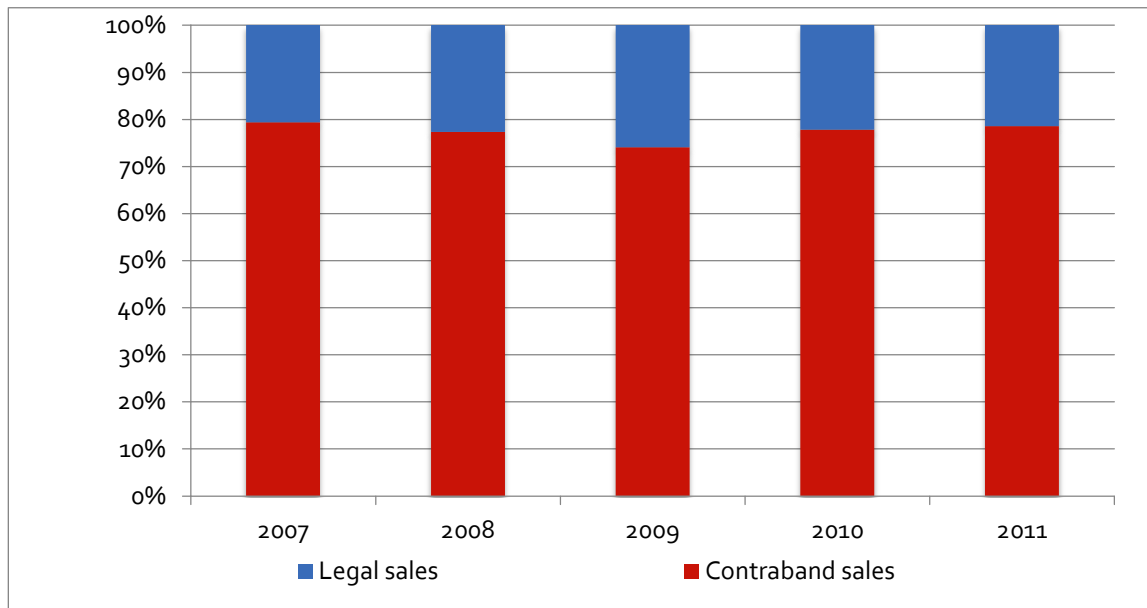
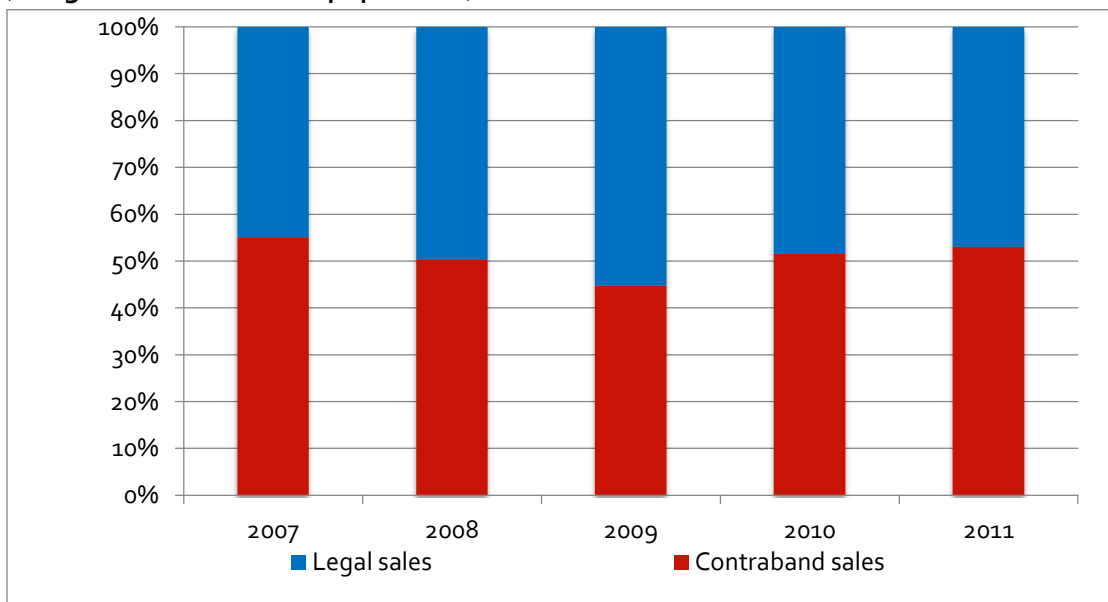


