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Thoughts on Licensing Requirements for Tobacco Production

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In 2007, Mussell and Martin wrote about the ongoing problems in the tobacco industry, and concluded that the government's anti-smoking policy is not working since roughly 30% of the cigarettes smoked in Canada are contraband.² High taxation drives consumers to the contraband market, and the government is unable or unwilling to control that contraband market.

The major results of the policy are high cigarette prices, reduced legal tobacco production, and a substantial loss of tax revenue due to ineffective enforcement. Tobacco producers who play by the rules suffer economic injury, which warrants compensation.

After much time, a Federal compensation program was finally announced and is scheduled to be available in March 2009. The program includes ending the quota system for tobacco and replacing it with a licensing concept, i.e. a producer would have to obtain a license to produce tobacco. Current tobacco producers will apparently have the choice of taking the compensation package and leaving production, or obtaining a license and continuing to produce tobacco. So, the details of the licensing allocation system are important for those who have to make a decision. They have not yet been announced.

Once again, government has the opportunity to develop an effective program, or get it wrong, as it did with the current system. Based on preliminary information about how licenses may be allocated, the probability seems high that the wrong choice will again be made.

This paper contains a brief discussion of alternative criteria for distributing licenses to produce tobacco, and their economic and political implications.

A Market with Licensing

Before discussing the alternative methods for licensing it is important to understand certain aspects of the market system, which will emerge after licensing is actualized. It appears the quota system will cease to exist. The licensing system will give license holders the right to produce tobacco. Characteristics of the system include the following:

- No limit. A license will not limit the quantity produced. Rather, it confers on the license holder the right to produce, so whether a license holder produces one pound or 100,000 pounds is not a function of the license. The license is in no way a quota.
- Use it or lose it. If licensees choose not to produce tobacco, those licenses will be null and void.

² Mussell, A. and L. Martin. 2007. The Tobacco Industry Exit Debate: Understanding the Broader Policy Context. <http://www.georgemorris.org/GMC/publications/agriculturalpolicy.aspx?IID=281>

- Non-transferable. Licenses cannot be sold or rented to other producers, so no value will be attached to the license. If a licensed producer stops producing, the license is null and void.
- Enforcement. A federal or combination of federal and provincial agencies will enforce rules associated with the system and with contraband.
- Selling. Currently, it is legal to grow tobacco, but illegal to sell it to unlicensed buyers. It is assumed that this will continue to be the case in the future.

Finally, while it is not likely a rule, it is expected that with licensing, tobacco production will quickly move to contract-type production, similar to other processed horticultural products. This is simply logical, given the market situation. Tobacco production requires many steps from starting plants in greenhouses through transplanting and other costly steps in the process. Legitimate producers do not want to incur these costs without knowing there is a market for their products. At the same time, tobacco manufacturers routinely make decisions about their raw material requirements before production begins. Under the quota system, this was decided as a group. Under a market system subject to the Competition Act, each individual end user would make the decision and manifest it in contracted acreage.

Alternative Requirements for Licenses

The issue with a licensing policy is the rigour of the requirements that must be met to receive one. Based on information to date, the government apparently plans to have few requirements. As stated earlier, the licensee must not have taken the current Federal compensation program (TAP) or have taken the previous Federal/Provincial package (TAAP). The only other requirement appears to be that the licensee must have no record of criminal activity in smuggling or tax evasion.

Additional requirements that should be considered are as follows:

- Must have a contract with a licensed dealer or manufacturer whose products are sold legally and on which taxes are incurred, **and/or**
- Proof of production for legitimate new product research
- Must have access to infrastructure required for production and storage of tobacco. Location of the production and storage site would be supplied by the licensee.

Implications of Alternative Requirements

These alternatives have some direct economic implications, but their indirect implications are likely much greater because of what they mean for controlling contraband. These are discussed below.

Requiring only that a licensee have no criminal record in tobacco makes policing of contraband much more difficult. Requiring a contract with a licensed dealer or manufacturer would have a large element of self-enforcement. One would expect a contract to include a clause indicating that the contract would be void if the producer sells contraband. It is clearly in the interest of a licensed manufacturer to reduce contraband. Hence, requiring a contract for a producer license has a large element of self policing in it.

Conversely, giving a license to a producer who does not have a contract would invite contraband production and make enforcement more difficult. The starting point for this is the following question: Why would a producer with no legitimate end use market want a license to produce? It is assumed that there is one reason – he or she has an illegitimate end use in mind. And, not having a contract with a licensed end user means that anyone with the responsibility of trying to stop contraband has no check against production. For example, if licensed producers A and B each have 100,000 kg production contracts with licensed manufacturer X, then an enforcement official can obtain this information from X. If producer A has enough acreage for 100,000 kg and producer B has enough for 150,000 kg, then both the official and manufacturer X would likely be suspicious. However, if producer C has no contract, then there is no basis on which to check his or her production.

For this reason alone, the twin requirements of having a contract as well as having the rule to “use it or lose it” make much more sense from the perspective of reducing the risk of contraband.

Closely related to this argument is the value of a requirement that a licensed producer must have access to tobacco infrastructure and must indicate his or her production and storage location. From the perspective of stopping contraband, knowing where production and storage of tobacco is supposed to take place means that an enforcement officer knows where to look to check quantities against contract requirements or sales receipts.

At the same time, knowing where to look means knowing that tobacco production or storage in unlicensed locations is quite likely aimed at the contraband market. Hence, it is easier to initiate an investigation and, if appropriate, a charge when one knows where things are supposed to happen.

Conclusion

The argument is apparently being made by some federal officials that it is appropriate to have only one requirement for obtaining a license to produce tobacco – that the licensee have no criminal record for tobacco offenses. This assertion is apparently being made on the grounds that the process would be transparent, and has been used for other products.

Tobacco is not like other products. Very few other products have a huge and growing contraband market. Current efforts to stop contraband have been ineffective. Policing is costly. Legitimate producers are undermined. Government loses large amounts of tax dollars.

Constructing a licensing system with few requirements increases enforcement costs, reduces the effectiveness of enforcement, and reduces tax revenues. It may be more transparent, but it allows less transparency for bad guys!