



2017 Pre-Budget Submission

House of Commons Finance Committee

August 4, 2016

Executive Summary

Illegal tobacco makes up a sizeable portion of Canadian cigarette sales and the problem is not getting better. In fact, international experience suggests it could get significantly worse if the Government proceeds with plans for plain packaging of tobacco products – meaning billions more in lost tax revenue. That policy needs to be reconsidered.

In addition, the Government needs to fix its tobacco excise stamping regime, which has been compromised, with tax stamps routinely appearing on clearly illegal products.

Other measures that will help fight illegal tobacco include adjusting the formula for tobacco tax increases in the *Excise Act*, and launching a federal-provincial task force to come up with actionable and sustainable solutions to this rampant criminality.

Introduction

Rather than take action to address Canada's significant illegal tobacco problem, the Government is considering policies like plain packaging of tobacco products that threaten to make it much worse.

That will have a significant fiscal impact as illegal tobacco is already costing the Federal and Provincial Governments upwards of \$2 billion annually.¹ The federal portion is around \$600 million each year.² Since 2006, Governments have lost \$16 billion or more.³

Worse still, the Government's stamping regime for tobacco products has been compromised, with federal tobacco excise stamps now routinely appearing on clearly illegal products.

Our submission offers four recommendations to address illegal tobacco which if implemented, should help recoup billions in lost revenue.

About Imperial Tobacco Canada Limited (ITCAN)

Established in 1908, ITCAN is Canada's leading tobacco company, is headquartered in Montreal and 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 that 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 which funds organized crime⁴ – 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.⁵ A 2015 KPMG report measured 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%.⁶

¹ Estimate based on federal and provincial contraband levels and projected tobacco tax revenues in budget documents.

² Based on a national contraband rate of 20% and projected federal tobacco excise revenues of \$3 billion.

³ Estimate based on average losses of \$1.5-2 billion a year since 2006.

⁴ <http://www.rcmp-grc.gc.ca/pubs/tobac-tabac/2012-contr-strat/index-eng.htm>

⁵ Illicit usage of cigarettes – national study for the CTMC, GFK Research Dynamics, 2007, 2008, 2010

⁶ Project Frost, KPMG, May 27, 2015

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 from illegal tobacco.⁷ As stated by the RCMP, “the illegal tobacco trade presents a serious and growing threat to public safety and health,” and “people need to be aware that they are funding criminal activity when they purchase contraband tobacco products.”⁸

The size of the problem and its links to other criminal activity were clearly demonstrated on March 30, when over 700 police officers in Ontario and Quebec conducted 70 raids on a massive illegal tobacco smuggling network, the largest such police operation of its kind in Canadian history. Police forces in South America and Europe were also involved. The details are stark:

- 2,081 tons of raw leaf tobacco was smuggled onto the Kahnawake and Six Nations reserves to supply illegal cigarette manufacturing facilities – enough to manufacture upwards of 2.34 billion cigarettes.
- This one operation represents \$530 million in lost tax revenue.
- Those involved had links to biker gangs and other organized crime groups.
- Along with tobacco, Canadian authorities seized massive quantities of cocaine, methamphetamine, marijuana and Fentanyl.
- Millions in cash was seized, with links to international money laundering.⁹

Were that not bad enough, a recent report from the Macdonald-Laurier Institute suggests this is only the tip of the iceberg, and globally the illegal tobacco trade is linked to the financing of terrorist groups like ISIS.¹⁰

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.¹¹ In other words, supply and demand.

Taxation drives demand. A carton of legal cigarettes sells for between \$88-135, depending on the Province,¹² with taxes usually representing 70% or more of the price. The same number of illegal cigarettes sells for \$6-45,¹³ 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.

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

⁸ <http://www.rcmp-grc.gc.ca/qc/nouv-news/com-rel/2016/03/160317-eng.htm>

⁹ <http://www.cbc.ca/news/canada/montreal/quebec-raids-contraband-tobacco-operation-international-1.3511876>

¹⁰ <http://www.macdonaldlaurier.ca/files/pdf/MLILeuprechtContrabandPaper-03-16-WebReady.pdf>

¹¹ <http://www.iticnet.org/images/AIT/English-FirstEd-TheIllicitTradeinTobaccoProductsandHowtoTackleIt.pdf>

¹² https://www.nusra-adnf.ca/cms/file/files/160704_map_and_table.pdf

¹³ RCMP Illicit Tobacco Strategic Report

The incentive to turn to contraband 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.

Economist Arthur Laffer 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.¹⁴

Building on that work, a tobacco taxation framework that allows for scheduled and moderate annual increases has been successfully implemented in countries like Germany and was introduced in the 2016 Ontario Budget.¹⁵ A variation of that model is also in place federally.

***Recommendation #1:** The 2014 Budget introduced a new formula for tobacco excise based on five-year adjustments tied to inflation. This formula should be amended to allow for yearly increases.*

RECONSIDER PLANS FOR PLAIN PACKAGING

On May 31 the Health Minister launched a consultation regarding plain and standardized packaging of tobacco products. Implementing this policy would be reckless in a market already so permeated by illegal tobacco.

