GEORGE MORRIS CENTRE

The Tobacco Industry Exit Debate: Understanding the Broader Policy Context

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1.0 Introduction

The tobacco industry in Canada is experiencing protracted difficulties. To some, this is neither surprising nor consequential. There is a broad recognition of health risks associated with smoking cigarettes and, through an increased focus by Canadian public health officials, apparent smoking rates have declined in Canada. One perception of this is that as tobacco consumption declines, it is appropriate that the Canadian contribution to the smoking problem also decline.

One result of this situation is a loss of production and income by tobacco farmers. Some producers, and their marketing board, are asking for a buy-out of their production quota by government. One school of thought about a buyout follows the foregoing – "you saw where the industry was going, you knew the risk, you chose to buy or hold your quota, so why does the public owe you something for the decisions *you* made?" "Moreover, many of you enjoyed the economic benefits of the quota system for many years and capitalized them into the value of quota. Now you want the public to pay you that value again after already receiving it in the market place. How can that be good public policy?"

However, closer examination of the situation brings out more complexity than first meets the eye. There is a counter argument to those opposed to a bailout: i.e. there are regulatory and public policy factors that go well beyond the appearance of a vested interest looking for a government handout. In addition, the case, while unique, may have implications for other more major policy decisions to come. Hence, its solution may have substantial implications.

The purposes of this paper are to examine the effects of public policy on the tobacco industry and to identify alternate solutions to the problems that now exist, including the proposed exit funding package. Specifically, the paper addresses whether there is basis for financial compensation either because of market or policy failure. Section 2.0 summarizes the current situation. In Section 3.0 the implications of the situation for tobacco producers are addressed. Section 4.0 contains discussion of potential market and policy failure. Section 5.0 considers alternatives and whether there are implications of this situation for the future.

2.0 Current Situation

The current situation facing Ontario tobacco farmers appears bleak.

2.1 Production and Industry Revenue

Figure 2.1 below shows the base crop size negotiated between growers and processors since the late 1980's. The figure shows that tobacco production will be at an historically low level of about 32 million lbs in 2007. This compares to well over 100 million lbs produced as recently as 2002. Figure 2.2 shows that tobacco prices have been increasing. Indeed, since the early 1990's, price increased from under $2/lb to almost $2.28/lb in the current year[2]. However, the decline in volume swamped the increase in price. This is shown clearly in Figure 2.3, which plots Ontario production of tobacco against total farm value. The figure shows that, as recently as 2001, total value was more than $250 million, but then it fell by almost half.

2.2 Imports of Tobacco and Cigarettes

Broadly speaking, the decline in production and revenue in Figures 2.1 and 2.3 are due to increases in Canadian imports of tobacco, both in terms of legal and illicit imports. A second cause is a material increase in the production and importation of illegal tobacco products. And a third is that one of the three major manufacturers closed its Canadian operations. Each of these is addressed below.

Data on legal imports of leaf tobacco are presented in Table 2.1 below. The table shows that tobacco imports tripled in the period 2001 to 2005 before slowing in 2006. However, in view of the sharply decreasing domestic crop, imports increased markedly in terms of market share. Add to the data the fact that one of the three major manufacturers stopped production in Canada after 2005. This is the major reason for the drop in leaf imports in 2006. Of course leaf imports were replaced by cigarette imports in that year. So, the leaf import data do not tell the whole story.

By definition, data are not available on illicit imports and production of tobacco and cigarettes. However, in a study conducted by GfK Research Dynamics, it was estimated that illicit imports have increased significantly and now represent a material share of the Canadian cigarette market. In their study, "illicit" product was defined as manufacturing and selling cigarettes on which appropriate taxes and duties are not paid. The results of the study, based on consumer market research, suggested that illicit cigarettes made up 16.5% of the Canadian market in 2005-06, and over 20% of the market in Ontario and Quebec. Most of the sales of illicit cigarettes occurred on native reserves or through personal acquaintances; however, more than 20% of sales occurred through conventional retail outlets. At the 2007 annual meeting of the Ontario Tobacco Board the local MP indicated her belief that illicit product has climbed to more than 25% of Canadian consumption this year, resulting in a loss of ***tax revenue*** of over $2 bil/year.

