

Part 5:  
**The Impact of the Tax Cut: A Five-Year Review**

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Governments presented the 1994 tobacco tax rollback as a temporary, strategic retreat that in no way signalled diminished commitment to protecting the health of Canadians from the disastrous effects of tobacco products and the misleading marketing of the tobacco industry. Five years later, a sober examination of the facts shows that very serious damage has been done and continues to be done, far beyond what governments predicted at the time of the rollback. Lower cigarette prices have injured public health by increasing cigarette smoking to levels higher than would otherwise be the case. They have also robbed public finances of billions of dollars. Five years later, it is also clear who gained most from the rollback: tobacco companies, which continue to set new profit records and have added to their Canadian customer base for decades to come.

**High- and Low-tax Regions: A unique policy comparison**

Although cigarette taxes were reduced by \$5.00 per carton throughout Canada on February 8, 1994, subsequent cuts were much less evenly felt. Five provinces elected to join the federal government in reducing the price of cigarettes. Five provinces made no reductions at all.

As a result, cigarettes in the ‘high-tax’ provinces (British Columbia, Alberta, Saskatchewan, Manitoba and Newfoundland) are almost twice as expensive as they are in ‘low-tax’ provinces (Ontario, Quebec, New Brunswick, Nova Scotia, Prince Edward Island). More than 75% of Canadians live in the ‘low-tax’ provinces.

This variety in cigarette tax policies across Canada has created a unique, if unintended, social laboratory in which to monitor the impact of the cigarette

City	Price per 200 cigarettes	Price per 200 cigarettes
	<i>Jan 94</i>	<i>Jan 99</i>
St. John’s	\$59.43	\$52.07
Yellowknife	\$46.62	\$50.77
Vancouver	\$51.30	\$50.11
Regina	\$48.83	\$48.23
Winnipeg	\$48.69	\$45.25
Whitehorse	\$49.10	\$44.31
Edmonton	\$43.47	\$39.92
Saint John	\$48.78	\$38.84
Charlottetown	\$50.02	\$36.71
Halifax	\$49.01	\$36.09
Montreal	\$47.46	\$29.88
Toronto	\$45.57	\$27.95

*Source: Statistics Canada, “Tobacco Prices, 1994-1999,” custom printout, July 26, 1994.*

tax rollback and to test cigarette-tax theory.

This unique circumstance provides confidence in assessing the consequences of the tax rollback. The results of this unintended experiment also confirm that high cigarette taxes provide a greater benefit to public health and to public finances than do low cigarette taxes, and strongly support a move to upwardly harmonize cigarette taxes with the levels in Western Canada and in most developed countries.

### Five Years Later: More Young Canadians are Smoking

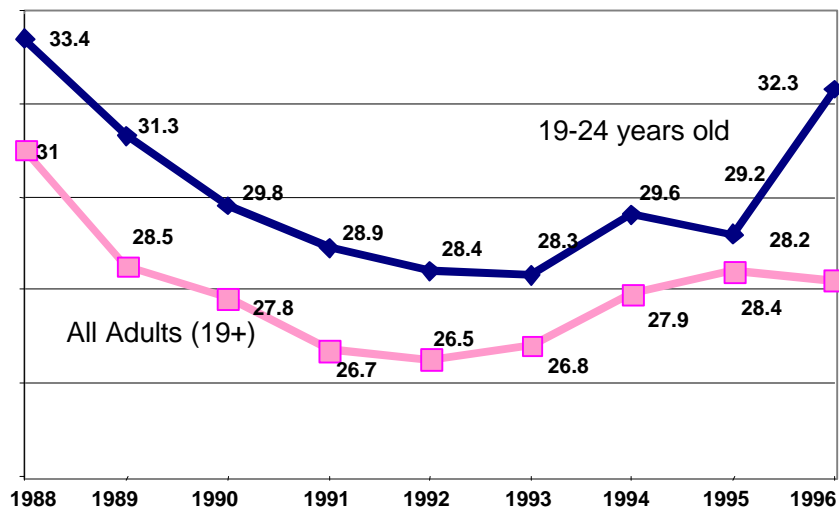
Since cigarettes became less expensive in 1994, Canadian government surveys show that more teenagers and more young adults are smoking today than at the beginning of the decade. This is in contrast to sustained, significant declines in smoking prevalence in these age groups since the mid-1970s.

