

The Unintended Consequences of Taxes on Tobacco, Alcohol and Gambling

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“Sin taxes,” as they are known, are taxes that are levied on a certain number of products that governments consider harmful like alcohol, tobacco, gambling and certain foods that are high in sugar or fat. In 2012, the average Canadian family paid 5.3% of its total contributions to government in the form of taxes on alcohol, tobacco, entertainment and other excise taxes.¹

These taxes have been fixtures of our lives for a long time, and risk becoming more so during periods of budgetary difficulty insofar as they allow governments to raise more revenue all while claiming to promote virtue. History shows, however, that they rarely achieve their contradictory objectives. Moreover, they sometimes have negative consequences for some of society's most vulnerable groups.

Governments' dilemma

Sin taxes are presented as a way of increasing government revenue while simultaneously helping reduce consumption of targeted products. We may wonder, though, whether these two objectives are really compatible in the long run. Indeed, if the first is achieved and consumption of these products starts to decline, this will lead to a reduction in government tax receipts.

And in fact, governments do become dependent on these revenue sources once they are in place. The initial objective of reducing consumption of products considered to be harmful takes a backseat in order to maintain the flow of revenue.

Thus, in Quebec as in other Canadian provinces, the establishment of a government monopoly on the sale of alcohol in the 1920s was originally meant to control the consumption of alcohol. This control generates considerable revenue, however. The net earnings of the Société des alcools du Québec (SAQ), the province's liquor commission, remitted as a dividend to the Quebec government, amounted to \$1,030 million in the 2012-2013 fiscal year. In addition, the SAQ pays Ottawa and Quebec excise taxes and customs duties, sales taxes and special alcohol taxes, all of which totalled \$915 million for the same year.²

The situation is similar in the gambling sector. The Crown corporation Loto-Québec runs, on top of its lotteries, four casinos and a whole network of video lottery terminals. In 2010, it also launched an online gambling site, a new source of revenue. Loto-Québec remits its total net earnings to the government as a dividend, which totalled \$1,194 million in 2012-2013.³ This dividend has been shrinking since it reached a high of \$1,537 million in 2005-2006, which should be good news if the goal were to reduce Quebecers' addiction to gambling.⁴



Misappropriated funds

Sin taxes are sometimes justified by setting up funding dedicated to specific programs. However, the funds collected are sometimes repurposed for government expenditures other than those that justified the creation of the taxes.

This is what happened with Quebec's Olympic tobacco tax. In 1976, the government doubled the tobacco tax in order to finance the Fonds spécial olympique (FSO) that was supposed to allow the Régie des installations olympiques (RIO) to reimburse the debt accumulated in the building of the stadium.⁵ This increase was justified by the fact that from that point on, 48% of the tax had to be paid to the FSO.⁶

Since revenue from the tobacco tax is redistributed at the discretion of the Finance Minister, we had to consult the RIO archives as well as those of the Finance Department to find out what this money was actually used for. We calculated that between 1976 and 2006, the period during which the FSO was in operation, only 18.4% of the revenue from the tobacco tax was transferred to it.⁷

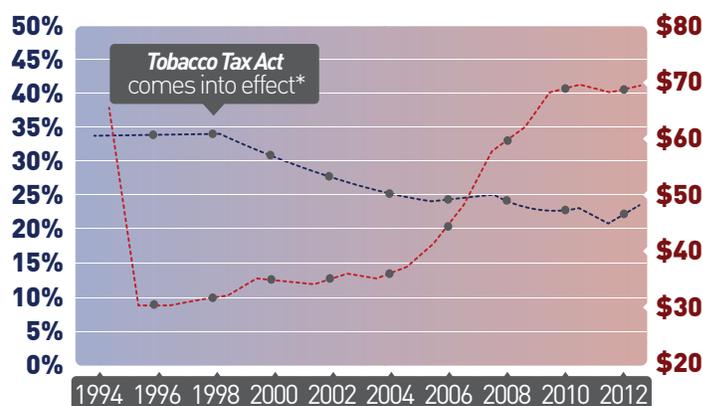
Quebec's tobacco tax hits the poor four times harder than it hits the wealthy.

Moreover, while it logically should have been lowered to its 1976 level once the Olympic debt was completely reimbursed, the tobacco tax was maintained at the same level. Today, the revenue is distributed among special funds and the Consolidated Revenue Fund. In 2012, when the tobacco tax was increased once again by 18%, only 8.5% of the revenue generated was dedicated to programs that could conceivably contribute to the improvement of Quebecers' health (the Sports and Physical Activity Development Fund and the Fund for the Promotion of a Healthy Lifestyle).⁸

Punitive and regressive taxes

Although the modification of consumer behaviour serves as a justification for setting up or increasing sin taxes in the eyes of the general public, this objective is not always attainable, as numerous studies have shown. For example, after an initial reduction, the level of consumption of products like tobacco generally reaches a threshold beyond which remaining

Figure 1 — Prevalence of tobacco use in Quebec in relation to the average price of a carton of 200 cigarettes



--- Prevalence of tobacco use in Quebec (left axis)
 --- Average price of a carton of 200 cigarettes in Quebec (right axis)

* The *Tobacco Tax Act* is the law that regulates tobacco use, in particular by prohibiting its consumption in all public spaces, including businesses and workplaces.
 Sources: See the Technical Annex on the website of the Montreal Economic Institute for sources and authors' calculations.