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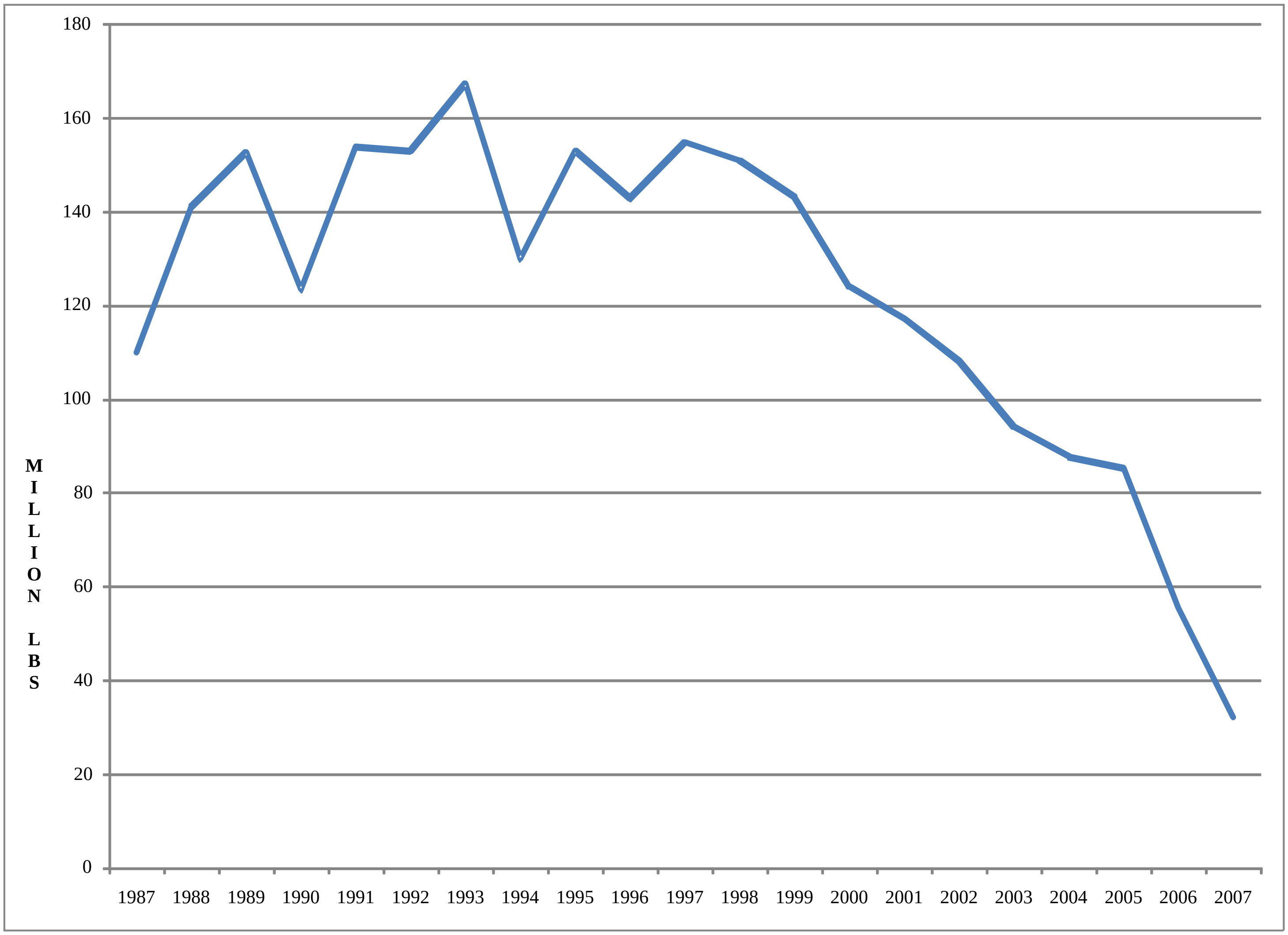
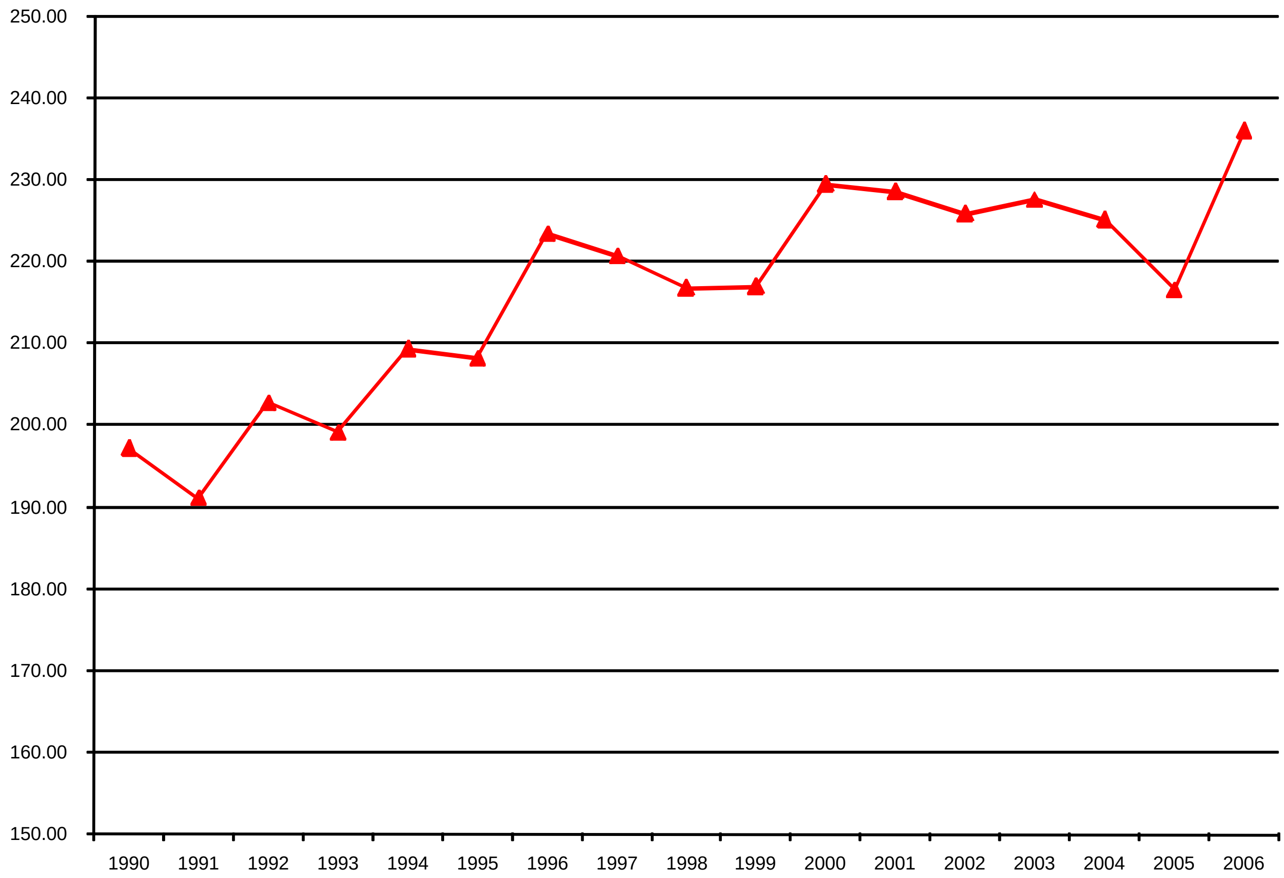
[2] The price increase in 2006 included a one-tine payment to assist producers until an exit strategy could be developed. Prices in 2007 are substantially lower than 2006 and lower than 2002.

