



**Pre-Budget Submission to the
House of Commons Finance Committee**

August 6, 2014

Executive Summary

Governments have lost billions to the contraband tobacco trade and continue to lose more as the RCMP sounds the alarm over the links between this activity and organized crime.

Illegal tobacco is driven by supply and demand, with consumers seeking cheaper alternatives due to high taxation and criminals providing the supply through dozens of illegal cigarette factories and hundreds of First Nations “smoke shacks.” Contraband is a truly national problem, with British Columbia the latest province to see a surge in illegal activity.

Avoiding further tax shocks is critical to ensure contraband does not worsen. The 2014 Budget offered hope, with a new forward looking formula for tobacco excise adjustments. This policy needs to be honoured, but adapted should inflation increase disproportionately, as do past contraband commitments around enforcement. However, a long-term solution requires addressing the illegal factories and smoke shacks supplying the market demand.

Introduction

Contraband tobacco remains a drain on Canada's fiscal performance, with upwards of \$2 billion in lost tax revenue to the federal and provincial governments annually.¹ The federal portion is upwards of \$750 million each year.² Since 2006, governments have lost \$15 billion or more.³

The Government has recognized the problem and taken initial steps to address it. The introduction of Bill C-10, *An Act to amend the Criminal Code (trafficking in contraband tobacco)*, should help. Also, if honoured, a new tobacco excise plan announced in Budget 2014 should help prevent the market shocks that are so beneficial to the illegal operators – provided the inflation rate remains low. Likewise, new resources for contraband enforcement pledged in Budget 2014 are welcome.

However, meaningful success requires a long-term commitment to these measures and our recommendations are built around that. The most critical is avoiding further tax shocks, with the latest evidence from British Columbia providing a new case study on how to create a contraband problem virtually overnight.

About Imperial Tobacco Canada Limited (ITCAN)

Established in 1908, ITCAN is Canada's leading tobacco company, offering brands like du MAURIER, Player's, Peter Jackson and Vogue to over five million adult Canadians who choose to smoke. ITCAN is headquartered in Montreal and employs 600 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 taken over 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 the Canadian market depending on the year.⁵ The RCMP reports there are 50 illegal cigarette factories and over 300 smoke shacks located on First Nations territory selling tobacco outside any legal, regulatory or tax framework, and more than 175 groups tied to organized crime that are profiting handsomely

¹ Estimate based on the level of illicit trade in 2010 from GFK Research and PTT Revenue is sourced from the Government budget documents (government Year-end March 31st, 2010).

² See #1.

³ Estimate based on average losses of \$1.5-2 billion a year since 2006, which is a conservative estimate since losses were pegged at \$2.4 billion in 2008.

⁴ 2013 RCMP Illicit Tobacco Strategic Report.

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

from illegal tobacco.⁶ Federal and Provincial Governments lose over \$2 billion in tax revenue annually to the illegal trade.⁷

The 2013 RCMP *Illicit Tobacco Strategic Report* highlighted the alarming nature of the contraband trade, stating that organized crime is exploiting First Nations reserves and that “some owners and operators of tobacco manufacturing facilities are either members of, or associates of, organized crime groups.” The report notes at least 20 First Nations manufacturers are associated with organized crime groups.⁸ As an example of that, a police operation in May shut down a tobacco smuggling operation involving the Italian mafia and members of the Akwesasne Reserve. As is common in these operations, drugs and guns were also involved.⁹

To put the size of the trade in perspective, consider that the Six Nations Reserve is believed to be transporting \$500 million of tobacco out of the community each month and reportedly has 200 acres of “unregulated” tobacco crops.¹⁰ Using last year’s yields as the benchmark, 200 acres generates enough raw leaf to produce at least 200 million cigarettes, or over \$21 million in lost federal revenue. There is also the example of the Kahnawake Reserve, where the RCMP identified \$100 million in suspicious transactions between 2006 and 2012.¹¹

The challenge is perhaps best summed up by the fact the RCMP identified “officer safety” as the primary concern in trying to deal with contraband, stating “the violence and associated criminality of the tobacco trade has compromised the safety of both the general public and police officers.”¹² There is far more at stake here than just lost tax revenue. Illegal tobacco seems to be big business for organized crime and a major threat to public safety.

