



Pre-Budget Submission
to the House of Commons Finance Committee

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Introduction

Canada has a significant contraband tobacco problem, with a May 2015 report from KPMG evaluating Canada's contraband rate at 18%. Particularly troubling was the revelation that Ontario's contraband market is the second largest in the Americas at 31%, trailing only Panama and on par with El Salvador.¹

Contraband tobacco is a drain on Canada's fiscal performance, with upwards of \$2 billion in lost tax revenue to the Federal and Provincial Governments annually.² The federal portion is in excess of \$600 million each year.³ Since 2006, Governments have lost \$16 billion or more.⁴

We offer five recommendations to contain and then reduce contraband, none of which involve significant financial commitments. In fact, they should generate additional revenue.

About Imperial Tobacco Canada Limited (ITCAN)

Established in 1908, ITCAN is Canada's leading tobacco company, is headquartered in Montreal and employs approximately 500 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.

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

Canada's Illegal Tobacco Crisis

Since 2006, illegal tobacco has made up between 16.5% and 32.7% of Canadian tobacco sales depending on the year.⁶ The RCMP reports there are 50 illegal cigarette factories and over 300 smoke shacks located on First Nations territories, selling tobacco outside existing legal, regulatory and tax frameworks, and more than 175 groups tied to organized crime that are profiting handsomely from illegal tobacco.⁷ Federal and Provincial Governments lose up to \$2 billion in tax revenue annually to the illegal trade.⁸

¹ *Project Frost, KPMG, May 27, 2015*

² *Estimate based on federal and provincial contraband levels and projected tobacco tax revenues in budget documents.*

³ *Based on a national contraband rate of 20% and projected federal tobacco excise revenues of \$3 billion.*

⁴ *Estimate based on average losses of \$1.5-2 billion a year since 2006.*

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

⁶ *Illicit usage of cigarettes – national study for the CTMC, GFK Research Dynamics, 2007, 2008, 2010*

⁷ *RCMP testimony to the House of Commons Public Safety and National Security Committee, April 27, 2010*

⁸ *See note #2.*

The problem is truly national in scope.

- In October 2015 the Atlantic Convenience Stores Association (ACSA) released data for Newfoundland and Labrador assessing the contraband rate at 10%.⁹
- The latest ACSA survey in Nova Scotia showed a continued upward trend in contraband, with rates rising from 14% in 2013 to a record high of 22% in 2015.¹⁰
- In New Brunswick contraband rates have jumped from 15.7% in 2013 to 24% in 2015,¹¹ again the highest rates ever recorded.
- In 2015 the Quebec Convenience Stores Association released data assessing the contraband rate at 16%.¹²
- In December 2014 the National Coalition Against Contraband Tobacco assessed the contraband rate in Ontario at 40%.¹³
- A November 2015 press release from the Western Convenience Stores Association (WCSA) evaluated the contraband rate in Manitoba at 13%.¹⁴
- In October 2015 the WCSA assessed the contraband rate in Alberta at 10% for the second year in a row, again representing the highest rate recorded.¹⁵
- In December 2015 the WCSA pegged the contraband rate in Saskatchewan at 9.5%.¹⁶
- In October 2015 the WCSA assessed the contraband rate in British Columbia to be 15%, a near record high.¹⁷

The problem, therefore, is undeniable and stretches from coast-to-coast. Let us now turn to solutions.

Recommendations

AVOID TAX SHOCKS

The primary drivers of the illicit tobacco trade are: a) a desire by consumers to save money by willingly purchasing much less expensive illicit products, and b) the potential for criminals to make high profits.¹⁸ In other words, supply and demand.

Taxation drives demand. A carton of legal cigarettes sells for between \$85-125, depending on the Province,¹⁹ with taxes usually making up 75% or more of the price. According to the RCMP,

⁹ See <http://www.cbc.ca/news/canada/newfoundland-labrador/illegal-cigarette-butts-1.3258275>

¹⁰ More than 20% of cigarette butts found at four NS high schools illegal product, press release from the Atlantic Convenience Stores Association, October 29, 2015

¹¹ <http://atlantic.ctvnews.ca/n-b-convenience-store-owners-want-crackdown-on-illegal-smoke-sales-1.2459278>

