Contraband tobacco in Canada: TIME FOR ACTION

2009 STATUS REPORT
Contraband tobacco is a scourge

FOR YOUNG PEOPLE
It means cigarettes for sale in the schoolyard that cost less than a pack of gum.

FOR TAXPAYERS
It means annual tax revenue losses in the billions of dollars - funds which are no longer available to help support health and education initiatives.

FOR PUBLIC SECURITY
It means unparalleled revenues flowing into organized crime to fund illegal activities such as arms trafficking and the growth of criminal networks.

FOR HONEST MERCHANTS
It means the loss of a significant source of revenue, one that creates jobs and offers an essential service to the community.

FOR ABORIGINAL COMMUNITIES
It means the increased presence of criminal groups which hide behind the screen of the reserve in order to participate in contraband tobacco sales and other illegal activities.

FOR OUR SOCIAL FABRIC
It means citizens losing faith in their government’s ability to enforce the laws of the land and protect them, their children and their communities.
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Contraband tobacco: the issues at a glance

- The rampant distribution and sale of contraband tobacco is flooding the Canadian market with untested and untaxed cigarettes.
- Illegally produced cigarettes pose a serious fire hazard for people who consume them, and for those who live nearby, since they generally lack the self-extinguishing mechanisms of legally produced cigarettes.
- The RCMP suggests that the vast majority of all contraband tobacco found in Canada is smuggled from the U.S. through the Akwesasne Mohawk Territory aboriginal reserve near Cornwall, Ontario. The Akwesasne Territory sits at the intersection of the borders of New York State, Ontario and Quebec making it the perfect entry point for smugglers.
- The problem has been escalating since 2006, when federal and provincial governments decided to more than double the tax on cigarette cartons from $20 to $45. As a result, the issue has reached alarming levels in recent years.
- As of late 2008, nearly 50% of the cigarettes consumed in Ontario, and over 40% of those consumed in Quebec were contraband.
- Studies of cigarette butts collected from schoolyards at high schools in Ontario and Quebec have indicated that an increasing number of teenagers are acquiring contraband tobacco. In a 2008 study, roughly 25% of cigarette butts collected near Ontario high schools and 35% of those collected near Quebec high schools were found to be contraband.
- Recent survey results show that Canadians who purchase contraband tobacco do not believe they are breaking the law.
- With prices as low as $6 to $8 per carton, contraband tobacco is undercutting legitimate sales of tobacco products forcing many family-owned and operated convenience stores out of business. In 2008, an average of one convenience store went out of business every day in Quebec. In Ontario 885 stores have closed in the same time translating to more than two stores a day.
- Organized crime groups in Canada use the contraband tobacco trade to finance other illegal activities such as drug and weapons trafficking, money-laundering and human smuggling.
- While there are no quick solutions, a number of measures can be undertaken by different levels of government to combat this threat to our local economies, the health of our children and our public safety.
What is contraband tobacco?

Illegal cigarettes, often referred to as contraband tobacco, are products that do not comply with Canada's tobacco regulations - specifically those regarding importation, stamping, manufacturing, distribution and taxation.

Contraband tobacco is largely manufactured in illegal factories, both in Canada and in the U.S., with a small portion coming in from China and India.

With prices as low as $1.00 for a pack of 20 cigarettes, compared to $8.00 for a pack of government regulated cigarettes, this illegal product undercuts legitimate tobacco sales, flooding the Canadian market with untested and unregulated cigarettes.

Contraband tobacco is distributed through a vast network of smugglers in communities across Canada. They bring these cigarettes directly to the doorsteps of consumers, or act as street vendors selling cigarettes out of the trunks of their cars. This illicit activity occurs with absolutely no government inspection, testing, or reviews, meanwhile robbing the Canadian people of the benefits of billions of dollars in tax revenue each year.

Illegal cigarettes have been a serious issue in Canada for a number of years. According to the RCMP, the problem is now at a record high. In 2008, the issue reached critical proportions and surpassed its previous peak in the early 1990s.¹

Contraband cigarettes are priced cheaply, often selling for $1.00 a pack. They are sold with absolutely no government inspection, tax collection or age verification.

