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5 Minutes for Business:

New industry, new taxes, new fees: Undermining the fight against the illegal cannabis market

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As of October 17, Canadian adults will be able to legally purchase and consume cannabis for recreational purposes; a year and a half after the federal government introduced its legislation to do so. It will mark the beginning of a fascinating battle between a new regulated industry and the existing illegal market that Canadians are currently turning to for recreational cannabis use.

This illegal market is the reason why the government made Canada the first large developed country to legalize recreational cannabis, seeking to displace illicit sales that profit organized crime to the tune of billions of dollars per year. How much? Statistics Canada reported that in 2015, Canada's illegal cannabis market was worth as much as $6.2 billion, nearly as much as Canada's wine market.

So what are the steps to legalizing a multi-billion-dollar illegal market? Over the last 18 months, federal legislators and civil servants have been establishing a national framework for regulating access to cannabis, which includes rules for cultivation, production, possession and marketing. Meanwhile, provinces and territories have been busy setting the rules for distribution and retail sales. This has been accompanied by a frenzy of private sector activity to supply the legal market with licensed producers, retailers, ancillary businesses and others investing billions of dollars in this new sector.

Some of the factors that will influence how effective Canada's legal cannabis market is at reducing illegal sales include safety, quality, access, supply and branding. Like all markets, one of the biggest factors will be price. As the head of the federal Task Force on Cannabis Legalization and Regulation, Anne McLellan, told Members of Parliament studying the *Cannabis Act*, "Price point here is going to be key in terms of what you see in the illicit market and how effective the legal market is at moving people over."

In late 2017, the federal government reached a cannabis tax revenue sharing agreement with the provinces and territories. On top of sales taxes, the agreement included a cannabis excise or 'sin' tax of 10% of the retail price or $1 per gram—whichever is higher. The 10% tax is expected to raise $300 million annually for the provinces/territories and $100 million annually for the federal government. The agreement projected that including the excise tax, legal recreational cannabis will be priced around $10 a gram.

Only a few months later, Statistics Canada released a survey that found Canadians are currently paying an average of less than $7 a gram for cannabis. One would expect that this data would be a strong signal to policy makers not to propose additional taxes on legal cannabis, which would widen the gulf between legal and illegal market prices. One would be wrong.

Fast forward to this July, when Health Canada proposed four 'cost recovery fees'—otherwise known as user fees—on the industry to recoup the costs the government will incur by regulating the sector. User fees are typically associated with a specific service from the federal government, such is the case with the first three of the proposed fees: an application screening fee, an import/export permit fee and a security screening fee. However, it is the fourth fee that caught the industry's attention, one meant to recover other federal regulatory costs. An annual regulatory fee of 2.3% of gross revenue for licensed producers was proposed, with a 1% fee for micro-cultivators and processors. The proposal is expected to put an additional $100 million into federal coffers every year. No clear policy rationale has been shared with industry for how government determined the 2.3% fee level. The annual regulatory fee proposal also excludes any government service standards despite the legal requirement to do so. This additional tax (which is what the fee is), was also proposed after licensed producers had already negotiated multi-year supply deals with provincial wholesalers based on the previously announced 10% excise tax. On top these taxes and regulatory fees, some provinces are considering additional taxes; Manitoba has proposed an additional 6% social responsibility tax.

As others have warned, high government taxes and fees will hurt legal producers' ability to compete with the illegal market and ultimately hurt Canadians as well, which runs counter to the government's rationale for legalizing cannabis in the first place. The imposition of the 2.3% fee also disregards the hundreds of millions of dollars in tax revenues that will flow to all levels of government from this new multi-billion-dollar industry, that will include new personal income and payroll taxes, corporate income taxes and municipal property taxes. The government would be wise to wait on imposing this new tax until after regulators see how effective Canada's legal market is at displacing the illegal one.

There are other looming policy issues that will influence the effectiveness of breaking up the illegal market. The government of Ontario's recent decision to move from a sparsely populated government-run retail distribution network to a private retail model will increase the reach of the legal market in Canada's largest province. Municipalities across the country will need to deal with the hundreds of unlicensed dispensaries that are operating outside the law to protect retailers who are investing and operating within new provincial rules. The federal government must also move quickly to establish regulations for the recreational production and sale of cannabis edibles, beverages and other products that will remain in the hands of the illicit market after October 17.

As we approach legalization, this new industry is quickly becoming familiar with some of the competitiveness challenges facing other sectors in Canada—namely outdated government thinking on business taxes and fees. Deloitte has forecasted that Canada's cannabis market will be worth up to $7.17 billion in sales next year. To maximize the economic benefits to Canadians of this $7-billion market, governments must create an environment that supports businesses that are playing by the rules, so they can in turn create new jobs and investment, along with the significant tax revenue for governments that will follow.

On September 24 at 8:20 a.m. ET the Canadian Chamber of Commerce will be hosting a panel discussion with some of Canada's leading cannabis companies on the economic development opportunities and policy issues in front of the sector. You can watch a live webcast of the discussion by clicking here.

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