¹² <http://www.newswire.ca/fr/news-releases/a-16--la-contrebande-de-tabac-persiste-et-surtout-revient-en-force-dans-plusieurs-ecoles-du-quebec-518562991.html>

¹³ http://stopcontrabandtobacco.ca/wp-content/uploads/2014/12/NCACT_CONTRABANDMONITOR_2014-11_ONTARIO_ForPR.pdf

¹⁴ <http://www.marketwired.com/press-release/illegal-tobacco-widely-available-across-manitoba-2074601.htm>

¹⁵ <http://www.marketwired.com/press-release/illegal-tobacco-rate-remains-98-in-alberta-2064242.htm>

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

¹⁷ <http://www.marketwired.com/press-release/bc-illegal-tobacco-rate-remains-highest-in-western-canada-2068178.htm>

¹⁸ <http://www.iticnet.org/images/AIT/English-FirstEd-TheIllicitTradeinTobaccoProductsandHowtoTackleIt.pdf>

the same number of illegal cigarettes sells for between \$6-45,²⁰ with no taxes paid. The supply is driven by the illegal factories and smoke shacks and the criminal organizations trafficking contraband across Canada, and that supply is virtually limitless.

The incentive to turn to contraband tobacco is exacerbated by tax shocks that further the price gap between legal and illegal products. When taxes are increased by a significant amount over a short time it has a noticeable impact on price, which prompts smokers to consider lower-cost alternatives. Tax shocks destabilize the market and create new consumer demand that can then be exploited by criminals supplying illegal tobacco products.

Our position regarding tobacco taxation is premised on the work of renowned economist Dr. Arthur Laffer, who has studied tobacco excise policies globally and documented the impact of tax shocks in countries like Sweden, Ireland and Greece. In each case, despite substantial tax increases, smoking rates remained stable but tax revenue declined as consumers switched to the black market.²¹ Building on that work, we are proposing a tobacco taxation framework that allows for scheduled and moderate increases, as has been implemented effectively in countries like Germany.

***Recommendation #1:** Avoiding further tax shocks is critical to ensure contraband levels do not increase. The 2014 Budget introduced a new forward looking formula for tobacco excise based on five-year adjustments tied to inflation. This policy should be honoured, but adapted should inflation increase disproportionately. If inflation remains low and this policy is maintained, the Government will be in a position to avoid the excise shocks that drive the illicit industry.*

AUDIT THE TOBACCO STAMPING REGIME

As evidenced by the photos below, a disturbing trend can be seen in the contraband marketplace: federal excise stamps on illicit cigarettes. In no way, shape or form do the baggies of cigarettes shown below meet the labelling, packaging and information requirements explicitly set out in the *Tobacco Act* and other federal legislation, yet baggies like these are being found with legitimate federal tax stamps.

¹⁹ See https://www.nhra-adnf.ca/cms/file/files/140605_map_and_table.pdf

²⁰ RCMP Illicit Tobacco Strategic Report

²¹ See <http://www.laffercenter.com/laffers-international-tobacco-taxation-handbook-governments-roadmap-optimize-tax-revenues/>



When the tobacco stamp system was launched it was framed as a means to allow law enforcement and the public “to more easily detect and respond to counterfeit and illicit tobacco products.”²² The Canada Revenue Agency said the stamps are designed “to enhance the integrity of the tobacco tax system and to combat the contraband tobacco market.”²³

The presence of a tobacco stamp on packaging leads consumers to believe that the purchase is perfectly legal. The fact that stamps are appearing on baggies suggests a complete audit of the regime is required. A pack of cigarettes that does not meet Health Canada or other federal tobacco labelling requirements is not legal and should not bear a federal tax stamp.

Recommendation #2: Launch an audit of the federal tobacco excise stamping program to determine how tobacco tax stamps are being found on clearly illegal tobacco products.

PUBLIC AWARENESS CAMPAIGN

The Government should invest in a public awareness campaign informing the population of how to identify contraband tobacco and highlighting its links to organized crime, the lack of any quality or safety monitoring, the penalties for its use and the costs to the economy. A significant number of smokers who purchase contraband may cease doing so if made aware of these factors.

Recommendation #3: Invest in a public education campaign regarding how to identify contraband tobacco and the social and economic consequences of purchasing the same.