Figure 6.3: Contraband tobacco as a % of total recorded allocation sales from Ontario reserves, 2007-2011 (using total Status Indian population)



CTF Finding: Using the *on-reserve population*, this report estimates that 448 million grams of tax-exempt tobacco were sold illegally on Ontario reserves in 2011, accounting for a full 79% of all allocation sales from reserves. Tax-exempt contraband allocation tobacco sales have increased every year since 2008, adding up to more than 2 billion grams in just the last five years. These figures *do not* include unrecorded sales of contraband tobacco.

Put another way, 539 million contraband allocation cigarettes were sold from Ontario reserves in 2011 and 2.5 billion allocation cigarettes over the last five years. That is 22 million packs in 2011 and nearly 100 million packs over the last five years.

Using the *entire Status Indian population of Ontario*, this report estimates that 303 million grams of tax-exempt allocation tobacco sold from reserves was illegal, accounting for 53% of total sales in 2011.

VII-Tax Loss from On-Reserve Contraband Allocation Tobacco

Determining the tax loss from tax exempt contraband allocation tobacco sales

As stated previously, tobacco is taxed at \$0.085 a gram by the federal government and \$0.1235 per gram by the provincial government in Ontario. The Harmonized Sales Tax (HST) of 13% is also charged on the combined price of the actual tobacco and the tobacco taxes. This constitutes a tax-on-tax. Using the July 2010 average cost in Ontario of \$0.4008 per gram,³⁰ this makes the average HST \$0.0545 per gram.

The combined federal and provincial tobacco and sales taxes add up to an estimated \$0.263 per gram. That is \$0.21 per cigarette or \$5.24 per pack.³¹

Since Status Indians and Canadians at-large alike pay the federal tobacco excise tax through wholesalers, it is not a major problem from the perspective of contraband allocation tobacco. Therefore, the federal tobacco excise tax is excluded from these calculations.

OT = Ontario tobacco tax

FS = federal sales tax (HST)

PS = Ontario sales tax (PST/HST)

TT = total applicable tobacco taxes per gram

$OT + FS + PS = TT$

OT = \$0.1235 per gram Ontario tobacco tax

FS = \$0.0210 per gram (estimate)³² federal sales tax (HST)

PS = \$0.0336 per gram (estimate) Ontario sales tax (PST/HST)

TT = \$0.1780 per gram (estimate)

With the data above it is relatively straightforward to estimate the cost of tax evasion from recorded, on-reserve contraband allocation tobacco sales in Ontario.

C = contraband tobacco sold on Ontario reserves

TT = total tobacco tax per gram

E = total tax evasion from tax-exempt contraband allocation tobacco on-reserve

$C \times TT = E$

³⁰ *Pricing and Taxation: Increases in taxes on tobacco across Canada*. Coalition for a Smoke-Free Nova Scotia.
<http://www.smokefreens.ca/nova-scotia-tobacco-control/pricing-and-taxation/>

