



2018 Pre-Budget Submission

House of Commons Finance Committee

August 2017

Executive Summary

In Imperial Tobacco's effort to tackle Canada's thriving illegal tobacco trade and draw attention to the unintended policy consequences of excessive regulation, we offer three recommendations.

Make moderate, predictable, inflation-based tax adjustments on an annual basis rather than in five-year increments.

Adopt a whole-of-government approach to tobacco control in which taxation, regulation and enforcement are considered in the context of a thriving illegal trade.

- a) *Pursue federal-provincial coordination on tobacco taxation and enforcement to fight the illegal market.*
- b) *Establish a Federal-Provincial-First Nations task force to address illegal tobacco manufacturing, sales and trafficking, with meaningful input from law enforcement and the tobacco industry.*

Reconsider plain and standardized packaging for tobacco products to prevent counterfeiting and address the Government's policy inconsistency between tobacco and marijuana.

INTRODUCTION

In the coming months, decisions made by the Federal Government will significantly impact the legal, regulated and taxed tobacco industry in Canada and, relatedly, the thriving illegal, unregulated and untaxed industry. Under pressure from tobacco control lobbyists, governments are considering regulations that further hamper the legal industry's ability to compete with the illegal operators. However, the majority of the regulatory proposals brought forth by tobacco control lobbyists fail to take contextual factors into account. As a result, a number of unintended consequences have surfaced, such as increased rates of illegal tobacco usage and the loss of tax revenue.

The illegal industry continues to grow, costing \$16.5-22 billion in lost tobacco tax revenue since 2006.¹ However, the negative externalities extend beyond lost tax revenue. According to the RCMP, profits from illegal tobacco are diverted to over 175 organized crime groups.² Despite this, many governments have neglected to introduce any substantial anti-contraband measures. Worse still, tobacco control lobbyists are pressuring governments to impose further regulation on the legal industry and increased taxes and fees,³ which gives the illegal operators a market advantage.

Meanwhile, the approach the Federal Government has taken with marijuana starkly contrasts with its treatment of tobacco. As the Government plans to legalize marijuana, it simultaneously acknowledges the presence of an illegal market and regulations are being proposed in light of the need to decrease its size.⁴ The same logic should be applied to tobacco to ensure that taxation and regulation do not give a further competitive advantage to the illegal market.

ABOUT IMPERIAL TOBACCO CANADA LIMITED (ITCAN)

Established in 1908, ITCAN is Canada's leading tobacco company. Headquartered in Montreal, ITCAN employs approximately 450 people across Canada.

ITCAN is dedicated to conducting its business responsibly, in a manner that meets society's expectations of a 21st century tobacco company. ITCAN recognizes the health risks associated with tobacco consumption and believes underage people should not consume tobacco products. We support reasonable and evidence-based regulation, especially those aimed at keeping tobacco products out of the hands of youth.

ITCAN strictly follows all laws and regulations that govern the tobacco industry and pays all required taxes. Unfortunately, the Canadian tobacco market is being tainted by an illicit trade

¹ Estimate based on average losses of \$1.5-2 billion a year since 2006.

² See <http://www.macleans.ca/news/one-third-of-cigarettes-sold-in-ontario-are-contraband-study/>

³ See <http://www.queensu.ca/gazette/sites/default/files/assets/attachments/EndgameSummit-Backgroundpaper%20.pdf>

⁴ See http://www.huffingtonpost.ca/2017/04/21/morneau-pot-taxes-low_n_16146484.html

which funds organized crime⁵ – and those who sell illegal tobacco abide by a completely different set of rules.

ILLEGAL TOBACCO IS THRIVING

Other than Quebec, where coordinated enforcement efforts have been in place for several years, the illegal tobacco market is thriving. The RCMP acknowledges the growth of the industry and on its website draws the link between illicit tobacco and other criminal activities.⁶ While the RCMP clearly understands illicit tobacco to be a serious issue, the data it offers regarding successful enforcement dates back to 2011, suggesting that little has been done in recent years to curb the illegal industry's growth.

A Growing National Problem

The Atlantic Convenience Stores Association (ACSA) released data in September 2016 that estimated New Brunswick's illegal tobacco rate to be 20%,⁷ the same as Nova Scotia.⁸ Meanwhile, there is an alarming trend in Newfoundland and Labrador. The latest data from the ACSA, released in November 2016, estimates the illegal tobacco rate at 15%,⁹ a 50% spike from a year earlier.¹⁰

Similarly, the Ontario Convenience Stores Association (OCSA) released data in November 2016 that measured that Province's illegal tobacco rate at 32.8%, up from around 24% in 2015.¹¹ A study by the National Coalition Against Contraband Tobacco in January 2017 found parallel results.¹²