Figure 2.1 Ontario Tobacco Negotiated Crop Size



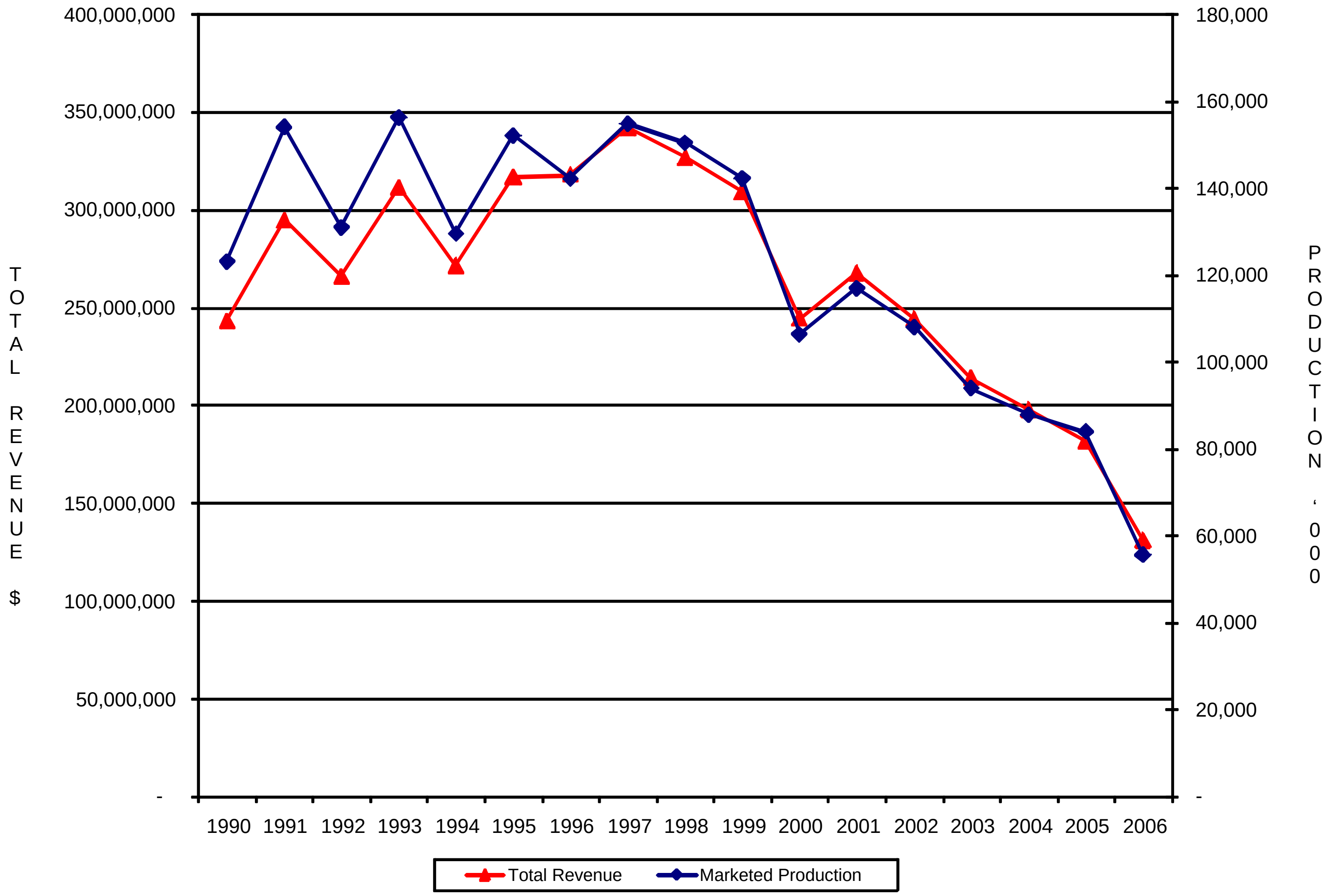
Source: Ontario Flue-Cured Tobacco Growers' Marketing Board

Figure 2.2 Total Price per Lb Marketed



Source: Ontario Ministry of Agriculture, Food, and Rural Affairs and Ontario Flue-Cured Tobacco Growers' Marketing Board

Figure 2.3 Ontario Tobacco Production and Total Revenue



Source: Ontario Ministry of Agriculture, Food, and Rural Affairs and Ontario Flue-Cured Tobacco Growers' Marketing Board

Table 2.1 Tobacco Leaf Imports, Percentage of Domestic Production

	Leaf Imports, Lbs Green	**Imports as % of ON Production**
2001	8,282,570	7.07%
2002	11,803,060	10.92%
2003	11,855,818	12.62%
2004	14,955,978	17.02%
2005	24,681,299	29.42%
2006	10,271,619	18.51%

Source: Statistics Canada and Ontario Flue-Cured Tobacco Growers' Marketing Board

The study also pointed out that illicit cigarettes are not required to comply with Canadian regulations on ingredients, health warnings, emissions information or tax rules, and that illicit cigarettes appear to sell at much lower prices (80-90% less) than conventional product.

2.3 Relationship between Cigarette Sales and Tobacco Production

As part of a general public policy on tobacco, it is useful to understand the relationship between cigarette sales and tobacco production. In particular, if a clear causal relationship can be demonstrated between reduced domestic tobacco production and cigarette sales, then a shrinking tobacco industry could be considered an element of public health policy to reduce smoking.

However, the nature of the actual relationship is inherently one of correlation rather than causation, particularly when the effect of cigarette taxation and illicit product is considered. This is illustrated in Table 2.2 below.

The table shows that legal Canadian cigarette sales increased through the 1990's before decreasing sharply in recent years. Tobacco production largely followed this trend (as a domestically-focused supplier would), but at a more accelerated rate of adjustment. For example, for the period illustrated in the table, cigarette sales reached a maximum in 1998. Since 1998, cigarette sales decreased by about 52%. Over the same period, Ontario tobacco marketings decreased by about 63%. If one takes into account that legal sales are likely only 70 – 75% of actual sales, then it is clear that declining domestic tobacco production is not a strong causal factor in reducing actual cigarette consumption since production is declining much faster than consumption.