³¹ Note: figures may not add up due to rounding

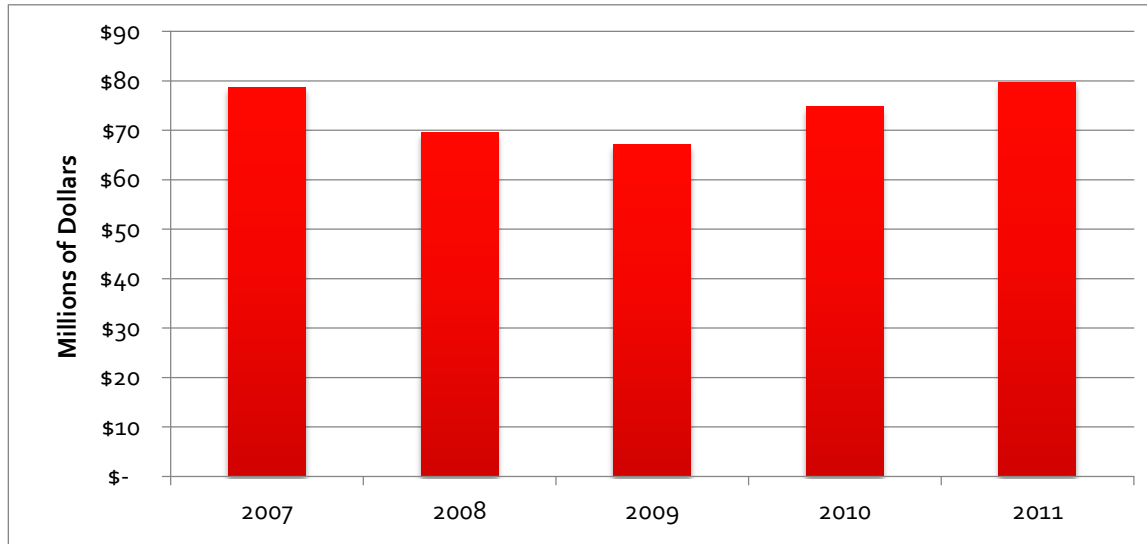
³² Calculated at a rate of 5%. This report estimates the GST to cost \$0.2488 per gram in 2007 at a rate of 6%.

C = 448 million grams are illegally sold as contraband (2011, using on- reserve population)

TT = \$0.1780 gram (2008-2011), \$0.1816 per gram (2007)

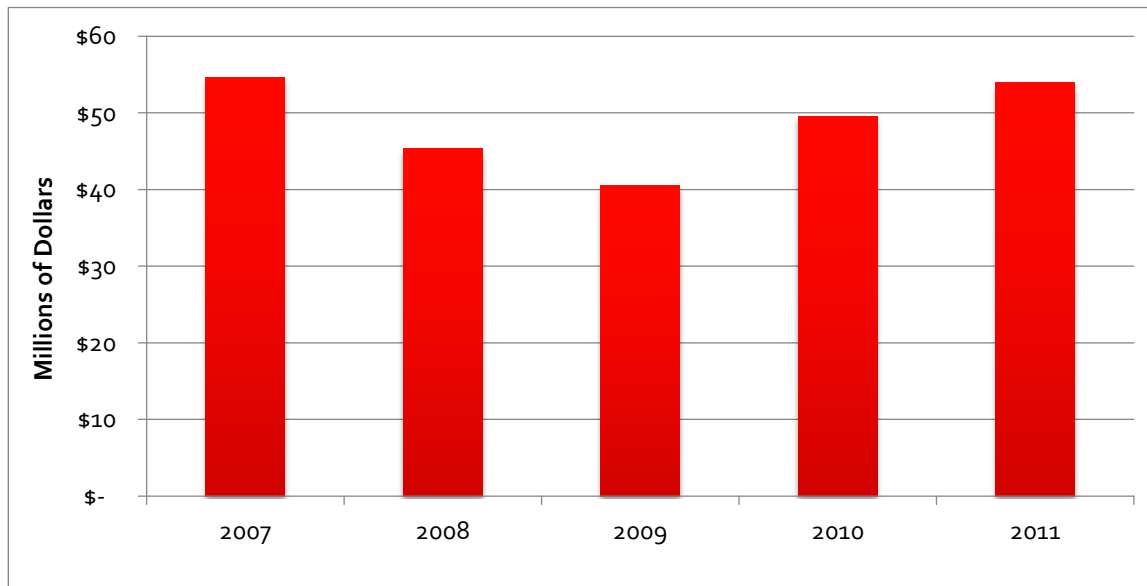
E = \$80 million per year lost in tax evasion from on-reserve contraband allocation tobacco (2011)

Figure 7.1: Tax loss to both federal and Ontario government from tax-exempt contraband tobacco sales on Ontario reserves, 2007-2011 (using on-reserve population)



Source: Canadian Taxpayers Federation, 2012 with data from Ontario Ministry of Finance, 'Exempt Tobacco Sales on aboriginal reserves in Ontario, 2005-2011' released under the Freedom of Information (FOI) Act