The trends in Western Canada are equally concerning. For Manitoba, the Western Convenience Stores Association (WCSA) reported an illegal tobacco rate of 15% in November 2016,¹³ up from 13% a year earlier.¹⁴ For Saskatchewan, data from the WCSA released in November 2016 estimated the illegal tobacco rate at 11.7%,¹⁵ up from 9.5% in December 2015.¹⁶

The WCSA also released data that suggests the illegal tobacco rate in Alberta jumped by 25% from 2015 to 2016, from under 10% to over 12%.¹⁷ Meanwhile, British Columbia's rate has held steady around 15% for two years in a row.¹⁸

⁵ <http://www.rcmp-grc.gc.ca/pubs/tobac-tabac/2012-contr-strat/index-eng.htm>

⁶ <http://www.rcmp-grc.gc.ca/ce-da/tobac-tabac/index-eng.htm>

⁷ <http://theacsa.ca/2016/convenience-store-retailers-support-crackdown-on-illegal-tobacco-sales-in-new-brunswick/>

⁸ <http://theacsa.ca/2016/illegal-cigarette-sales-in-nova-scotia-too-high/>

⁹ <http://www.southerngazette.ca/news/local/2016/11/29/illegal-cigarettes-still-common-in-n-l-.html>

¹⁰ <http://www.cbc.ca/news/canada/newfoundland-labrador/illegal-cigarette-butts-1.3258275>

¹¹ <http://ontariocstores.ca/contraband-tobacco-usage-rises-even-higher-in-2016/>

¹² <http://www.newswire.ca/news-releases/average-of-1-in-3-cigarettes-sold-in-ontario-are-contraband-611523745.html>

¹³ <http://www.marketwired.com/press-release/illegal-tobacco-rate-climbs-in-manitoba-2171475.htm>

¹⁴ Ibid.

¹⁵ <http://www.marketwired.com/press-release/saskatchewan-maintains-lowest-illegal-tobacco-rate-2171998.htm>

¹⁶ <http://www.marketwired.com/press-release/saskatchewan-has-lowest-illegal-tobacco-rate-2080317.htm>

¹⁷ <http://www.newstalk770.com/2016/11/03/illegal-tobacco-use-at-over-12-in-alberta-study/>

¹⁸ <http://www.cbc.ca/news/canada/british-columbia/illegal-smokes-a-big-problem-in-b-c-says-study-1.3853311>

The primary drivers of the illegal tobacco trade are: a) a desire by consumers to save money by purchasing much less expensive illicit products, and b) the potential for criminals to make high profits.¹⁹

Taxation drives demand. A carton of legal cigarettes sells for between \$88-135, depending on the Province,²⁰ with taxes representing approximately 70% or more of the price. The same number of illegal cigarettes sells for \$6-45,²¹ with no taxes paid. Meanwhile, there is a heavy supply of illegal tobacco within our national borders, with 50 illegal cigarette factories and approximately 300 smoke shacks located on First Nations territories and organized crime groups distributing the product across Canada.²²

As this system continues to operate outside existing legal, regulatory and tax frameworks, governments are losing tax revenue. A 2016 Macdonald-Laurier Institute report suggests federal and provincial governments lose \$1-3 billion annually in tobacco tax revenues due to contraband.²³

RECOMMENDATIONS

1. Make moderate, predictable, inflation-based tax adjustments on an annual basis rather than in five-year increments.

Tax increases further the price gap between legal and illegal products. Large tax increases over a short time have a noticeable impact on price, causing consumers to switch to lower-cost alternatives. Economist Arthur Laffer has studied tobacco excise policies and documented the impact of tax shocks in countries like Sweden, Ireland and Greece. He found that despite substantial tax increases, smoking rates remained stable but tax revenue declined as consumers switched to the illegal market.²⁴

Based on Laffer's work, ITCAN recommends a tobacco taxation framework that allows for scheduled, moderate and predictable tax increases. The 2014 Budget introduced a formula for tobacco excise based on five-year adjustments tied to inflation. This formula should be amended to allow for yearly adjustments, as the Government has done for alcohol.

¹⁹ <http://www.iticnet.org/images/AIT/English-FirstEd-TheIllicitTradeinTobaccoProductsandHowtoTackleIt.pdf>

²⁰ http://nsra-adnf.ca/wp-content/uploads/2017/07/170701_map_and_table.pdf

²¹ RCMP Illicit Tobacco Strategic Report

²² RCMP testimony to the House of Commons Public Safety Committee, April 27, 2010

²³ <http://www.macdonaldlaurier.ca/files/pdf/MLILeuprechtContrabandPaper-03-16-WebReady.pdf>

²⁴ <http://www.laffercenter.com/laffers-international-tobacco-taxation-handbook-governments-roadmap-optimize-tax-revenues/>

2. Adopt a whole-of-government approach to tobacco control in which taxation, regulation and enforcement are considered in the context of a thriving illegal trade.

a) Pursue federal-provincial coordination on tobacco taxation and enforcement to fight the illegal market.