*“[Y]ounger Canadians are, indeed, more sensitive to price changes than adults.”*

**Department of Finance,  
“Tobacco Taxes and  
Consumption” June 1993, p.iv.**

Figure 14  
Smoking Rates among Canadian Adults and Young Adults, 1988 – 1996

Source: Letter from Richard Kauffeld, Chairman and CEO, RJR-Macdonald to David Sweanor, Senior Legal Counsel, Non-Smokers’ Rights Association, and Tom Stephens, June 10, 1997



Tobacco industry data (which, unlike government data is collected on a monthly and yearly basis and with consistent methodologies) confirms that smoking rates increased after the 1994 rollback. RJR-Macdonald provided smoking rates to the Non-Smokers’ Rights Association in 1997 for the years 1988 to 1996. This company surveys

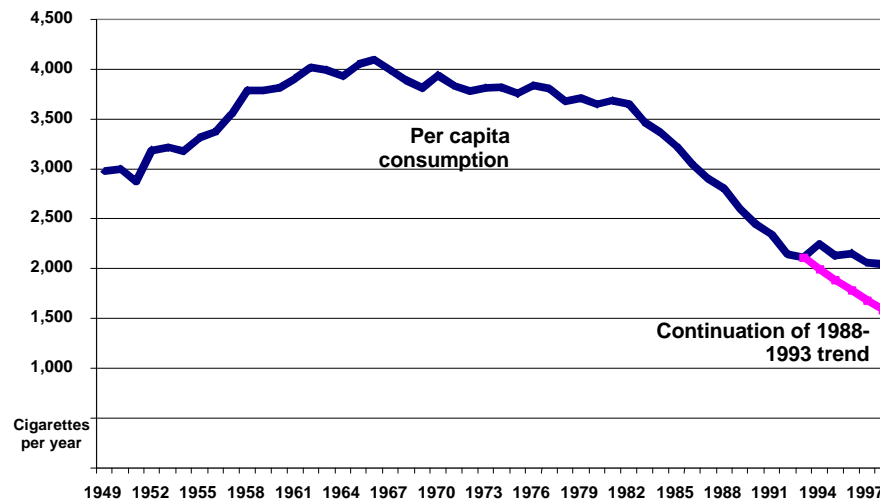
respondents aged 19 or older. While the surveys show an increase in smoking in all age groups after 1994, there is a more pronounced increase among Canadians aged 19-24.

### Five Years Later: Canadians are Smoking More Cigarettes

From a public health perspective, both the number of people who smoke (smoking prevalence) and the amount of cigarettes that are smoked (cigarette consumption) are of consequence. Health is affected both by the number of smokers (each of whose health can be expected to suffer as a result of smoking) and the amount smoked (greater quantities of cigarettes smoked result in greater disease).

For many years, Canadians were the world's heaviest smokers. In 1981, Canadians smoked an average of 3,685 cigarettes per person (over 15 years of age) per year. During the 1980s and early 1990s, this number began to drop significantly: by 1992 it had fallen to 2,143 cigarettes per person (over 15 years of age) per year.

Figure 15  
Cigarette Consumption<sup>54</sup>, 1949 – 1998, with projection of continued reduction had pre-1994 trend continued.



Sources: See Appendix A, Table G.