Some of the data in Table 2.2 show that sales of legal cigarettes increased in the mid-1990's. This resulted from sharp reductions in federal and provincial taxes, done to curtail smuggling and illicit sales. Subsequently, cigarette taxes were increased substantially and sales of legal cigarettes declined sharply. Since 1998, Ontario cigarette taxes increased 425% and the federal tax more than doubled. Based on these data, legal cigarette sales appear to be influenced significantly by taxes, not just by health concerns. It is unclear that any role is played by the size of the tobacco crop. It is not at all clear that onerous taxes are curtailing consumption, but rather that they are curtailing sales of legal product and producing an apparently profitable black market.

More will be said about this in subsequent sections.

Table 2.2 Canadian Cigarette Sales, ON Tobacco Production, and Cigarette Taxes 1992-2006

	Canadian Cigarette Sales (Thousand Sticks)	ON Tobacco Marketings (Thousand Lbs)	Federal Tax ($/pack of 25)	ON Provincial Tax ($/pack of 25)
1992	35,060,790	131,101	2.35	2.05
1993	30,224,722	156,412	2.35	2.05
1994	45,743,167	129,621	.73-1.36	0.43
1995	45,581,675	152,187	.81-1.36	0.43
1996	47,117,904	142,241	.81-1.36	0.43
1997	45,520,274	154,913	.89-1.36	0.51
1998	45,613,257	150,576	.97-1.36	0.59
1999	45,121,386	142,379	.97-1.36	0.59
2000	43,442,938	106,422	1.05-1.36	0.66
2001	42,300,873	117,094	1.29-1.36	0.91
2002	38,216,735	108,060	1.54	1.12
2003	36,104,864	93,955	2.45-2.58	2.15
2004	34,366,969	87,852	2.48-2.63	2.78
2005	32,720,918	83,905	2.48-2.63	2.93
2006	21,877,562	55,495	2.48-2.63	3.1

Source: Statistics Canada and Ontario Flue-Cured Tobacco Growers' Marketing Board

3.0 Impact on Affected Parties

The impact of all this is severe for tobacco producers, and by extension, on the region of Ontario in which the industry is concentrated. As the size of the market available to domestic growers decreases, the ability to generate earnings against investments in tobacco-specific farm facilities decreases. One way to measure this is to consider utilization of tobacco quota. Figure 3.1 presents historical data on percentage growability – the percentage that producers are allowed to produce - of Basic Production Quota (BPQ) since 2000. In 2000, producers had access to about 38% of BPQ; this has since fallen to just less than 12%. So, as the market adjusted, an individual producer with 1000 lbs of quota is now allowed to produce only 120 lbs. Part of this decline is from the decline in the underlying demand for cigarettes. Part is due to a policy that created a huge black market.

This clearly affects the cost and financial structure of farm businesses: Kilns, harvesters, and other specialized equipment are fixed costs that are difficult to use for other purposes. When a farm can't use them efficiently because production is limited by quota restrictions, the result is higher cost per unit of output. Figure 3.1 also contains an estimated minimum BPQ growability required to cover capital costs and household income of $35,000 (Stiefelmeyer and Mussell, 2004). This level was estimated to be about 45% for a farm with mechanized harvest technology (illustrated in the figure) and 60% for a more labour-intensive harvest system. What this means is that in 2000, BPQ utilization was high enough for a farm with mechanized harvest technology to almost cover the full cost of capital employed and to meet modest household income targets. But the situation has since deteriorated to the point that even farms with mechanized harvesting cannot make anywhere near efficient use of capacity nor cover the costs of capital invested with their own quota. Logically, the broader infrastructure in tobacco processing, handling, and input supply is likely to have suffered a similar fate.