Economics 101: Supply and Demand

The primary drivers of the illicit tobacco trade are: a) a desire by consumers to save money by willingly purchasing cheaper illicit products, and b) the potential for criminals to make high profits.¹³ In other words, supply and demand.

Taxation drives demand. A carton of legal cigarettes sells for between \$85-125, depending on the Province,¹⁴ with taxes usually making up 75% or more of the price. The RCMP pegs the same number of illegal cigarettes between \$6-45,¹⁵ with no taxes paid.

⁶ RCMP testimony to the House Public Safety and National Security Committee, April 27, 2010

⁷ See note #1.

⁸ RCMP *Illicit Tobacco Strategic Report*

⁹ See <http://aptn.ca/news/2014/05/01/weapons-found-home-akwesasne-man-strip-club-owner-caught-sq-tobacco-operation/>

¹⁰ RCMP *Illicit Tobacco Strategic Report*

¹¹ *Ibid.*

¹² *Ibid.*

¹³ *The Illicit Trade in Tobacco Products and How to Tackle It*, International tax and Investment Center, 2010

¹⁴ See https://www.nsr-a-dnf.ca/cms/file/files/140605_map_and_table.pdf

¹⁵ RCMP *Illicit Tobacco Strategic Report*

A Fraser Institute report found that high taxes “create powerful incentives to buy and sell contraband tobacco products.”¹⁶ This was confirmed by the C.D. Howe Institute, which noted a direct link between the substantial increase in tobacco taxes during the 2000-05 period and the growth of illicit supply from First Nations reserves.¹⁷

The supply side is driven by the illegal factories and smoke shacks and the criminal organizations trafficking that contraband tobacco across Canada. The supply of contraband is virtually limitless. Consider that our company has a roughly 50% share of the legal market in Canada. To supply that, we use 24 different cigarette manufacturing machines (to varying degrees). If each of Canada’s 50 illegal factories had only one machine, they could supply the Canadian market many times over – and we suspect many have multiple, highly sophisticated machines.

Contraband is made worse by tax shocks that further the price gap between legal and illegal products. When taxes are increased by a significant amount overnight, it has a noticeable impact on price, with smokers prompted to consider lower cost alternatives. Tax shocks destabilize the market and create new consumer demand that can then be exploited by criminals operating on the supply side. Canada has seen a number of such shocks in recent years, including the 2014 Budget and its \$4.03/carton tax increase. That followed a host of provincial tax hikes that have dramatically increased legal prices.

Province/Territory	Federal and Provincial Tobacco Tax Increases Since January 2011 (per carton)
Newfoundland and Labrador	\$13.03 (+24%)
Prince Edward Island	\$5.03-7.03 (+7%)
Nova Scotia	\$8.03 (+13%)
New Brunswick	\$18.53 (+46%)
Quebec	\$12.63 (+25%)
Ontario	\$7.28 (+17%)
Manitoba	\$21.03 (+36%)
Saskatchewan	\$12.03 (+20%)
Alberta	\$4.03 (+7%)
British Columbia	\$9.23 (+27%)

¹⁶ [http://www.fraserinstitute.org/uploadedFiles/fraser-ca/Content/research-news/research/publications/contraband-tobacco-in-canada\(1\).Pdf](http://www.fraserinstitute.org/uploadedFiles/fraser-ca/Content/research-news/research/publications/contraband-tobacco-in-canada(1).Pdf)

¹⁷ http://www.cdhowe.org/pdf/Commentary_350.pdf

Yukon	\$4.03 (+7%)
Northwest Territories	\$6.43 (+9%)
Nunavut	\$12.03 (+20%)

Keep in mind the RCMP report that suggests the illegal equivalent of a carton will sell for as little as \$6 and the consumer motivation on the demand side becomes readily apparent. In fact, since January 2011, all but two jurisdictions have seen a tax increase bigger than the total price paid for an illegal carton.