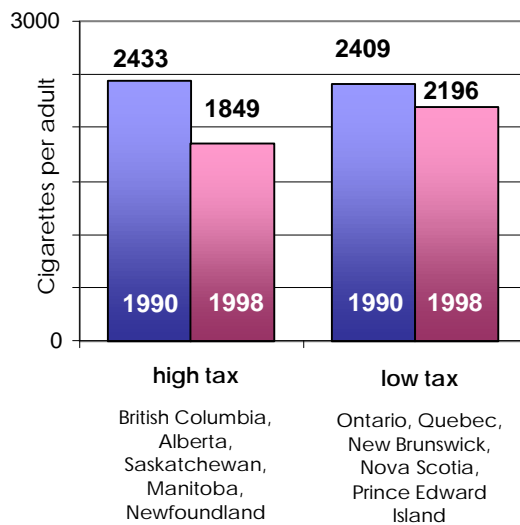
The 1994 tax cut arrested the dramatic progress made in the previous 12 years. If the average decline established between 1988 and 1993 had continued, per capita

<sup>54</sup> Including estimates of consumption of contraband cigarettes.

consumption in 1998 would have been 1,590 cigarettes, compared to the actual figure of 2,042, a difference of fully 22%.

There is a stark difference in reductions of cigarette consumption between the regions of Canada where cigarette taxes were maintained and those where they were cut. Per capita consumption in the 'high-tax' provinces dropped by 24% during this eight-year period; in the 'low-tax' provinces, it dropped by less than 8%.

Figure 16  
Cigarette Consumption Per Capita (15+), 1990 and 1998



Sources: See Appendix A, Table F.

### Five Years Later: Governments Lose Billions

When the federal government forecast in 1994 that cutting cigarette taxes would cost the federal treasury \$300 million a year, its prediction was far short of the mark. The annual shortfall in federal tobacco tax revenue was twice the amount forecast, as the Auditor General pointed out in his 1996 report to Parliament. In each fiscal year since the rollback, federal tobacco-tax revenues have been lower than in 1993-94, by an average of \$575 million. This is a conservative estimate of revenue losses, since the reference year (1993-94) included almost two months of the new low-tax regime and since the estimate excludes lost GST revenue.

“We are concerned, however, that the departments have not fully reviewed the cost and benefits of the anti-smuggling measure. For example, the 1994 Budget Plan forecast that the anti-smuggling initiative would result in a \$300 million decline in tobacco tax revenue in 1994-95. Ex post federal revenue from tobacco taxes declined by over \$600 million in 1994-95 compared with 1993-94.

**Report of the Auditor General  
September 1996**

Like the health consequences, the revenue consequences of this decision continue to be felt. Continued delays in restoring taxes add to the cumulative burden of this decision. Together with losses to provincial treasuries, public finances are \$4.8 billion poorer from reduced tobacco revenues in 1998-99 than they were in 1993-94, not including sales taxes. The cumulative loss to federal revenues for the five-year period is \$2.9 billion, not including GST.

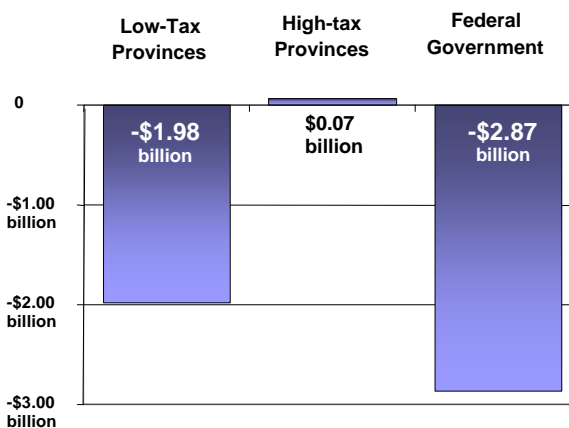
Foregone federal revenues resulting from lower cigarette taxes are enough for the federal government to:

- Double the budget of Environment Canada (currently \$531 million)
- Triple the budget of the Medical Research Council (currently \$275 million)
- Fund the operating costs of two universities the size of the University of British Columbia (current operating costs \$344 million).

The provinces which joined the federal government in reducing cigarette taxes shared in the loss: their joint revenues were depleted by almost \$2 billion in the five-year period, not including sales taxes (see Appendix A, Table D) .

**Figure 17:  
Five-year cumulative impact of cigarette tax-cuts on provincial and federal government tobacco-tax revenues (1994-95 to 1998-99)**

Sources: Public Accounts for each jurisdiction, 1994-95 to 1997-98; budget



documents for 1998-99.