Figure 7.2: Tax loss to both federal and Ontario government from tax-exempt contraband tobacco sales on Ontario reserves, 2007-2011 (using total Status Indian population)



Source: Canadian Taxpayers Federation, 2012 with data from Ontario Ministry of Finance, 'Exempt Tobacco Sales on aboriginal reserves in Ontario, 2005-2011' released under the Freedom of Information (FOI) Act

Figure 7.3: Tax loss to both federal and Ontario government from allocation tobacco sales on Ontario reserves, 2007-2011

Millions of \$	2007		2008		2009		2010		2011	
	Res.	Total	Res. Pop.	Total Pop.	Res. Pop.	Total Pop.	Res. Pop.	Total Pop.	Res. Pop.	Total Pop.
Total	\$99	\$99	\$90	\$90	\$91	\$91	\$96	\$96	\$102	\$102
Legal	\$20	\$45	\$20	\$45	\$23	\$50	\$21	\$47	\$22	\$48
Contraband Allocation	\$79	\$55	\$70	\$45	\$67	\$41	\$75	\$50	\$80	\$54

Source: Canadian Taxpayers Federation, 2012 with data from Ontario Ministry of Finance, 'Exempt Tobacco Sales on aboriginal reserves in Ontario, 2005-2011' released under the Freedom of Information (FOI) Act

CTF Finding: Using the on-reserve population, the sale of tax-exempt contraband allocation tobacco on Ontario reserves has created an estimated tax hole to the federal and Ontario government of \$370 million over the last five years, averaging \$74 million per year. This has increased every year since 2008, spiking at \$80 million in 2011.

Importantly, this does not include the lost tax revenue from the sale of non-allocation contraband tobacco sales.

Using the total Status Indian population of Ontario in these calculations, a tax hole of \$244 million has been created by the sale of contraband allocation tobacco over the last five years, and \$54 million in 2011.

VIII-Total tax evasion from contraband tobacco in Ontario

Scope of the contraband tobacco trade

To this point, this report has examined only one element of the contraband tobacco trade, namely the cigarette allocation system and the amount of contraband contained within that one sphere of the overall contraband problem. As noted in the introduction, there several other elements of contraband tobacco trade.

Assessing the size and scope of the *overall* contraband tobacco trade is a task dominated by estimates and proxies. One important, but incomplete proxy is the amount of contraband tobacco seized annually by authorities.

According to a 2011 report published by the *Fraser Institute*, the volume of contraband tobacco seized in Canada increased significantly between 2001 and 2009. While the *RCMP* confiscated only 29,000 cartons of cigarettes in 2001, it confiscated 965,000 in 2008. Of this, 85% (820,000 cartons) were confiscated in Ontario and Quebec, 368,000 alone in the Cornwall, Ontario region where the Akwesasne aboriginal reserve is located.³³

Contraband tobacco is not just the dominion of smugglers and thieves however, and it cannot be accurately estimated by the proxy of seizures.

A 2009 study by the *Canadian Tobacco Manufacturers Council* estimated that a full 48.6% of cigarettes purchased in Ontario were illegal, making Ontario ground zero for contraband tobacco, followed by Quebec at 40.1%.³⁴

In response to this crisis, the *RCMP* established the Combined Forces Special Enforcement Unit-Contraband Tobacco Initiative in 2010. While law enforcement authorities may be better coordinated, the problem of contraband tobacco in Ontario remains fundamentally a political one.

The federal Task Force on Illicit Tobacco estimated that in 2008, contraband tobacco made up approximately 30% of all tobacco products sold in Canada at a market value of \$2.6 billion,³⁵ not including lost tax revenue.

³³ Gabler, Nachum. "Combating the Contraband Tobacco Trade in Canada." Fraser Institute. December 2011.
<http://www.fraserinstitute.org/research-news/display.aspx?id=2147483963>

³⁴ Benzie, Robert and Brennan, Richard. "\$2 billion in tax revenue up in smoke." November 15, 2009. *The Toronto Star*.
<http://www.thestar.com/news/investigations/article/726038---2-billion-in-tax-revenue-up-in-smoke>. Accessed August 31, 2012

³⁵ Gabler, Nachum. "Combating the Contraband Tobacco Trade in Canada." Fraser Institute. December 2011.
<http://www.fraserinstitute.org/research-news/display.aspx?id=2147483963> Accessed August 2012.