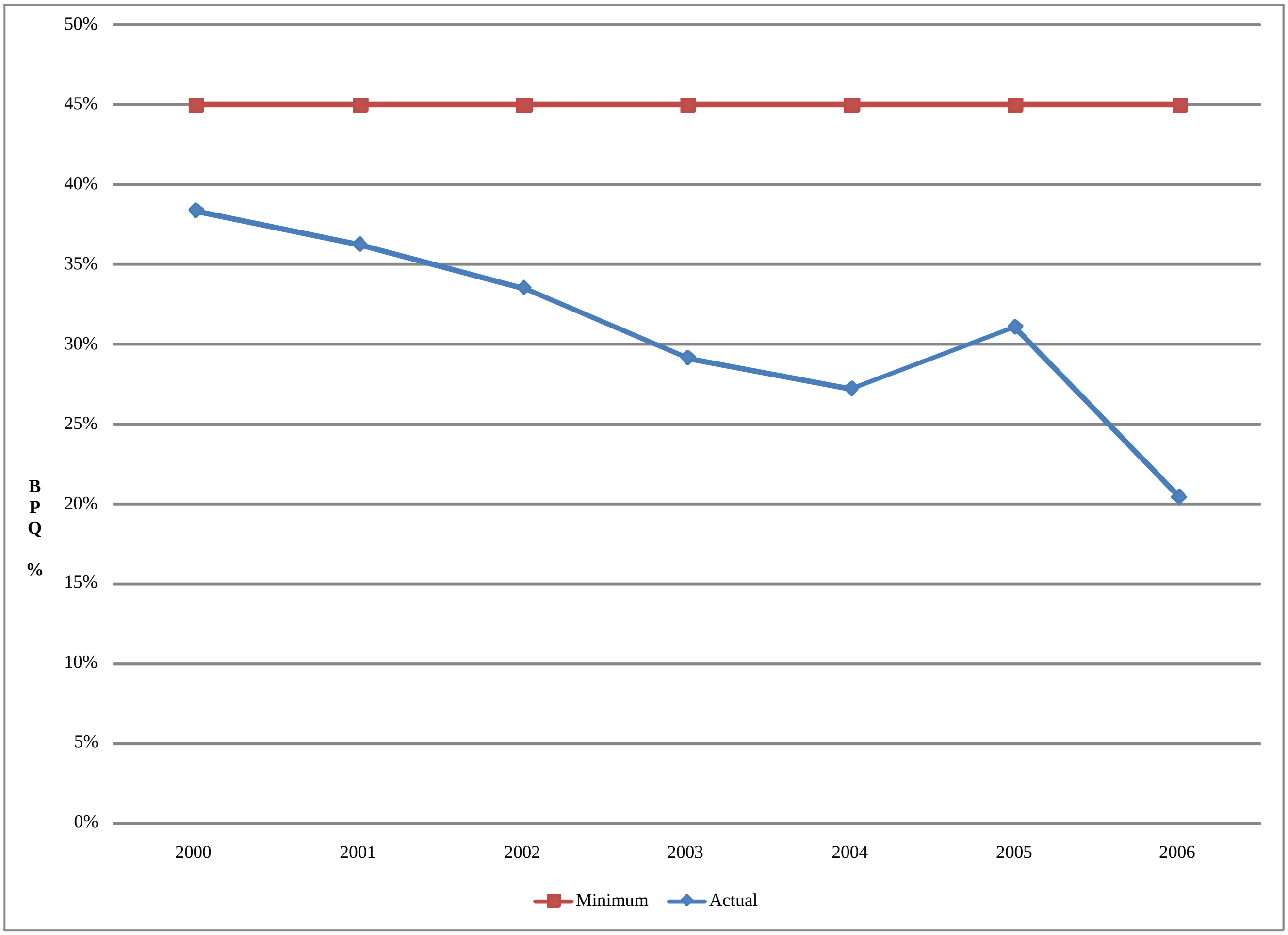
This situation produces a truly bizarre result. As the size of the crop falls, fewer and fewer farmers can actually produce tobacco efficiently. Those who do, try to maintain a level of production that allows them to use their equipment, greenhouses and kilns efficiently. Therefore, they must rent quota from others who don't. As the size of the market shrinks and the portion of BPQ falls, they need to rent more and more BPQ each year to simply produce the same amount of tobacco. Hence their cost of quota rises despite a shrinking market.

This result extends one step farther. Quota is carried as an asset on the balance sheets of quota holders. Financial institutions use a portion of it for security on loans. If it disappears, financial ratios are materially affected and lenders will likely take steps to protect themselves from loan losses. Producers will, therefore, be affected materially by both the loss of production and changes in their financial obligations.

In other contexts, farmers would simply redeploy capital and shift into other crops. However, as scores of studies have shown, this is not easily done in tobacco. First, the investment in tobacco farm equipment tends to be highly specialized and is not easily redeployed for use in other crops. Indeed, as shown by Stiefelmeyer and Mussell, the tobacco market environment in recent years resulted in significant asset devaluation in tobacco farm equipment. Second, tobacco production occurs on sandy soils that are not amenable to switching into alternatives that provide returns comparable to tobacco. Efforts have been ongoing for years to find a suitable successor(s) that can deliver comparable returns to tobacco and at the same time not swamp other crop markets. With some exceptions (notably ginseng and asparagus, with limited markets) this search has been unsuccessful.