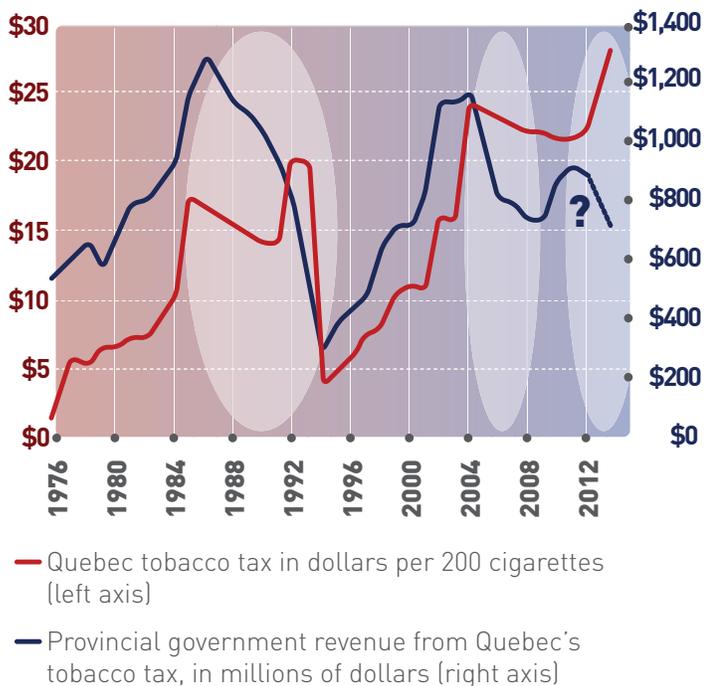
users will tend not to modify their behaviour any further. This devoted core is made up of smokers whose demand is very inelastic, which means that their consumption levels will be little affected by price increases.⁹

The case of Quebec provides a good example of this, as the prevalence of tobacco use has hovered around 24% since 2003 despite the fact that the price of cigarettes has doubled during this same period. Prior to that, the prevalence of tobacco use in Quebec had been falling since 1987, when 40% of Quebecers smoked.¹⁰ The goal of modifying smokers' behaviour through a price increase has not been attained for a decade (see Figure 1).

When they fail to modify the behaviour of consumers of products considered harmful, sin taxes become the equivalent of "punitive" taxes for that part of the population that does not want to change its consumption habits and must shell out larger and larger sums in order to satisfy its wants.

What's more, they are also highly regressive. Indeed, the rate of tobacco use among the poorest people is 50% higher than among the wealthiest.¹¹ An additional hike in tobacco taxes,

Figure 2 — Evolution of provincial government revenue from the tobacco tax in relation to the tobacco tax rate



Sources: See the Technical Annex on the website of the Montreal Economic Institute for sources and authors' calculations.

which already account for 63% of the price of a pack of cigarettes in Quebec,¹² would impact low-income people in particular.

According to our calculations, Quebec's tobacco tax hits the poor four times harder than it hits the wealthy. In 2009, the least well-off smoking households spent \$869 a year, or 5.2% of their income, on tobacco taxes alone. For the sake of comparison, this is more than the average household in this income group spends on clothing or heating. The richest Quebec smokers, in contrast, pay \$1,778 in tobacco taxes, but this amount represents just 1.4% of their income.¹³

A drop in government revenue

Another unintended consequence of sin taxes is that when the tax level for a product is too high, according to the “too much tax kills tax” principle, consumers turn to other, legal or illegal, sources, like the black market or cross-border shopping. The government's tax receipts therefore start to fall.

This is precisely what happened in Canada in the early 1990s. Indeed, following a steep increase in duties and taxes applicable to tobacco products by the federal government and the provinces,¹⁴ a vast illegal trade in cigarettes sprang up. Contraband's share in the Canadian tobacco market jumped from 1% in 1987 to approximately 31% by the end of 1993.¹⁵ In February 1994, taxes were slashed by the federal government and five eastern Canadian provinces, including Quebec, in order to put an end to the contraband and re-establish legal sales and tobacco tax receipts.¹⁶

These measures largely achieved their goal.¹⁷ The federal government and the provinces do not seem to have learned the lesson of the early 1990s, however, since taxes were once again increased starting in 2001. As was to be expected, this led to a resurgence of the black market, which made up an estimated 27% of the total tobacco market in 2008.¹⁸

In its latest budget, the Quebec government once again raised the tobacco tax with the goal of increasing its revenue by \$43 million in 2012-2013. In fact, however, revenue decreased, from \$913 to \$907 million.¹⁹ The historical evolution of tax revenue from tobacco for the Quebec government shows that above \$15 in taxes per carton, there is a “disconnect” between the tax rate and the revenue generated. This has happened on three separate occasions in recent decades (see Figure 2). In other words, when taxation becomes excessive, it entails a decrease in tax revenue.