Determining the *total* tax loss from contraband tobacco in Ontario

Estimates of the total scope of the contraband tobacco trade in Ontario and Canada vary. As previously noted, a 2009 study by the *Canadian Tobacco Manufacturers Council* estimated that 48.6% of cigarettes purchased in Ontario were illegal. A separate study by the *Federal Task Force on Illicit Tobacco* estimated that 30% of tobacco sold in Canada is contraband. While both studies' conclusions are estimates - as are the calculations in this report - they provide a range in which to estimate the *total* tax evasion from contraband tobacco in Ontario. Using these two established estimates as a baseline, this report uses the formulas below to extrapolate the *total* cost of tobacco tax evasion in Ontario.

In the calculations on the amount of tax loss due to contraband within the cigarette allocation system on reserve, we removed the federal excise tax. Because allocation cigarette contraband is only a small portion of the overall contraband problem, we have added back in the federal excise tax as part of the total calculation in this section.

O = total Ontario tobacco tax revenue

OT = Ontario tobacco tax rate

AX = approximate grams of tobacco sold in Ontario

$$O / OT = AX$$

O = \$1.16 billion (2010-2011)

OT = \$0.1235 per gram Ontario tobacco tax

AX = 9.4 billion grams of tobacco sold in Ontario (estimate)

AX = approximate grams of tobacco sold in Ontario

TT = total tobacco taxes per gram

TR = total tobacco and sales tax revenue (federal and provincial) in Ontario

M₁ = low estimated market share of contraband tobacco in Ontario

M₂ = high estimated market share of contraband tobacco in Ontario

TC = total tax evasion from contraband tobacco in Ontario

$$(AX \times TT = TR) \times M = TC$$

AX = 9.4 billion grams of tobacco sold in Ontario (estimate)

TT = \$0.2630 per gram (estimate)

TR = \$2.5 billion in federal and provincial total tobacco and sales tax revenue (estimate)

M₁ = low estimated market share of contraband tobacco: 30% (Federal Task Force on Illicit Tobacco)

M₂ = high estimated market share of contraband tobacco: 48.6% (Canadian Tobacco Manufacturers Council)

TC = \$742 million to \$1.2 billion is lost in tax revenue every year to the overall contraband tobacco trade in Ontario (estimate)

CTF Finding: Using established estimates of the market share of the contraband tobacco trade in Ontario, this report estimates that between \$742 million and \$1.2 billion was lost in tax revenue to both the federal and Ontario governments in 2011. This amount of money could construct a new hospital in Ontario every single year.

XI-Options for Fighting Contraband Tobacco

1. Tobacco tax levels

The federal and Ontario governments have fought contraband tobacco before. Between 1985 and 1991, the federal government increased the tobacco excise tax by 218%. Like high taxes on anything, this fueled a black market. According to the RCMP, 456,300 cartons of contraband cigarettes were seized in 1994.³⁶

In response to the expansion of the contraband problem, the federal government lowered its tobacco tax and recommended the provinces follow suit. In February 1994, the federal government's excise tax on tobacco dropped from \$10.36 per carton (approx. \$0.065 per gram) to \$5.36 (approx. \$0.0336 per gram). This was a 48.3% reduction in the federal excise tax.

Five provinces followed their lead: Quebec, New Brunswick, Ontario, Prince Edward Island and Nova Scotia.

Despite already having the lowest tobacco taxes in the country, the two provinces that see the bulk of the contraband tobacco trade, Ontario and Quebec, lowered their tobacco excise taxes the most. Quebec dropped its excise tax in 1994 from \$29.61 per carton (approx. \$0.1858 per gram) to \$8.61 (approx. \$0.054 per gram). That was a 70.9% reduction. In Ontario, the government reduced the provincial excise tax on tobacco from \$28.85 per carton (approx. \$0.181 per gram) to \$9.65 (approx. \$0.0605 per gram). This represented a 66.6% reduction.³⁷

Both provinces slightly increased their excise taxes in 1995, with Quebec moving up to \$10.81 per carton (approx. \$0.0678 per gram) and Ontario moving to \$10.85 per carton (approx. \$0.0681 per gram).