Thus, the decline in tobacco production is likely to cause widespread injury to the economies of the very specialized tobacco-producing region in a few counties in Ontario.

Figure 3.1 Actual and Minimum BPQ Estimated by Stiefelmeyer and Mussell (2004)



4.0 Public Policy Role

Not every negative economic outcome justifies public involvement through a bail-out. For example, the development of the automobile did not result in a bailout package for displaced blacksmiths or buggy whip makers. The basic economic concepts relevant in assessing public assistance to a disadvantaged group are that of "market failure" and its converse "policy failure". The idea behind market failure is that factors exist in a market that cause prices not to reflect true economic value, and as a consequence, adjustment according to price signals leads an industry to a negative economic outcome. The idea behind policy failure is that public intervention is enacted in a way that is inconsistent with or has a perverse effect on stated policy goals. Either concept serves as a potential economic basis for public corrective action.

Given the situation described above, both concepts deserve attention. It is difficult to argue that some sort of market failure (buyers and sellers that don't compete with one another, unpriced values, etc.) is the basis for the problems facing the tobacco industry. Indeed, the advocates of a tobacco buyout have not advanced this argument. To the extent that any market failure occurred, the marketing board that used its statutory powers to push for ever-increasing tobacco prices in the face of a declining market and rising import penetration should face criticism. The criticism extends to the fact that the Board seems to have lost all interest in its job of marketing the crop, and become completely focused on the buy-out. But this cannot provide the rationale for government support.

Policy failure deserves attention as a rationale for public action. In this regard, the government's policy regarding taxation, and an inability to enforce its own regulations are at issue.

The objectives of domestic tobacco policy regarding cigarettes are to reduce smoking and to improve public health. These are presented in the *Federal Tobacco Control Strategy* (Health Canada, 2002), which lists four key areas of strategy for tobacco policy:

- Protection
- Prevention
- Cessation
- Harm reduction

According to Health Canada, under the *Protection* strategy, ensuring compliance with federal legislation is a priority**.** The argument is apparently that people will be protected against some aspects of risk if rules are followed Under *Prevention*, Health Canada states that "Health Canada will continue to work with the Department of Finance to ensure that Canada's tobacco product taxation policy is consistent with the government's health objectives". This means that Health Canada apparently believes high taxes prevent people from starting to smoke. *Cessation* is obvious. With regard to *harm reduction*, Health Canada states that it will explore ways to mandate changes to tobacco products that will reduce hazards to health, work in collaboration with other countries to ensure that any changes made to tobacco products *in those countries* will reduce the negative health impacts on the smoker and those exposed to smoke, and aim to reduce the health hazards of tobacco products by ensuring that misleading information is not provided to consumers.

None of these policy objectives is being attained by allowing market penetration of illicit product. Consider the following:

- Punitive taxes are once again creating the perfect elements for a thriving black market.

- The rules are not being enforced. There are reports of several farms (non-quota holders) growing tobacco which have not for many years, and do not now have the infrastructure for planting, harvesting and handling the crop on the farm. There are reports of growers being offered premiums well above market prices to sell tobacco illegally. There are reports of people selling cigarettes originating from the Reserve quite openly in the tobacco area without charging taxes. And there are reports in communities far from the tobacco growing area of illegal cigarette sales in normal retail outlets.

  Hence it is clear that the "black market" has moved well beyond the Reserve. These activities are being carried out in relatively plain sight, but to date only one set of charges is known to have been laid for illegal practices and they are said to be "pending". So, the system levies extraordinarily high taxes against the legitimate industry and, by not enforcing the rules, provides an extremely lucrative market for the illicit industry at relatively low risk.

- The foregoing means that the legitimate industry is contracting at a much higher rate than would be the case absent punitive taxes and if the rules were enforced because substantial demand is being shifted to illicit product. This reduces the opportunity for legitimate producers and legitimate tobacco companies.

- The issue for legitimate producers and manufacturers is not just a demand issue. Because tobacco companies have to compete with un-taxed illicit product, they minimize their cost by using as much imported tobacco in their products as possible.

- Perhaps the most questionable aspect of the failure to enforce the rules is the potential risk to human health. Cigarettes produced illegally are also produced without official health inspection. Packages often do not carry health warnings. An already dangerous product may be made even more so when standards are not met. None of this does anything for protection, prevention, cessation or even harm reduction since little is known about illegal imports.

The Health Canada policy provides the basis for rules with which the domestic industry must comply, and bear the associated costs, while illicit product simply circumvents. This unevenness in application is certainly inconsistent with the public health objectives of stated tobacco policy. Moreover, it creates an incentive to enter the illicit tobacco trade.