In order to combat the illegal sale of cigarettes, the government implemented several strategies:

1. **Taxation:** Increasing the tax rates on cigarettes.
2. **Law Enforcement:** Seizure of contraband cigarettes and prosecution of offenders.
3. **Public Awareness:** Campaigns to educate the public about the dangers of contraband tobacco.

**Average Tax Rates and Contraband Tobacco**

The graph shows the average tax rates and the number of cartons of cigarettes seized by the RCMP from 1994 to 2006. The data indicates a significant rise in both tax rates and the number of cartons seized, highlighting the efforts in combating contraband tobacco.

- **Average Tax Rates:** The graph displays a steady increase in average tax rates over the years.
- **Cartons Seized:** The number of cartons seized shows a peak in 2006, reflecting effective law enforcement strategies.

**Contraband Cigarettes:**

- **Pricing:** Cheaper than legal cigarettes, often for $1.00 a pack.
- **Selling Conditions:** Sold without government inspection, tax collection, or age verification.
- **Impact:** Contraband cigarettes contribute to the black market economy and negatively affect public health and revenue collection.
How significant is this problem?

In one word - huge.

The RCMP has quantified the problem through the results of investigations and numerous seizures of illicit tobacco products.

Independent research firm GfK Research Dynamics has also analyzed the issue through both quantitative and qualitative studies over the past three years.

Its 2008 study reveals some startling facts:

- Almost one half (48.6%) of the cigarettes consumed in the seven days prior to the study in Ontario were contraband.
- Ontario's share of the illegal cigarettes consumed in Canada has increased from 31.6% in 2007 to 48.6% in 2008, and has more than doubled since 2006.
- Quebec's share of the illegal cigarettes consumed in Canada has increased from 30.5% in 2007 to 40.1% in 2008, and has also nearly doubled since 2006.

2 GfK Research Dynamics, Illicit Usage of Cigarettes in Canada, 2008
Despite the significant resources that the RCMP and other police forces are pouring into controlling the problem, the prevalence of contraband tobacco appears to be growing at an exponential rate.

If the rates of contraband tobacco use documented in this study continue to rise at this pace, the level of contraband tobacco use in Canada could rise to as high as 80% by the end of 2010.

**Trend - Contraband Use in Canada**

Source: GfK Research Dynamics (2008)

*Speculated Projection*
Where is contraband tobacco coming from?

Based on the most recent findings, and as outlined in the RCMP framework to combat contraband tobacco, these products are coming into Canada from a number of different sources:

- Cigarettes manufactured in the US and smuggled into Canada (90% of the contraband product available);
- Cigarettes unlawfully manufactured in Canada, often on aboriginal reserves;
- Counterfeit cigarettes, made to look like legitimate brands of tobacco products, smuggled into Canada, largely from Asian sources;
- Improperly sold tax and duty-free cigarettes, often from aboriginal reserves;
- Legal cigarettes stolen from retail stores or delivery trucks and resold through the black market.

A large proportion of illicit tobacco appears to be sold by so-called street vendors. These vendors typically visit specific areas in vehicles laden with illegal cigarettes, selling their products in bulk in plastic bags. Or they may appear as individuals who frequent specific locations such as street corners in urban centers, selling cartons or single packs.

The RCMP notes that in the past, law enforcement and government actions to curtail the market for illegal cigarettes have been generally successful. However, this most recent surge in illegal cigarettes is the result of a combination of different factors which require a modified plan of action.

According to the RCMP Contraband Tobacco Enforcement Strategy, 2008, “The current system of manufacturing, distributing and selling contraband tobacco involves organized crime networks exploiting aboriginal communities and the politically sensitive relationship between these communities and the different levels of government and enforcement agencies, as well as counterfeit tobacco products arriving in Canada mainly from China.”

RCMP sources have noted that the vast majority of the contraband in Canada is coming through the Akwesasne Mohawk Territory aboriginal reserve near Cornwall, Ontario. Manufacturing operations are mainly on the U.S. side of Akwesasne, but can also be found on the Kahnawake reserve in Quebec, and the Tyendinaga and Six Nations reserves in Ontario.
About Akwesasne

The Mohawk Nation of Akwesasne is a Mohawk Nation territory with a population of 13,000. It is located at the intersection of the borders of New York state, Ontario, and Quebec along the southern bank of the St. Lawrence River. Akwesasne's unique geographic situation has long been a lure to smugglers and organized crime looking to move illegal products quietly between Canada and the United States.

