John Ivison: Trudeau’s signature pot legalization is failing on all fronts

Ottawa's attempts to outflank the illicit market has been undermined by the clumsy and unresponsive nature of the tax regime

Published Jul 18, 2024 • Last updated 1 day ago • 5 minute read

Isaac Newton said he lost money on the South Sea Bubble financial collapse because, although he could track the movement of stars, he could not calculate the madness of men.

In Canada, the legalization of cannabis in October 2018, unleashed a mania that has seen nearly 1,000 companies receive federal production licences and retailers open nearly 3,500 stores selling cannabis products across the country. It is a short street indeed that doesn’t have a pot shop on it.

The Cannabis Act was a cornerstone piece of legislation for the Trudeau government — a welcome end to 94 years of failed prohibition and an attempt to make Canada safer by closing down the black market in unregulated pot.

It hasn’t quite worked out that way and now there are dire warnings that the onerous federal regulatory and tax regime is in danger of killing the nascent licensed production market.

Bill Blair, then parliamentary secretary to the justice minister with special responsibility to usher in legalization, said the legislation was an effort to outflank organized crime. “We’ve created competition in the marketplace,” he said.

The reality is that the black market is alive and kicking, accounting for around 35 per cent of sales, according to Statistics Canada, and faces virtually no risk from enforcement. A study by Deloitte suggested that the average price in the illicit market remains 20-per-cent lower than in legal retail stores.

In part, this is because of federal excise taxation.

A Department of Finance backgrounder in 2017 said the tax on cannabis would be kept low “to support the objective of legalization, keeping it out of the hands of youth and profits out of the hands of criminals.”

The federal government said it would cap its tax receipts at $100 million annually, with any excess going to the provinces.

Neither of those promises has been kept. Tax was set at 10 per cent of the value of dried and fresh cannabis plants or seeds, or $1 per gram, whichever was greater. The government originally thought that producers would sell for around $10 a gram, making the $1 per gram levy a reasonable excise duty.

However, the flood of new entrants saw the price producers could offer drop to $3 or $4 a gram, resulting in a 30 to 40-per-cent effective tax rate that does not scale up or down with the selling price.

Toronto-based cannabis producer Organigram is a typical example. In its fiscal year ended last September, it paid $72 million in excise taxes on gross sales of $233 million — an effective excise levy of 30 per cent. That compares to around 23 per cent for cigarettes and 11 per cent for a bottle of Crown Royal at the LCBO. Cannabis companies are also liable for a 2.3-per-cent regulatory fee that is not mirrored in tobacco or alcohol regimes. A study by Ernst and Young said 50 per cent of the price of a basket of legal cannabis products ends up in federal and provincial government coffers.

Producers condemn the excise model as inflexible, unsustainable and illogical.

But from the government's point of view, it makes perfect sense.

The Public Accounts of Canada for 2023 show that total cannabis taxes administered by the federal government topped $1 billion, of which two-thirds went to the provinces and territories. This left Ottawa with three times the $100-million cap it imposed on itself.

Paul McCarthy, the new president of Cannabis Council of Canada, said 40 per cent of all filings from companies seeking protection from creditors to restructure last year came from the cannabis sector. "The regulatory and taxation regime is suffocating this business," he said. "None of this works if the private sector can't be profitable."

The heady days that followed legalization are long gone. Production may have been up to 10 times demand at one point and has now fallen to around two or three times sales, which hit $4.5 billion in 2022. (According to Statistics Canada, 5.6 per cent of Canadians consumed cannabis in 1985; 14.8 percent did so before legalization in 2017 and the number stabilized at 22 percent in 2021).

Producers have been retrenching for the past five years — the amount of indoor growing space has shrunk by one-third from its peak in mid-2020. Last year, Canopy Growth laid off 800 workers and closed its Hershey production facility in Smiths Falls, Ont. Canopy's valuation has plummeted 98 per cent in the past five years. Tilray Brands has been using excess production capacity to grow fruit and vegetables as a "temporary bridge" to profitability.

Without some relief on the excise-tax front, few in the industry will make it to the other side.

The federal finance committee recognized this reality in its pre-budget submission earlier this year, which recommended adjusting the excise duty formula to remove the $1-a-gram stipulation and limit it to 10 per cent of transactions.

That suggestion was ignored by the finance minister, Chrystia Freeland. The prevailing mood in government seems to be to watch even more producers fail, as a way to correct the demand/supply imbalance. But that’s not much of a strategy and could end up creating even more volatility if the whole sector fails.

Freeland’s office appeared to leave the door open to future changes in a statement to National Post. “The government recognizes the need to ensure the existing excise duty framework is fair and as current as possible, including in its application to the cannabis industry,” said Navpreet Chhatwal, Freeland’s communications adviser.

Blair’s pledge on privatization was that public health was the government’s main consideration, not maximizing tax revenue. But the idea that Ottawa could outflank the illicit market has been undermined by the clumsy and unresponsive nature of the tax regime. A simple legislative change would transform the cannabis landscape.