As described in the GfK study, it cannot be ignored that native reserves appear to play a central part in the illicit tobacco trade. Federal and provincial governments are engaged in ongoing and highly contentious dialogue with native groups over land claims and a range of other issues. One explanation for the apparent tobacco policy failure is that governments have been unwilling, or do not have the right, to enforce policy on the reserve. If this is true, the mainstream tobacco industry finds itself caught in the middle of a failed policy. The simplest way to solve it is to remove the conditions that make the illegal market profitable.

5.0 Conclusions: Potential Alternatives for the Industry

As things now stand, there are apparently two policy alternatives for the industry. One is to do nothing. This seems to be the present tendency of governments. The second is to accept the proposal for a government buy-out of the remaining quota.

5.1 Another Alternative

Based on the market and policy situations, it would seem that there is at least one more alternative.

There is a certain lack of logic to the argument that quota should be bought out because tobacco farmers' incomes are depressed as a result of a policy failure. Tobacco is a legal product in Canada, and governments collect considerable tax from the legal product. Tobacco farmers, and the region in which the crop is grown, are good at growing it. There are very few good alternatives for farmers in the region. Manufacturers have substantial investment in relatively efficient plants. And there is little evidence to suggest that reducing legal production of tobacco contributes to a reduction of smoking in Canada.

If this was not tobacco, the foregoing scenario would never result in putting an industry out of business. Substitute the words "automobile industry" and assume governments tax domestic cars, thereby giving an advantage to imports, and create a reduction in incomes of domestic manufacturers. Therefore, should governments pay domestic manufacturers to shut down? This is obviously asinine. The alternative would be to stop unfairly taxing the domestic industry and pay compensation for some portion of the income lost through policy failure.

The tobacco producing industry in Canada is the victim of a public health policy failure. A significant portion of the cigarette market is being served by illegal product that circumvents Canadian regulatory oversight with regard to ingredients, labeling, and taxation. Canadian purchasers of illicit product are, thus, left uninformed about the nature of the product they are buying, and lost domestic product volume creates injury to domestic producers. This regulatory failure justifies compensation, and it should be motivated as such.

Hence it makes more sense to propose an alternative in which a portion of the domestic production industry is maintained to supply the domestic and, where feasible, the export markets. The domestic industry would continue to generate economic activity both for itself and the region in which it is located. The alternative would include the following:

- Manufacturers be involved in a portion of compensation payments to producers to safeguard and expand tobacco volumes in their plants
- Health Canada actually adheres to its own policies and enforces its regulations to clamp down on illegal production and sales of cigarettes. If that's not possible, it will be more efficient and effective to once again lower tobacco taxes.
- Tobacco producers be compensated for a reasonable portion of the net income they lost because of the policy failure.
- The marketing system be re-examined from a value chain perspective to determine whether there are ways to drive in value and drive down system costs so that the industry's competitiveness is improved in on-going negotiation processes. This re-examination should address whether there are other end uses for tobacco that are less dangerous to health. If so, a marketing plan should be put in place.

The above components would extend the current discussion to reflect the fact that the tobacco issue is not one of pandering to vested interests; rather, it is a complex public policy issue. By considering the above in addition to alternatives currently on the table, the prospect would exist to decrease the illicit tobacco problem, and put in place measures that could allow the tobacco industry to continue or even grow in some form, thereby mitigating the injury to communities dependent upon tobacco.

5.2 Reality Check – Is It Too Late?

Some will argue that the foregoing proposal is too little too late. The industry has already accepted that it is going to close down, and plans are being made to do so. If that's the case then government and the industry will be left to find a way to close down the quota system. This has rarely been done in the past, although Australia had experience with this some years ago with the dairy industry. Interestingly, that country's approach was to add a temporary consumer tax to milk to compensate producers for the loss of quota. Also of note is that the transformed dairy industry in Australia is now a net exporter since the quota system ended.

If the decision is to close the industry down, it would remain appropriate to use the concept discussed here of compensation from policy choices as the basis for compensating producers. We have no idea what that injury would be. But it is no easier to calculate the value forgone of losing quota. Quota hasn't traded for some time, market conditions have clearly changed since it did, and the current balance sheet values may or may not reflect what it is worth. And whether the intent of policy is to continue the industry at a reduced level of production or to provide an exit strategy, there is too much quota and market forces will devalue it.

Therefore, separating the issue of policy failure from the issue of systemic decline in demand provides an appropriate motivation for compensation. There will be no confusion about whether compensation is for the policy failure or whether society is responsible for compensating investors in quota.

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