Following the reduction in excise taxes, contraband seizures by the RCMP dropped to a low in 2001 at 29,000 cartons.³⁸

Having largely conquered the contraband problem, Ottawa raised the excise tax from \$0.0525 per gram to \$0.085 per gram in 2001. Ontario similarly hiked its tobacco tax during this period, reaching the current rate of \$0.1235 per gram in 2006-2007.

Once again, the contraband problem began to grow, with RCMP seizures reaching an all-time high in 2009 of 975,000 cartons. This is nearly a 34 times increase over 2001.

³⁶ RCMP. 2010 Contraband Tobacco Statistics. <http://www.rcmp-grc.gc.ca/ce-da/tobac-tabac/stats-eng.htm>. Accessed December 14, 2012

³⁷ Ouellet, Jean-Francois et al., "The Impact of Cigarette Tax Reduction on Consumption Behavior: Short-and Long-Term Empirical Evidence From Canada," May 2010. CIRANO. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1611822. Accessed December 7, 2012.

³⁸ RCMP. 2010 Contraband Tobacco Statistics. <http://www.rcmp-grc.gc.ca/ce-da/tobac-tabac/stats-eng.htm>. Accessed December 14, 2012

While the intention of once again hiking tobacco taxes was to price smokers out of the market, the major unintended consequence of this was to merely price some smokers out of the *legal* market and into the black market.

High tobacco taxes are not the only reason for the existence of the contraband tobacco industry. While taxes on tobacco are high in Ontario and Quebec, they are lower than in other provinces. Despite this, 95% of the contraband tobacco trade takes place in these two provinces and on the American side of the Akwesasne Reserve.³⁹ This is due in large part to the sources of supply in both of these provinces, combined with timidity towards cracking down on smoke shacks.⁴⁰

This however is only what *allows* the contraband tobacco industry to thrive. Its primary *cause* is the incentive created by high taxes.

High taxes on anything create incentives for evasion. High income taxes almost always result in at least some of the wealthy setting up offshore accounts. Similarly, high taxes on tobacco - however politically popular - create a black market. Tax-exempt tobacco from aboriginal reserves only fills that market created by the government.

Governments need to find a balance between the stated goal of reducing smoking through higher prices, and the need to ensure that the tobacco trade is conducted through legal and legitimate means in provinces with a high contraband problem, like Ontario and Quebec.

The government experience in the 1990s shows that you cannot ignore tax rates if you are serious about attempting to reduce the amount of contraband tobacco.

Further, with the contraband problem, at least for now, restricted to Quebec and Ontario, any adjustment to tobacco tax rates should occur at the provincial, rather than federal level.

2. Tax sharing agreements with aboriginals

Aboriginals require an incentive to participate in the lawful tobacco industry, as opposed to mere government decrees. In the Fraser Institute's '*Combating the Contraband Tobacco Trade in Canada*,' author Nachum Gabler recommends instituting tax agreements between Aboriginal communities and Canadian governments. Recognizing that federal and provincial authorities stand little hope of effectively combating contraband tobacco without the support of aboriginals, so-called 'smoke shacks' could be given the authority to collect tobacco excise taxes, which would be directed solely towards the local aboriginal government.

³⁹ "Towards effective tobacco control in First Nations and Inuit communities." *Physicians for a Smoke-Free Canada*. March 2007. http://www.smoke-free.ca/pdf_1/Effective%20tobacco%20control%203.pdf

⁴⁰ Benzie, Robert and Brennan, Richard. "\$2 billion in tax revenue up in smoke." November 15, 2009. *The Toronto Star*. <http://www.thestar.com/news/investigations/article/726038---2-billion-in-tax-revenue-up-in-smoke>. Accessed August 31, 2012

Governance benefits for aboriginals

An Aboriginal Tobacco Tax (ATT) would constitute a major concession on the part of the federal and Ontario governments in terms of tax equality, but it is one that could help to quash the black market for tobacco in addition to several positive spin-offs for aboriginal communities.

A self-sufficient source of revenue for aboriginals could not only add to the money available for public works and services, but it would strengthen aboriginal sovereignty and reduce financial dependence on taxpayers at-large.