In a 2008 CBC news report, RCMP Sergeant Michael Harvey speculated that 90% of illegal cigarettes sold in Canada come from Akwesasne. He further indicated that police were now routinely seizing in one week the number of cigarettes they previously confiscated in one month.3

Tobacco manufacturing and trade in Aboriginal communities

The Government of Canada grants licences to many aboriginal companies allowing them to manufacture tobacco products on their reserves. These cigarettes are tax-exempt and intended for consumption solely by residents of the reserve.

However, the requirements for obtaining a legal tobacco manufacturing licence on a reserve are quite low and merely require prospective manufacturers to post a small $5,000 bond. As a result, these cigarettes are incredibly cheap to produce and result in an increasing number being sold to off-reserve residents and illegally distributed throughout Canada.

On Canadian reserves, cigarettes are subject to a patchwork of taxes and tax exemptions. Under Sections 87 and 90 of the Indian Act, registered Aboriginals are not required to pay federal or provincial taxes on their personal property, so long as it is located on a reserve. Personal property includes goods, services and income consistent with Canada Customs and Revenue Agency (CCRA) policies.

In some cases on Eastern Canadian and British Columbian reserves, retailers collect the equivalent of the GST or HST, and this money is returned to Band Councils.

In other provinces, such as Ontario, tobacco sales on reserves are exempt from taxes under the provincial Tobacco Tax Act, whose regulations provide for a system of tobacco allocation to aboriginal communities. Thus, registered Aboriginals may acquire unmarked cigarettes on a reserve which are exempt from Ontario tobacco tax, for their personal use. Remarkably current laws permit up to 1000 cartons per year for every man, woman and child on each reserve.

In Quebec, provincial sales taxes are collected on the sale of tobacco to non-First Nations citizens. These funds are then transferred back to aboriginal governments through a tax collection agreement. This is similar to an arrangement between the government of New Brunswick and the aboriginal governments in that province.

While in principle these approaches appear to bring some order and regulation to managing tobacco sales, the price disparity between the legal and illegal markets, coupled with the ease of smuggling, have created a massive gap in Canada's tobacco industry. This gap encourages the free flow of contraband tobacco and opens the door to smuggling of other illegal products such as drugs and firearms.

“It is our responsibility to put an end to this unacceptable situation, which is destroying the very foundations of our country.”
- Jean Chrétien, February 8 1994, unveiling a major contraband tobacco Action Plan

Youth and contraband tobacco

For decades, successive governments in Canada have worked to keep cigarettes out of the hands of youth. Convenience store retailers view the prevention of the sale of cigarettes to minors as an important social responsibility. The Canadian Convenience Stores Association (CCSA) devotes significant resources to this issue, most notably through the promotion of the “We Expect ID” program. “We Expect ID” is a training and certification program for retailers and their employees which aims to prevent the sale of age-restricted products to minors. While the CCSA firmly supports its age verification program, the association would like to see the government take additional steps to reduce smoking amongst youth. An example of this includes the recent request made by the CCSA for government to prohibit the consumption of tobacco by minors, as it does for alcohol products.

Regardless of the many measures put in place to deter kids from smoking, the influx of massive amounts of inexpensive, easily accessible cigarettes has continues to derail those efforts. Illegal cigarettes can be purchased at the same cost as a packet of chewing gum, inevitably driving the increase in demand by youth for contraband tobacco. While smoking rates among youth in Canada are at an all-time low of 15%, that number has not continued to decline. Speculation is strong that increasing numbers of young people are taking up smoking with cheap, illegal cigarettes.

In addition, minors incur minimal legal penalties for contraband tobacco-related offences. This lack of a judicial “stick,” coupled with the “carrot” of the quick financial gain that the trade offers, and the widespread access to the contraband network in Canada, all serve in attracting more young people to illegal trafficking activities. Smuggling and selling contraband tobacco has become a gateway crime for young people to other criminal activities such as drugs and weapons trafficking.

In an effort to better understand the problem, and the extent to which young people are using contraband cigarettes, the CCSA undertook a two-year study to examine the effects of contraband tobacco on youth in Canada.

The results were staggering.