The Finance Minister has recommended a federal-provincial approach to marijuana taxation on the basis that the overall tax level could prevent consumers from transitioning to the legal market. This is a prudent approach when dealing with a product that has a large illegal market. However, the same logic is absent when it comes to tobacco, even though prices for illegal tobacco are a fraction of that for legal tobacco.

Federal and provincial governments should develop tobacco taxes in the same coordinated fashion so as to undermine the illegal tobacco market. For the Government to truly address the threat of illegal tobacco and organized crime, it should apply its logic consistently.

At the same time, Federal and provincial governments should work together to overcome the weak enforcement of existing regulations. The lack of enforcement has been blamed on jurisdictional issues, scarce resources, legislative gaps, the difficulty of detection and lenient penalties.²⁵

When resources are dedicated to fighting contraband, such as in Quebec, the investment pays for itself via fines, seizures and increased tax revenue.²⁶ For example, the Province's Accès Tabac program received \$18 million in 2014-15. According to Government estimates, Quebec's annual revenue losses due to illegal tobacco dropped from over \$305 million annually to roughly \$125 million.²⁷ In other words, the Province gained \$180 million in annual revenue from an \$18 million annual investment.

b) Establish a Federal-Provincial-First Nations task force to address illegal tobacco manufacturing, sales and trafficking, with meaningful input from law enforcement and the tobacco industry.

There are jurisdictional concerns and political sensitivities in addressing the illegal manufacture and sale of tobacco. It is therefore recommended that a joint task force be formed to reinvigorate an evidence-based discussion on solutions.

²⁵ <http://www.macdonaldlaurier.ca/files/pdf/MLILEuprechtContrabandPaper-03-16-WebReady.pdf>

²⁶ <http://www.macdonaldlaurier.ca/files/pdf/MLILEuprechtContrabandPaper-03-16-WebReady.pdf>

²⁷ See the 2014-15 Quebec Budget.

3. Reconsider plans for plain and standardized packaging for tobacco products to prevent counterfeiting and address the Government's policy inconsistency between tobacco and marijuana.

The Government has introduced legislation (Bill S-5) to allow for plain and standardized packaging of tobacco products. This offers illicit traders a golden opportunity to counterfeit legitimate manufacturers' products as it effectively provides a mandated "template" for packaging, making it exceedingly easy to reproduce packaging identical to that of legal tobacco products.

Health Canada is also leaning towards the standardization of cigarettes – banning any slight variations that would allow legal tobacco companies to differentiate their products from one another or from illegal counterparts. A regime which requires all cigarette packages and cigarettes to look exactly the same will make it very difficult, if not impossible, for consumers, retailers and law enforcement to differentiate between legal and contraband or counterfeit products.

Health Canada has argued that federal excise stamps will allow for differentiation. However, ITCAN has provided the Government with overwhelming evidence that the federal excise stamping system has already been compromised, with legitimate federal stamps routinely appearing on illegal packs and baggies of cigarettes.

Meanwhile, the Government's marijuana legislation (Bill C-45) does not mandate plain packaging, despite studies that show youth usage rates for marijuana are much higher than tobacco. For example, the 2014-15 Canadian Student Tobacco, Alcohol and Drugs Survey found that the percentage of youth who were daily or occasional smokers is at a record low of 3% whereas 17% had used cannabis in the past year.²⁸ The Canadian Centre on Substance Abuse has found that as many as 10% of Grade 12 students smoke marijuana daily.²⁹

If the goal with both marijuana and tobacco legislation is to protect youth, how can two legislative frameworks for products that both carry known health risks have the same stated goal yet vastly different approaches?

No explanation has been offered for this policy inconsistency, but it has been well-documented that the marijuana industry lobbied against plain packaging, stating it needs branding to draw consumers away from the illegal market. The tobacco industry has made the same argument and has clearly demonstrated that forcing all products into plain and standardized packages is a gift to the organized crime groups behind the illegal tobacco trade, but has been ignored.

²⁸ <http://healthycanadians.gc.ca/science-research-sciences-recherches/data-donnees/cstads-ectade/summary-sommaire-2014-15-eng.php>

²⁹ <https://www.theglobeandmail.com/life/health-and-fitness/health/your-kids-brain-on-pot-the-real-effects-of-marijuana-on-teens/article21127612/>

CONCLUSION

Governments need to recognize the realities of Canada's illegal tobacco trade in the development of policy. Higher taxes, plain and standardized packaging and further regulation significantly undermine the legal industry's ability to compete with the illicit market. This is costing billions in lost tax revenue while enriching organized crime. The Government recognizes this for marijuana and seems to be taking a sensible approach. The same logic should be applied to tobacco.