Importantly, citizens care much more about how governments spend their money when revenues come from them, and not from federal transfers. As aboriginals develop their own sources of revenue, they are likely to demand increased accountability and oversight into how their leaders spend their money.

It is also worth noting that funds generated independently are not subject to federal control, as federal transfers are. These funds could be used however aboriginals see fit.

Reduced low-price tobacco and smoking rates

Taxing and legitimizing on-reserve tobacco merchants would have the obvious effect of increasing tobacco prices. This economic disincentive is a major tactic used by governments, with the stated goal to price smokers out of the market.

While high tobacco taxes will always create an appetite for the black market, 'marginal' smokers and those who are highly price-sensitive (like teens) without easy access to tax-exempt cigarettes will be under greater pressure to quit. This would be true of Canadians who are not Status Indians that purchase tobacco illegally, and legitimate Status Indians who have a smoking rate far above the national average, likely due in some part to their access to cheap tobacco.

Harmonized tax rates

While Section 87 of the *Indian Act* exempts Status Indians from taxation by the federal and provincial governments, Section 83 of the Act and other self-government agreements empower aboriginal governments to impose direct taxation on band members living on-reserve land. Using the First Nations Tax, the First Nations GST and the First Nations Personal Income Taxes as a model, the federal government should negotiate similar agreements with regards to an ATT administered by the Canada Revenue Agency.⁴¹

Ideally, the Aboriginal Tobacco Tax would be levied at the same combined rate as the federal and Ontario tobacco taxes.

⁴¹ Gabler, Nachum. "Combating the Contraband Tobacco Trade in Canada." Fraser Institute. December 2011. <http://www.fraserinstitute.org/research-news/display.aspx?id=2147483963>

At its most basic level, giving aboriginals a share of tax revenues will create incentives for leaders and authorities to end its support - open or tacit - of the contraband tobacco trade.

Experience with tax-sharing regimes

Tobacco tax sharing agreements are already in place in several jurisdictions, in several forms.⁴²

In New Brunswick, 13 of 15 Aboriginal groups share revenue from provincial tobacco taxes. In these cases, on-reserve tobacco sales to status Indians are exempt from the provincial tobacco tax and the HST, and the band is reimbursed for 95 per cent of the value of tobacco taxes collected from non-status Indians.

In Prince Edward Island, provincial tobacco taxes collected on the Lennox Island reserve are completely reimbursed to the community for local development projects. A similar agreement exists for members of the Kahnawake First Nation in Quebec.

In Nova Scotia, each Aboriginal group has the option of levying a tobacco tax on their allocation tobacco. While this money would stay in the community, it is not mandatory.⁴³

Tobacco tax revenue-sharing agreements are supported by a long list of varied organizations including the:

- Canadian Cancer Society
- Heart and Stroke Foundation of Canada
- Physicians for a Smoke-free Canada
- Non-Smokers Rights Association
- Quebec Coalition for Tobacco Control
- Ontario Campaign for Action on Tobacco
- Action on Smoking and Health
- Canadian Council for Tobacco Control
- Canadian Dental Association
- Fraser Institute

3. Reducing allocation cigarettes

As this report has made clear, unmarked tobacco distributed to aboriginal reserves under the Cigarette Allocation System (CAS) is not just for personal use. With 53% to 79% of all allocation tobacco sales going towards non-Status Indians, it is clear that too much tobacco is making its way under the government's nose to aboriginal reserves.

⁴² Gabler, Nachum. "Combating the Contraband Tobacco Trade in Canada." Fraser Institute. Page 17. December 2011.
<http://www.fraserinstitute.org/research-news/display.aspx?id=2147483963>

⁴³ Physicians for a Smoke-Free Canada

One way of fighting this is to simply reduce the amount of tobacco allowed under the CAS formula to reach reserves untaxed. If 53% to 79% of the tobacco distributed under the CAS is illegal, then authorities should reduce the generosity of the formula to better reflect legitimate tax-exempt sales.

A good first step would be to cut the allocation amount in half, with future investigations, much like this one, determining if additional reductions were necessary.

Increased transparency should accompany this with the provincial government pro-actively sharing monthly and annual CAS data online.