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We can also observe that the same causes had the same effects in Denmark, which in October 2011 introduced the first fat tax in the world, on food products containing more than 2.3% saturated fat. Far from reducing their consumption of butter, milk or cheese, Danes opted for less expensive brands or went abroad to do their groceries, especially to Germany, where prices were approximately 20% lower. The negative effects on Danish retailing and the discontent of the population led to the abolition of this sin tax in November 2012, and convinced the government to abandon its planned sugar tax.²⁰

Conclusion

In situations of budgetary deficit, there is a real temptation for governments to increase existing sin taxes or to introduce new sin taxes. These kinds of taxes are easier to justify in the eyes of the population than other consumption taxes or income tax hikes. Indeed, no one can be against virtue.

In 2012, the average Canadian family paid 5.3% of its total contributions to government in the form of taxes on alcohol, tobacco, entertainment and other excise taxes.

However, as we have seen, sin taxes are not generally able to attain their contradictory objectives. Moreover, they can have undesired consequences, by disproportionately affecting the incomes of the poorest households or by contributing to the emergence of a black market. For all of these reasons, governments would be better off themselves practising the virtue of thrift in order to balance their budgets.

9. Serginio Sylvain, "The effects of excise tax on cigarette consumption: a divergence in the behaviour of youth and adults," *Michigan Journal of Business*, Vol. 1, No. 2, April 2008, p. 100.
10. See the Technical Annex on the website of the Montreal Economic Institute for sources and authors' calculations.
11. Department of Health and Social Services, *État de santé de la population québécoise — quelques repères (2010)*, 2010, p. 14.
12. See the Technical Annex on the website of the Montreal Economic Institute for further details and authors' calculations.
13. See the Technical Annex on the website of the Montreal Economic Institute for further details and authors' calculations.
14. Between 1989 and 1993, federal and provincial excise taxes increased sharply, from an average of \$19 per carton to an average of \$35. Jonathan Gruber, Anindya Sen and Mark Stabile, "Estimating Price Elasticities When There Is Smuggling: The Sensitivity of Smoking to Price in Canada," *Journal of Health Economics*, Vol. 22, 2003, p. 822.
15. Gylliane Gervais, *The Size of the Underground Economy: A Statistics Canada View*, Statistics Canada, No. 13-603E, 1994, cited in Maxime Fougère, "Tobacco Smuggling in Canada, the Demand for 'Nico' Dollars, and the size of the Underground Economy," *Canadian Tax Journal / Revue fiscale canadienne*, Vol. 48, No. 6, 2000, p. 1804.
16. In Quebec, contraband entailed substantial fiscal losses, evaluated by the Quebec Finance Department for the years 1990-1991 to 1993-1994 at close to \$1.3 billion. At the start of 1994, nearly 65% of cigarettes bought in the province came from the black market. On February 9, 1994, the federal excise tax per carton of 200 cigarettes fell from \$15.85 to \$5.85 and Quebec's tobacco tax fell from \$13.76 to \$2.75. Revenue Quebec and Finance Department, *Mémoire présenté à la Commission des finances publiques sur l'étude des mesures pour contrer la consommation de tabac de contrebande*, 2011, pp. 5 and 7.
17. Jean-François Ouellet, "L'échec des politiques de taxation à combattre le tabagisme : les résultats de l'enquête de statistique Canada de 1994," HEC Montréal, January 4, 2010, p. 3.
18. Nachum Gabler and Diane Katz, *Contraband Tobacco in Canada. Tax Policies and Black Market Incentives*, Fraser Institute, July 2010, pp. 5 and 21.
19. As for tax revenue from alcoholic beverages, it went up a little more than expected in 2012-2013, by \$40 million. Quebec Department of Finance and the Economy, *op. cit.*, note 4, p. A.109; Quebec Department of Finance and the Economy, *op. cit.*, note 3, p. 176.
20. See Stephanie Strom, "Fat Tax in Denmark is repealed after criticism," *The New York Times*, November 12, 2012; Sarah Kliff, "Denmark scraps world's first fat tax," *The Washington Post*, November 13, 2012.

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3. Quebec Department of Finance and the Economy, *Public Accounts 2012-2013*, Volume 1, 2013, p. 174.
4. Quebec Department of Finance and the Economy, *Budget Plan, Budget 2013-2014*, 2013, p. A.103.
5. Quebec Department of Finance and the Economy, *Discours sur le budget 1976-1977*. Renseignements supplémentaires, 1976, p. 31.
6. National Assembly, *Act to amend the Tobacco Tax Act*, Chapter 21 of the laws of 1976, article 24a, approved June 30, 1976.
7. During this period, the tobacco tax generated \$25.4 billion of tax receipts for the government (in constant 2012 dollars). Régie des installations olympiques, *Rapports annuels* from 1975 to 2006; Quebec Institute of Statistics, compilation obtained on demand on November 26, 2013. See the Technical Annex on the website of the Montreal Economic Institute for further details and authors' calculations.
8. Quebec Department of Finance and the Economy, *op. cit.*, note 4, p. A.111 and C.15, 2012. See the Technical Annex on the website of the Montreal Economic Institute for further details and authors' calculations.

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