“Year in and year out our studies conclude that those under 19, who are prohibited from purchasing cigarettes, are having no trouble getting their hands on cheap unregulated illegal cigarettes. The sad thing about this is all the government initiatives that have been developed to reduce smoking such as taxes, health warnings, display bans, and mandatory ID checks are useless when you consider the accessibility of Contraband in our communities.”

- Dave Bryans President, CCSA

Youth Contraband Study 2007

The CCSA study, led by independent research firm Arcus Group, clearly demonstrated that contraband tobacco has infiltrated high schools in Quebec and Ontario. Cigarette butts were collected from public areas where smokers gather at 55 high schools in Ontario and 50 in Quebec. In total, over 11,000 cigarette butts (5,457 in Ontario and 5,810 in Quebec) were collected and then carefully examined and classified into three categories: legal, contraband or unknown.

The study revealed that in Ontario, 24% of cigarette butts collected from high schools were contraband, while in Quebec, contraband made up 35% of the cigarettes collected.

- In Ontario, the highest incidences of contraband were found in Newmarket and Aurora with 50% and 47% respectively, while Burlington and Oakville had the lowest, at 9% and 8% respectively.
- In Quebec, the highest incidences of contraband were found in Anjou and Côte-des-Neiges with 74% and 60% respectively, while St-Michel and Greenfield Park had the lowest at 12% and 18% respectively.
- In half of the municipalities/regions surveyed, more than 30% of the cigarette butts found were contraband.
- In 11 of the municipalities/regions surveyed, more than 40% of the cigarette butts found were contraband.
Youth Contraband Study 2008

The second year of the study confirmed that teen smokers are becoming increasingly hooked on contraband tobacco. The numbers reveal that these inexpensive, readily-available illegal cigarettes are quietly undermining government anti-smoking measures.

While youth smoking rates are considered to be at an all-time low, this study clearly revealed that contraband tobacco usage continues to be widespread among young people.

The CCSA’s 2008 Youth Contraband Study was conducted by independent researchers who collected cigarette butts from 80 high schools in Ontario and 75 in Quebec. A total of 22,498 cigarette butts were collected by research personnel which were then examined and classified in three categories: legal, contraband or unknown. This was double the number collected in the first year of the study.

The 2008 study revealed that 26% of cigarette butts collected in Ontario were contraband, while in Quebec, the rate of contraband was even higher at 36%.

Community-by-community results are shown in the following figures:
Percentage of cigarette butts found in Quebec high schools which were contraband, by region

Percentage of cigarette butts found in Ontario high schools which were contraband, by region
Governments and contraband tobacco

At a time when federal and provincial governments are entering an era of budget deficits, contraband tobacco intensifies current economic conditions in a number of ways, including:

- Depriving governments of essential revenues to help finance other key public expenditures and social programs;
- Forcing authorities to divert precious human and financial resources to the suppression of traffickers;
- Robbing thousands of honest merchants of profits derived from the legal sale of tobacco products and costing a significant loss in overall store sales as a result of a decrease in store traffic forcing many retailers out of business;

The proliferation of contraband tobacco feeds the cynicism that some citizens feel with regard to politicians and the effectiveness of government. It suggests that tax evasion in Canada is a profitable endeavour and that it has become not only endemic, but perhaps even tolerated.

Government inaction towards the issue seems to legitimize public participation in the trade of contraband tobacco. In appearing powerless and incapable of halting this scourge, the government loses credibility when it does attempt to rally Canadians to fight against it.
Contraband tobacco siphons public funds

Sustained drops in provincial government revenue in Quebec and Ontario.

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LOSSES OF $360 M A YEAR IN ONTARIO

LOSSES OF $300 M A YEAR IN QUÉBEC

“`We will no longer be the bandits’ accomplices.”`
Canadian attitudes towards contraband tobacco

The CCSA commissioned polling firm Léger Marketing for a study on opinions and perceptions regarding the purchase and consumption of contraband tobacco. Over 1,500 smokers and non-smokers in Quebec and Ontario were surveyed in the summer of 2008.

The survey revealed that while less than one-quarter of Canadians still smoke, a high proportion of those smokers are consuming illegal cigarettes. In addition, consumers of contraband cigarettes do not feel they are doing anything illegal by purchasing this product, and are not afraid of being caught by police. The study also clearly indicated that the primary sources of contraband are aboriginal reserves and the informal networks of friends and associates who are selling contraband in an extensive underground economy.