4. Introducing a Cigar Allocation System

Although the Ontario government limits the number of untaxed cigarettes through the CAS, no such regulation exists for cigars. In fact, Ontario, Nunavut and the Yukon Territory are the only jurisdictions in Canada not to have an allocation system in place for tax-exempt cigar sales on aboriginal reserves. In his 2010 report, the Auditor General of Ontario made clear that such a system was needed, however ineffectual the existing CAS is.⁴⁴

Using the 2011 data in this report, every man, woman and child over the age of 15 living on reserve would have to consume more than 1,079 cigars annually. That is nearly 3 cigars a day, every day.

With approximate tax-exempt cigar sales topping 187 million grams of tobacco, the creation of an enforceable Cigar Allocation System is necessary.

5. Increased audit activity

Authorities are simply not paying enough attention to the problem of contraband tobacco at the administrative level. As noted from a 2008 report, the Auditor General of Ontario found that:

Although all seven of the large gasoline and diesel-fuel tax collectors had been audited every four years as planned, only a few of the 38 large tobacco tax collectors had been audited at least once every four years as planned.⁴⁵

The failure of authorities to frequently audit major tobacco tax collectors is an oversight that is easily correctable. By enforcing existing laws as recommended by Ontario's *Drummond Report* and subjecting tobacco

⁴⁴ "2010 Annual Report of the Office of the Auditor General of Ontario." *Office of the Auditor General of Ontario*. http://www.auditor.on.ca/en/reports_en/en10/410en10.pdf Accessed August 31, 2012.

⁴⁵ "2010 Annual Report of the Office of the Auditor General of Ontario." *Office of the Auditor General of Ontario*. http://www.auditor.on.ca/en/reports_en/en10/410en10.pdf Accessed August 31, 2012.

tax collectors as the same rigors as other tax collectors, the ability to scam the system on a mass level will become, at the very least, significantly more difficult.⁴⁶

6. Political sensitivity of authorities

As this report has shown, the contraband tobacco trade that thrives from tax-free status on aboriginal reserves is a massive problem in Ontario. Bringing this underground industry to heel will require that politically correct sensitivities imposed on the police must be done away with.

Unfortunately Ontario's government has steadfastly refused to do anything that would spark a confrontation with systemic aboriginal legal violations. Most notoriously, the Ontario government allowed the Caledonia occupation to drag on for so long that those illegally occupying the land must believe - with cause - that they now own the land for all intents and purposes. The Ontario government even went so far in conceding defeat that it purchased the occupied land from non-aboriginal private citizens. It is on this land that illegal, contraband smoke shacks now appear.

⁴⁶ "Commission on the Reform of Ontario's Public Services." *Don Drummond*. Chapter 18.
<http://www.fin.gov.on.ca/en/reformcommission/chapters/ch18.html>

XII-Conclusion

Increased law enforcement by the authorities is a critical component of fighting the contraband tobacco trade in Canada, but even unlimited police resources will be unable break the industry unless the fundamental incentives that create this black market are altered. Doing so will require both a readjustment of tobacco excise taxes and/or the implementation of tax agreements with aboriginals to ensure that they have a stake in a fair, legal, and above-ground tobacco trade.

This report and the CTF recognize that aboriginals have historic treaties signed in good faith with the Crown, which must be respected; nonetheless it is unacceptable that laws *intended* to maintain the sovereignty of aboriginals are abused by allowing Canadians without Indian status to enjoy the fruits of such treaties. While many merchants dealing in contraband tobacco claim that their industry is legitimate because of the longstanding and historic aboriginal tobacco trade, they are in fact breaking treaties and the law.⁴⁷ Section 87 of the *Indian Act* and treaties granting tax-exempt status are clear that such status does not apply to Canadians who are not Status Indians doing business with them. By reinterpreting the law and treaties in such a fashion, illegal smoke shacks undercut law-abiding merchants, farmers and smokers, and they undermine anti-smoking initiatives and the rule of law itself.

⁴⁷ "Towards effective tobacco control in First Nations and Inuit communities." *Physicians for a Smoke-Free Canada*. March 2007. Page 24. http://www.smoke-free.ca/pdf_1/Effective%20tobacco%20control%203.pdf