Australia remains the only country with plain packaging in effect, and there contraband rates increased by 24% after the policy was implemented.¹⁶ In fact, Australia had to expand its contraband tobacco task force just six months after the policy's implementation.¹⁷

This situation is likely to be exponentially worse in Canada. Unlike Australia, which is relatively isolated from a contraband perspective, Canada already has significant illegal manufacturing capacity that could supply the entire market many times over.

Furthermore, plain packaging offers illicit traders a golden opportunity to counterfeit legitimate manufacturers' products. It effectively provides a mandated "recipe" for tobacco packaging, making it exceedingly easy to reproduce packaging identical to that of genuine tobacco products.

¹⁴ <http://www.laffercenter.com/laffers-international-tobacco-taxation-handbook-governments-roadmap-optimize-tax-revenues/>

¹⁵ <http://www.fin.gov.on.ca/publication/tobacco-tax-rate-increases-en.pdf>

¹⁶ [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)

¹⁷ <http://www.peterdutton.com.au/Dickson/DicksonNews/tabid/74/articleType/ArticleView/articleId/626/EXPANSION-OF-ABF-TOBACCO-STRIKE-TEAM.aspx>

It is currently difficult for counterfeiters to make passable replicas of legal packages; once standardized, technical barriers to the production of counterfeit packages are removed. In such an environment, it will be very difficult, if not impossible, for consumers, retailers and law enforcement to differentiate between legal and counterfeit products.

In short, plain packaging could very well open the floodgates to contraband. A 24% increase in contraband here would mean another \$480 million in lost federal and provincial tax revenue annually.¹⁸

Finally, there is no evidence to suggest plain packaging is effective. Looking again at Australia, a report from SLG Economics, using primarily Government data and that from tobacco control groups, found the following two and a half years after implementation of plain packaging:

- “... there is a significant body of evidence to show that plain packaging did not achieve its objectives.”
- Data from the Australian National Drug Strategy Household Survey (ANDSHS) shows “there has been no significant effect on daily smoking from the introduction of plain packaging in Australia.”
- Meanwhile, the ANDSHS found the percentage of 12-17 year olds who smoked on a daily basis increased from 2.5% to 3.4%, suggesting there is no validity to the claim plain packaging leads to fewer adolescents taking up smoking.¹⁹

Consider also that Australia, with plain packaging, has a smoking rate of 13.3%.²⁰ British Columbia, without it, has a smoking rate of 11%.²¹ Would it not be more productive to investigate how B.C. achieved such a low smoking rate without a costly plain packaging policy?

Recommendation #2: Reconsider plans to implement plain packaging of tobacco products to allow for some degree of branding to differentiate legal from illegal products.

REVIEW THE TOBACCO EXCISE STAMPING REGIME

As evidenced by the photos below, a disturbing trend can be seen in the contraband marketplace: federal excise stamps on illicit packages of cigarettes. In no way do these baggies of cigarettes meet the labelling and packaging requirements explicitly set out in federal legislation, yet they are being found with legitimate federal tax stamps.

¹⁸ Using the estimate of \$2 billion in lost federal and provincial tax revenue now.

¹⁹ AIHW 2014, National Drug Strategy Household Survey detailed report: 2013, Drug statistics series no. 28, page 21.

²⁰ <http://www.health.gov.au/internet/main/publishing.nsf/content/tobacco-kff>

²¹ <http://healthycanadians.gc.ca/science-research-sciences-recherches/data-donnees/ctads-ectad/summary-sommaire-2013-eng.php>



When the stamping 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 stamping system has clearly been compromised and the presence of a tobacco stamp on packaging leads consumers to believe that the purchase is legal and from a legitimate source. The fact stamps are appearing on baggies suggests a complete review of the regime is required.

ITCAN has raised this issue with multiple departments for four years and still no explanation has been offered. It has taken on even greater importance given the Government’s plans to introduce plain packaging. At present, legal brands can at least be identified via their packaging. In a plain pack environment it will be impossible for consumers, retailers and law enforcement to tell a legal from an illegal pack if stamps are still making their way onto illegal products, greatly increasing the risk of the Canadian market being overrun with contraband and counterfeit.

Recommendation #3: Launch a review of the federal tobacco excise stamping program to determine how tobacco tax stamps are being found on clearly illegal products.

²² <http://www.marketwired.com/press-release/new-tobacco-excise-stamp-on-cigarette-packages-one-step-closer-against-tobacco-contraband-1044340.htm>

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

NATIONAL ANTI-CONTRABAND TASK FORCE

Most provinces now recognize that illegal tobacco needs to be addressed. However, federal leadership and national coordination are missing.

There is a need for a federal-provincial-First Nations task force to fight illegal tobacco. That should include law enforcement agencies and, if possible, U.S. representation. This task force should focus on identifying actionable, sustainable solutions to eradicate the illegal production and distribution of tobacco across Canada and to international markets, with clearly defined goals and public reporting on progress.

Finally, governments cannot continue to make tobacco control policies in a vacuum, as is being done now with plain packaging. Implementing that policy without first addressing illegal tobacco and the problems with Canada's stamping regime is reckless. This silo approach to policy-making has to end for Canada to ever make significant progress in reducing illegal tobacco levels and recouping the billions in lost revenue now flowing to organized crime.

Recommendation #4: *Establish a federal-provincial task force to coordinate anti-contraband tobacco efforts with clear goals and measures of success, and consider contraband realities when making tobacco control policy.*