HIGHLIGHTS OF THE LÉGER MARKETING SURVEY

DO YOU SMOKE?
(General population)
DO YOU SMOKE CONTRABAND TOBACCO? (Yes)

The majority of smokers in Ontario and Quebec are choosing an illegal product that is offered, distributed and sold by a criminal network, robbing the Canadian people of the benefits of billions of dollars in tax revenue every year.

DO YOU THINK PURCHASING CONTRABAND TOBACCO IS ILLEGAL? (No)

DO YOU THINK BUYING TOBACCO ON A NATIVE RESERVE WITHOUT PAYING TAX IS ILLEGAL? (No)
The results show that a majority of smokers surveyed did not think they were breaking the law when they buy contraband tobacco. Clearly, education is needed on the part of governments to inform people that it is illegal to buy tobacco products through illicit distribution networks or from aboriginal reserves without paying taxes.

What is the main reason for buying contraband tobacco?

(...Because it’s cheaper than legal tobacco)

Tax avoidance is the primary reason that people buy contraband tobacco. Since illegal cigarettes are 10 times cheaper than those sold legally with taxes included, the market for illegal tobacco continues to widen at an alarming rate.
WHERE DO YOU BUY CONTRABAND TOBACCO?

NATIVE RESERVES

A COLLEAGUE OR FRIEND

A CONVENIENCE STORE

The results clearly show that aboriginal reserves, and the organized network of distribution that brings contraband tobacco off reserves, are fuelling the spread of these illegal cigarettes in communities throughout Ontario, Quebec and, increasingly, in other parts of Canada.
Organized crime and contraband tobacco

According to the RCMP, there are approximately 105 organized crime groups currently engaged in the contraband tobacco trade in Canada.

The enormous profit margins generated through the sale of contraband tobacco help provide these groups with cash flow to support other illegal activities. Two-thirds of the groups engaged in contraband tobacco are also involved in drug trafficking (mainly cannabis and cocaine), arms trafficking, counterfeit cash, money-laundering and human smuggling.

The RCMP states that there has been an increase in the number of seizures of shipments of illegal tobacco which are accompanied by drugs or firearms. 30% of these organized crime groups are also known to have violent tendencies.

Furthermore there have been numerous studies, including a recent report from the Mackenzie Institute in Toronto, that highlight how contraband trafficking is in some cases funding terrorist activities. The study entitled “Sin Tax Failure” includes references to cases in the US where members of Hizbolah and al Qaeda have been involved with contraband trafficking.6

“Illicit cigarette manufacturing and sales represent a significant threat to the safety and security of our communities and to our economy. Trafficking in contraband tobacco fuels other illegal activities by organized crime, such as drug trafficking and gun smuggling.” 7

– Honourable Stockwell Day, federal Minister of Public Safety, 2008

7 http://www.cra-arc.gc.ca/nwsrm/riss/2008/m09/nr080904-eng.html
Convenience stores and contraband tobacco

Convenience store owners see a clear link between contraband tobacco and other problems including a decrease in customer traffic and revenue and an increase in the threat of violence.

Retailers are seeing sales decline as more consumers switch from legal to illegal tobacco products. These law-abiding businesses have no way of competing with contraband tobacco products that are sold at a fraction of the cost of legal cigarettes.

As fewer customer come in to buy cigarettes, fewer sales are made in other product areas, often driving revenues down so low that many of these small businesses have been forced to close their doors, further harming local economies in communities across the country and reducing access to legal tobacco products.

A decline in customer traffic can also result in increased security risks as stores with less customer traffic are more attractive to criminals and tend to have a higher rate of armed robberies.

This trend of reduced tobacco sales is especially damaging for convenience stores in Ontario, where tobacco products represent the most important sales and profit category.
“[smugglers are even advertising] … this is a business card saying, ‘$25 to $30 per carton delivered to your door’; and this is a flyer saying, ‘$19 carton - call 905.324.XXXX cigarettes delivered to your door’; I have to buy each carton at $70. If a guy is selling it for $20 to $30 per carton, how can I compete?”