British Columbia is the new case study on how to create a contraband problem. When illegal tobacco emerged as a major threat around 2006, B.C. was largely immune. For example, when illegal tobacco hit levels of 48% in Ontario and 40% in Quebec in 2008, B.C.'s rate was only 3.7%.¹⁸ A 2010 study put the rate around 5%¹⁹ – still well below that seen in provinces with a major contraband problem.

However, effective October 1, 2013, B.C. increased its tobacco tax by \$2/carton. The February 2014 provincial budget added another \$3.20/carton increase. A week later the Federal Government increased its tobacco tax by \$4.03/carton. The net impact was a \$9.23/carton tax increase over five months.

The resulting market impact has been stunning. In a recent survey conducted by the Western Convenience Stores Association, the average rate of illegal tobacco use in B.C. is now 17%. Some locations had contraband rates over 50%.²⁰ This case study should dispel any doubts that tax shocks lead to increased contraband activity.

Finally, the Government should be very concerned with reports suggesting the Kahnawake Mohawk Council is considering its own regulatory regime for tobacco in what appears to be a blatant attempt to undermine the enforcement measures of Bill C-10.²¹ Some First Nations manufacturers already cite compliance with a handful of laws to argue their products are legitimate, even when others are blatantly disregarded. Any Government recognition of self-regulation will make that problem worse, create further consumer confusion and undermine anti-contraband efforts. More importantly, any proposed self-regulation is completely ineffective as long as the tax gap between legal and illegal products remains.

¹⁸ *GFK Research Dynamics, 2008*

¹⁹ *GFK Research Dynamics, 2010*

²⁰ *High Rates of Illegal Tobacco Found in British Columbia Universities and High Schools, Western Convenience Stores Association, July 9, 2014*

²¹ *Kahnawake to regulate its tobacco industry, Montreal Gazette, July 29, 2014*

Recommendations

First, the Government must avoid any further tax shocks like that implemented with the 2014 Budget. Fortunately, that Budget also included a commitment to establish a tobacco excise tax regime in which increases will automatically take effect every five years based on a formula tied to inflation. If inflation remains low and this policy is honoured, the Government will be in a position to avoid the excise shocks that drive the illicit industry.

Second, the Government needs to implement its promised anti-contraband measures. Bill C-10, originally promised in the 2011 election, needs to be passed and implemented as quickly as possible. The money set aside in Budget 2014 for anti-contraband measures should be invested in meaningful initiatives like public education and enhanced enforcement. Also, the details of a 50-person RCMP force dedicated to contraband promised in the 2011 election have not yet been shared.

Finally, a long-term solution requires an honest discussion about how to shut down or bring under the law the 50 illegal cigarette factories and the 300+ smoke shacks on First Nations reserves. If, as indicated by the RCMP, concerns about officer safety are preventing enforcement from taking place, then a broad range of options needs to be considered to restore normalcy to the tobacco market. A federal-provincial-First Nations task force is one potential forum for such a discussion.

Conclusion

The recommendations address three pre-budget goals. First, there are hundreds of millions of dollars of lost tax revenue that could be recouped if contraband was reduced or eliminated, thereby helping balance the budget. Second, if honoured, the 2014 Budget commitment for a new tobacco excise model will improve Canada's taxation regime and prevent the market shocks that give the illegal operators a further competitive advantage, provided inflation remains low. Third, eliminating unfair competition improves the job opportunities for Canadians across a range of sectors tied to the tobacco industry – from farmers to convenience store owners to wholesalers and shippers.