Oh Cannabis! Little Growth High

Aaron Goertzen, Robert Kavcic, Alex Koustas, Benjamin Reitzes

Canada became the first OECD country to legalize cannabis this week. We're not in the business of evaluating the social implications, so we'll focus strictly on the economic impact. Until this week, StatsCan was planning to treat the legalization as a bump to Q4 GDP and revise the historical data to account for illicit activity at a later date. However, the Q4 GDP release (due in late February) will now include current estimates and revisions as well. Therefore, the impact on growth is expected to be relatively muted, but the level of GDP will be boosted. And, even then, the slow roll out of legal retail dispensaries will spread out the impact over a few quarters.

The Numbers Behind the Green

The economic impact of cannabis legalization will depend on two crucial factors: how much of the dominant non-licensed black market (85% of users) migrates to the legal space; and, how many non-users (over 25 million Canadians of legal age) choose to indulge in the substance. StatsCan has devoted material resources to scoping out intentions through its National Cannabis Survey. It estimates that over 75% of illegal users either plan to switch (50%) or may switch (25%) to legal channels. However, those hoping for a deluge of demand from non-users may be disappointed to find that only 5.9% "will try" and 9.4% "may try" cannabis after legalization (*Chart 1*). StatsCan assumes that 50% of the marginal respondents in both categories ("may switch", "may try") actually do so, which adds up to roughly 5.5 million users after legalization—with 1.7 million remaining in the black market for the time being. The estimated legal market is likely subject to some bias as survey respondents are typically hesitant to confirm illegal activities, but there was probably some apprehension by non-users to answer that they would consider trying. So, we'll call it a wash for now.

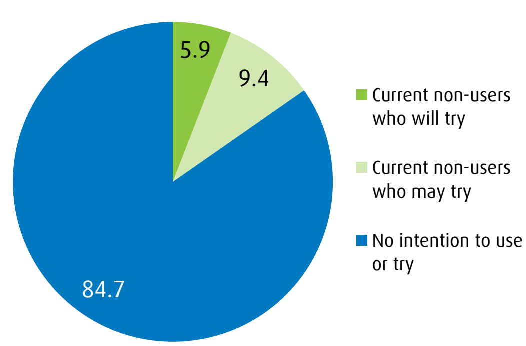
An estimated market of 7.1 million Canadians would overshadow the pre-legalized market of 4.8 million (of which 4.4 million are of legal age), thanks to the addition of roughly 2.7 million new users. Key to any growth projections will be how many of these new users become regular consumers. The cannabis market is bifurcated, with 42% of current users consuming once or less per month and 41% consuming at least once per week or daily. Given these uncertainties, StatsCan offers a number of alternative scenarios, with personal quarterly expenditures on cannabis ranging from $177 to $221. Adjusting the quarterly data for the legalization date of October 17th, annualized spending through legal and illegal channels would range from $5.0 billion to $6.3 billion. However, StatsCan's planned inclusion of past illegal activity to the national accounts means that only the 2.7 million new users being added to the existing market will produce a marginal effect, adding 0.1 ppts-to-0.4 ppts to annualized Q4 GDP growth. This could be scaled down over time as users either choose not to repeat, or find savings elsewhere if they do.

Cannabis-related capital expenditures have already been included in the GDP data as producers invested through traditional channels (greenhouses, agricultural equipment, etc.), so there should be

Chart 1
Still Taboo

Canada (% of respondents)

Non-Cannabis-User Intentions



Sources: BMO Economics, Statistics Canada almost no growth impact on the investment front in Q4. However, given the run-up in cannabis stocks and deal-making that has played out recently, it's possible that industry investment could move the needle on national business investment in the years ahead.

The impact on government finances should be moderate at first, as both the federal and provincial governments have agreed to a pricing and tax regime that will keep prices low enough to compete with the black market. Ottawa will generate revenues through an excise tax regime, payable at the producer level. The tax will be the greater of $1 per gram or 10% of the product price. For the first two years, Ottawa will keep 25% of the revenue and distribute 75% to the provinces. Additionally, the federal government will cap its revenue take at $100 million for the first two years, with the excess flowing to the provinces. Based on the estimated legal market size, revenues could indeed run close to that level, which would also mean roughly $300 million flowing to provincial coffers (though this is a very crude estimate). At the provincial level, the impact will likely be modest as well, at least in the near term. Many provinces have agreed to transfer a share of revenues (typically about a third) to the municipal level and to cover education and anti-black market programs. Additionally, the early cost of setting up distribution (e.g., the Ontario Cannabis Store) will likely bite into revenue gains. At the consumer level, increased consumption would drive a bump in GST/HST revenues at both levels of government, but that could be partly offset by lower spending elsewhere (i.e., alcohol).