“Customers show me their DKs, which come from Aboriginal reserves. I have also seen counterfeit cigarettes … they look like DuMaurier but they are fakes.”
Solutions: favouring a multilevel approach

Crimes seldom occur without motive. Contraband criminal activity will therefore cease when the economic incentive to participate has been eliminated. This was proven in 1994 with the combined Federal and Provincial tax rollbacks implemented at that time.

Unfortunately, our situation is different today.

Baggies of contraband cigarettes are available to consumers for as little as $6.00 - $8.00 per 200 sticks. At this price point, using a single solution taxation approach, it is unlikely that anything short of a Federal and Provincial rollback to zero would be effective.

Taxation Levels - A general commentary on the current situation.
The RCMP has clearly shown that the most recent rise in contraband tobacco coincided with a substantial tax increase on tobacco products beginning in 2001. Over this time span, both levels of government more than doubled taxes on tobacco. This has created a significant price differential between legal and illegal tobacco products. This differential provides the “room” for significant criminal margins to exist, while maintain an attractive (albeit illicit), consumer price point.

Although responsibly designed to counter high smoking rates, tobacco taxation policy has backfired badly; today, tobacco has never been more accessible and inexpensive, especially for young people, who increasingly are being targeted by smugglers and criminal networks.

Provincial Tobacco Tax (PTT) Collection by Aboriginal Communities
By allowing Band Councils to collect and use their own PTT, aboriginal communities would be less supportive of the existing contraband trade as its continuation would reduce a new and important source of revenue. This model has already been used successfully with the federal government’s GST/HST, in cooperation with some aboriginal communities.

We understand that the precedent also exists in the U.S. with a concept called “Payment in Lieu of taxes”.

Enforcement
Major contraband seizures are being made on a weekly basis. Increased resources for law enforcement in targeted and well-identified areas will play a major role in reducing the problem. Coupled with Minimum pricing legislation, enforcement is aided by easy contraband identification. Governments who increase budgets for enforcement will benefit by reduced contraband trafficking when coupled with these suggestions.
Licensing
Implement more stringent licensing requirements for aboriginal manufacturing facilities, and make that licence mandatory in order to manufacture provincial taxable products. For those facilities located on reserve our earlier suggestion of combining PTT, GST and FED has particular importance. Further, we believe there is an opportunity to require the reconciling of raw material inputs and tax-paid tobacco production. Low ignition propensity paper (LIP) can be demanded for production that is to remain in Canada and reconciled against the quantity of such paper acquired and the volume of cigarettes produced. This is another solution that can be supported by all stakeholders and is of immediate benefit to Canadians.

Education
Research confirms that a significant portion of the problem rests on the fact that Canadians remain uneducated and misinformed regarding the fact that the purchase of contraband tobacco is illegal. A targeted messaging and education campaign to inform Canadians that they are breaking the law - and that there are serious consequences for doing so - could dramatically reduce the problem right across the country.

Border Security
The RCMP notes that 90% of the contraband tobacco being sold in Ontario is being manufactured on the U.S. side of the Akwesasne reserve, and smuggled across the border into Ontario. A concerted effort to close the gaps in our border which currently allow this problem to flourish would severely impede smugglers' ability to carry on their business. We believe that the problem with contraband needs to be repositioned from being a “victimless crime”, to being “a symptom of the permeability of our border” with the U.S. Further, we would argue that the contraband problem needs to be repositioned from being a “native problem” to being one of “criminals masquerading as natives”.

Canada/US Relations
As we are told that most manufacturing of contraband tobacco takes place across the border, it seems impossible for the Canadian government to curtail the principal source of production directly. However, we could leverage our relationships with the U.S. federal government and the New York state government to persuade our American neighbours to shut down the illegal factories on their side of the border. For those factories that do remain, our suggestions to combine Federal and Provincial taxes, coupled with our view of requiring the reconciliation of raw material inputs - may resonate with U.S. officials. On April 1st, U.S. Federal taxes on tobacco will rise by slightly less than $7.00 per carton. This widens the price gap facilitating the expansion of contraband within U.S. borders. We believe Canada’s experience with contraband may provide important insight for authorities in the U.S. and facilitate cooperation. The elimination of these factories would also go a long way toward closing a major conduit for guns and drug trafficking.