It should be noted that these figures on revenue loss measure only the effects of the decision to roll back taxes, *once smuggling had already become a serious issue*. For example, these figures do not include the taxes that should have been paid on smuggled cigarettes. According to a separate estimate by the Non-Smokers’ Rights Association for

the years 1990 through 1998, the federal treasury alone was deprived of *roughly \$15 billion* through cigarette smuggling and the tax rollback it led to.

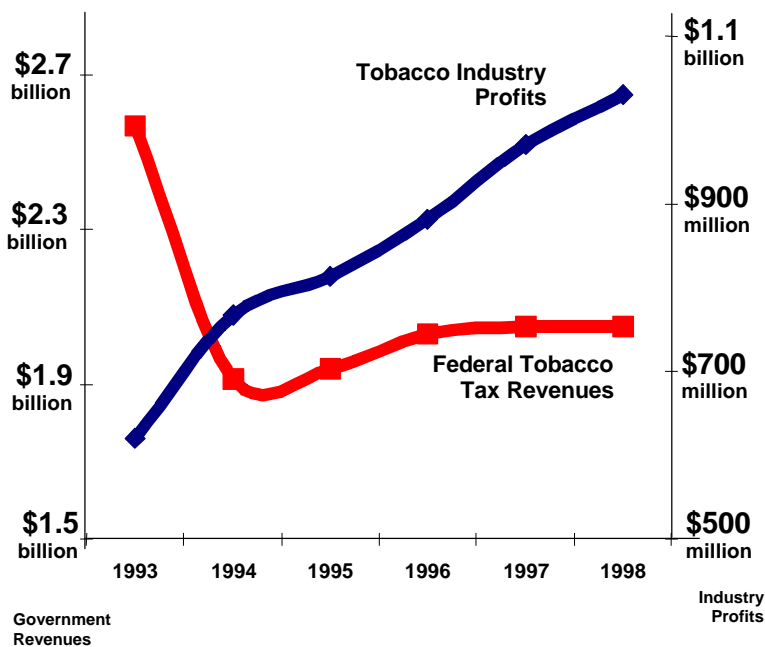
By contrast, provinces which chose to address smuggling with increased enforcement instead of tax cuts experienced very little tax loss. In aggregate, these five provinces actually increased their tax revenues by \$72 million dollars.

Rumours of significant increases in smuggling from low-tax provinces like Ontario and Quebec into the high-tax western provinces are not, *prima facie*, supported by tax revenue data, which shows that these provincial governments have been able to defend their revenue base against illegal sales. Interprovincial smuggling could be addressed by raising taxes in the low-tax provinces.

*“Federal and provincial government tax policies over several years have pushed the retail price of cigarettes to extraordinary levels. The very high retail prices, more than any other factor, account for the decline in domestic industry sales.”*

**Imasco Ltd., Annual Report 1990, p.6.**

Figure 18:  
Tobacco industry pre-tax profits and federal tobacco-tax revenues, 1993-94 to 1998-99.



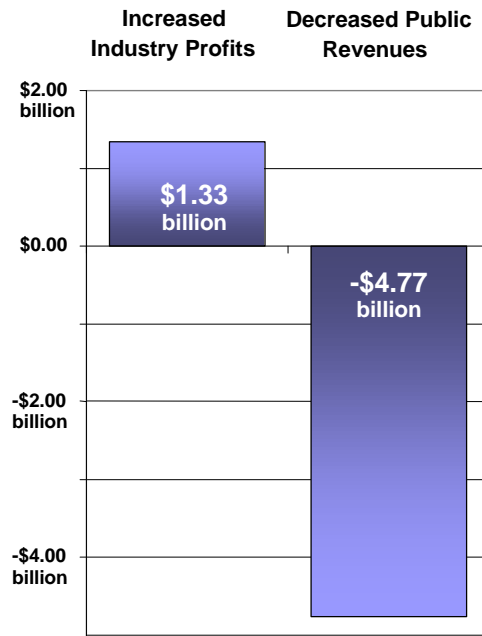
*Sources: Public Accounts for each jurisdiction, 1994-95 to 1997-98; budget documents for 1998-99 and annual reports, IMASCO Ltd and Rothmans Inc, 1994 to 1998. Profits for Canada’s third manufacturer, RJR-Macdonald are not publicly available nor included in this estimate.*