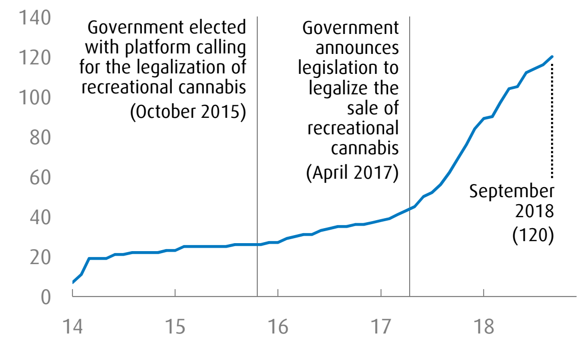
Finally, while Canada is well-positioned to become a global leader in cannabis exports, markets remain limited to a small-subset of jurisdictions permitting medical use. Exports were only a nugget of total production in Q2 at 745 kg, or less than 10% of the limited medical-use market, hardly enough to influence the export account in any way. The illegal market is much larger, however, with StatsCan estimating that Canada exported roughly $1.2 billion worldwide in 2017. These figures are also expected to be incorporated into the national accounts data; though, like consumption, they will simply represent a level shift rather a contribution to the quarterly growth.

Chart 2

Growing Like a Weed

Canada (number of facilities)

Medical Cannabis — Licensed Production Facilities



Sources: BMO Economics, Statistics Canada

Table 1

Concentrated Growth

Regional Distribution of Medical Cannabis Production Facilities

	Licensed Facilities — Sept. 2018 Number	Share (%)	Share of National GDP — 2017 — (%)
British Columbia	25	21	13
Alberta	8	7	16
Saskatchewan	4	3	4
Manitoba	2	2	3
Ontario	65	54	39
Quebec	9	8	19
Atlantic Canada	7	6	6
Total	**120**	**100**	**100**

Sources: BMO Economics, Statistics Canada

Supply and Investment

On the supply front, the number of facilities licensed to produce medical cannabis has increased steadily since Health Canada began to allow private companies to sell directly to authorized Canadians in 2014 (*Chart 2*). In late 2015, the federal election of the current Liberal government on a platform including the legalization of recreational cannabis increased the stream of entrants into the market. When the government announced its plan to table legislation legalizing recreational use in April 2017, that stream turned into a torrent. In the intervening 18 months, the number of licensed production facilities has nearly tripled to 120 as of September 2018 as entrants positioned themselves for legalization this week. Industry employment is not especially high, with 2,400 Canadians working in the space at the end of 2017, and perhaps 3,500 at present. On a regional basis (*Table 1*), production is concentrated in Ontario (cultivated by an expanding industry of start-up accelerators and venture capital funds) and British Columbia (previously a hub of illicit production). The clear laggard in the race for the cannabis market is Quebec—perhaps surprisingly, given the province's abundance of cheap hydroelectricity. The apparent dearth of cannabis production in Quebec has little to do with regulation, however, which is determined on a national basis for growers.

With the cannabis industry still in its formative stages and shortages reported across various parts of the country this week, there appears to be room for further investment in both production and retailing. At the producer level, an increasingly crowded market (at least, in terms of the number of entrants) is leading larger players to bolster their competitive positions by investing in automation, giving them a leg up on smaller, more labour-intensive operations. The largest producers also have wider global ambitions and are hoping to capitalize on their early-mover advantage by expanding into foreign markets.

A few foreign markets are already open in the medical space, and the possibility that medical and recreational cannabis could be legalized in new jurisdictions represents an important longer-term opportunity. Indeed, there must be some confidence that global markets are set to open given Canadian producers' intentions to expand capacity to over 1.5 million kilos per year, compared to projected domestic annual demand of just over 1.0 million kilos in the near term.

Domestically, there may also eventually be room for companies to expand into more capital-intensive cannabis derivatives, including edible and drinkable products, depending on the evolution of the regulatory environment. Retail-level capital spending represents a minor tailwind for the Canadian economy, though in some provinces that activity will play out mainly in the public sector.

Key Takeaway: Despite the buzz around legalization, the economic impact looks minimal. We'll have to wait for longer-term implications given the lack of precedent, and anticipate an over-supply of bad puns as cannabis is fully integrated into the economic data.