²² <http://www.cra-arc.gc.ca/nwsrm/rlss/2009/m09/nr090914b-eng.html>

²³ <http://www.cra-arc.gc.ca/nwsrm/ftshts/2009/m09/fs090914b-eng.html>

WHOLE OF GOVERNMENT APPROACH

One of the primary challenges in the battle against contraband is a lack of coordination across Government regarding tobacco policy decisions. For example, new enforcement measures may be put in place, but before they are given a chance to work a tobacco tax shock is imposed, thereby stimulating further demand for contraband.

In another example, some provinces have banned menthol cigarettes, which represent about 5% of the market. In doing so, these provinces handed a monopoly on menthol cigarettes to the illegal operators – and we are now aware of at least 35 contraband menthol brands in Canada, which is approximately double the number of legal ones. There are also issues around tobacco growers becoming licensed wholesalers for their own crop, greatly increasing the risk that raw leaf flows into the illegal market.²⁴

Tobacco policies cannot be made in a vacuum and must take contraband realities into account. This is a critical consideration for the Federal Government given its stated intent to implement plain packaging for tobacco products. There are at least two reasons for this. First, as detailed previously, there are already significant problems with the federal tobacco excise stamping regime, with stamps appearing on clearly illegal products. If all legal products are forced to look the same, it will be much easier for the illegal operators to sow further consumer confusion regarding what is versus what is not an illegal product.

Second, Australia is the only country in the world with plain packaging in effect, and there contraband rates increased by 24% after the policy was implemented, according to KPMG.²⁵ This is a critical consideration since Australia is a relatively isolated market from a contraband perspective when compared to Canada. With the existing illegal supply in Canada, plain packaging could well open the floodgates to contraband.

***Recommendation #4:** Adopt a whole of Government approach to contraband, ensuring taxation; enforcement and tobacco control policies are determined taking the issue of contraband into consideration.*

CONTRABAND TASK FORCE

The Federal Government and most provinces now recognize that contraband tobacco needs to be addressed. However, there is still a lack of coordination between Governments and with Canada's international partners.

²⁴ CRA enabling illicit tobacco trade, *The Hill Times*, July 13, 2015

²⁵ See

[http://www.bata.com.au/group/sites/bat_9rnflh.nsf/vwPagesWebLive/DO9RNMTE/\\$FILE/medMDA4K5RM.pdf?openelement](http://www.bata.com.au/group/sites/bat_9rnflh.nsf/vwPagesWebLive/DO9RNMTE/$FILE/medMDA4K5RM.pdf?openelement)

For example, some degree of coordination around taxation would be helpful. As a case in point, in February 2014 the Federal and B.C. budgets were tabled a week apart and when considered jointly increased tobacco taxes by \$7.23/carton. The B.C. Finance Minister later conceded that “[A]t the time we finalized and authorized the increase of the provincial tax rate, we did not know that the Federal Government was intending to increase,” with the combined increase described as “a not insignificant amount.”²⁶

There are also practical issues. For example, the 2015 Ontario Budget suggested “examining opportunities to regulate other tobacco product components such as acetate tow, a key component of cigarette filters. This would help reduce the supply of these components to contraband tobacco manufacturers, thereby limiting their production capability.”²⁷ Since acetate tow is for the most part imported, there is an obvious need for federal-provincial coordination.

Likewise, the 50-odd illegal cigarette factories in Canada have to source raw leaf tobacco from somewhere. Some may come from tobacco growers in Ontario, but it is safe to assume the volume required would also necessitate importing raw leaf from the U.S. To what degree, therefore, are Canadian and U.S. law enforcement and border agencies cooperating to track this?

At a broader level, there is a need for greater transparency around efforts to combat contraband. The Federal and Provincial Governments have made a number of commitments, some of which are easily identifiable. However, many tend to be more general, such as increasing enforcement efforts. Therefore, there is a need not just for a federal-provincial task force, but also the establishment and public reporting of identifiable goals and clear measures of progress. If willing partners can be identified, that task force should also include First Nations and U.S. representation.

Recommendation #5: Establish a federal-provincial task force to coordinate anti-contraband tobacco efforts with clear goals and measures of success.

²⁶ British Columbia Hansard, March 13, 2014

²⁷ <http://www.fin.gov.on.ca/en/budget/ontariobudgets/2015/>