## Five Years Later: Tobacco Industry Profits up \$1.33 billion

*“The Corporation continues to expect that future earnings performance may be adversely affected by two major factors: declines in industry volumes caused by continued excessive taxation; and, constraints on market share imposed by increasingly stringent government controls over the marketing and sale of tobacco products.”*

**Rothmans Inc., “Annual Report 1991” p.11.**

**Figure 18 :**  
Cumulative increased industry profits and decreased public revenues, 1993-94 to 1998-99.



Where lower cigarette taxes proved harmful to government tax revenues, they have been a boon to tobacco industry profits. Profit levels continue to spiral upwards, with companies reporting year after year of record-breaking earnings. Moreover, the industry’s success in rejuvenating its customer base in the 1990s means this upward trend will likely continue — especially if governments fail to rejuvenate their approach to tobacco taxation.

The major force behind increased tobacco industry profits is the dramatic rise in the wholesale price charged by tobacco companies throughout Canada.

According to its annual reports,

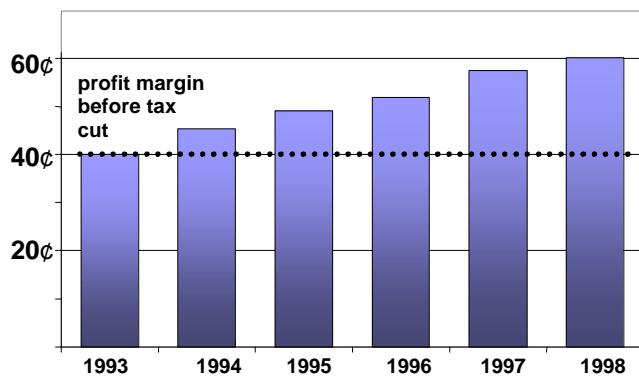
industry-leader Imperial Tobacco has increased its prices at least six times since 1994, including by the following amounts:

- April 1996            3.2% increase
- December 1996      3.6% increase
- April 1997            2.9% increase
- October 1997        4.3% increase
- April 1998            4.4% increase
- April 1999            4.4% increase

Each of these price increases highlights an inconsistency in the tobacco industry arguments for low taxes and against export taxes. On the one hand, the companies argue that tax increases trigger smuggling; on the other hand, this stated concern does not dissuade them from raising their own prices at a rate many times higher than the inflation rate. If smuggling truly were driven by demand and not by supply, it should not make any difference whether price increases are caused by taxation or industry profit-taking.

Since 1994, pre-tax profit margins on Imperial Tobacco cigarettes have increased by 50% — from \$0.40 per package to \$0.60 cents per package (or an increase of \$1.60 per carton). In short, after convincing governments to enter into a price war with smugglers, the industry has rushed in to partially fill the price gap. This opportunistic behaviour, at public expense, deserves a firm government response. One possibility that should be explored is a tax measure to simultaneously force down manufacturers’ prices and increase tax levels. (See recommendations section.)

Figure 19  
 Imperial Tobacco gross profit per package of 25 cigarettes, 1993 - 1998



Sources: IMASCO annual reports. See Appendix A, Table K.

## Conclusion and Recommendations

The 1994 decision to give into tobacco industry pressure and cut cigarette taxes has had a profound and negative impact on both the health of Canadians and the finances of their governments. The tax cut contributed to the rapidly increasing profitability of tobacco companies, including \$1.3 billion in cumulative incremental profits over five years. By the most conservative estimate, it led to the loss of almost \$5 billion dollars in public revenue. It was followed by an increase in smoking, especially compared to what would otherwise have been the case.

The decision by governments in Western Canada and Newfoundland to refrain from cutting provincial taxes but to focus on other anti-smuggling initiatives (such as increased enforcement) appears to have succeeded in protecting provincial tax revenues and in further discouraging smoking.



The government should move quickly to reverse the 1994 policy decisions by implementing the tax increases recommended in Part 3.