ITEP Institute on Taxation and Economic Policy

TALKING TAXES

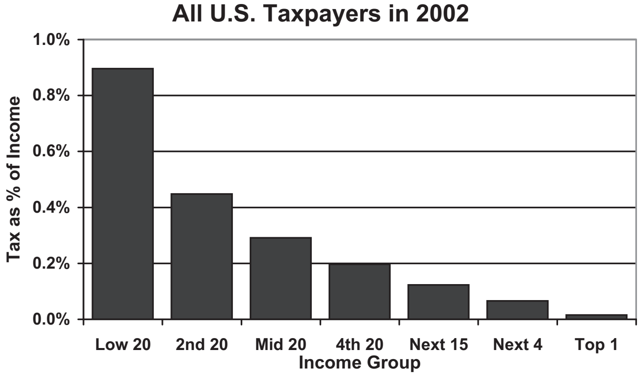
Cigarette Taxes: Issues and Options

In recent years, state lawmakers across the nation have engaged in intense partisan battles over plans to balance budgets through increases in sales and income taxes. Yet in many states, lawmakers have been able to agree on one approach to revenue-raising: the cigarette tax. In the past four years, more than thirty states have enacted cigarette tax increases, for reasons that include funding health care, discouraging smoking, and simply raising revenue to help balance state budgets. This policy brief looks at the advantages and disadvantages of cigarette taxes, and cigarette tax hikes, as a state and local revenue source.

A Regressive Tax

Cigarette taxes are *regressive*: that is, low- and middle-income taxpayers pay more of their income in these taxes, on average, than do upper-income families. These taxes are regressive because the fixed amount of tax on a pack of cigarettes represents a larger share of the income of low-income smokers than of the wealthy. As the chart at right shows, in 2002 the poorest twenty percent of non-elderly Americans spent 0.9 percent of their income, on average, on these taxes, while the wealthiest 1 percent spent less than 0.1 percent of their income on cigarette taxes. In other words, cigarette taxes are about ten times more burdensome for low-income taxpayers than for the wealthy.

Cigarette Tax as a Share of Personal Income
All U.S. Taxpayers in 2002



A Declining Tax

Over time, cigarette tax revenues grow more slowly than do most other taxes. This is partially because these taxes are usually calculated on a per-pack basis: a 25-cent-per-pack tax will always yield the same amount of tax revenue for each pack. (By contrast, general sales taxes are calculated as a percentage of the sales price of a taxable item. This means that when inflation drives prices up, sales tax revenues will automatically increase, but cigarette tax revenues will not.)

Because cigarette taxes are calculated on a per-pack basis, a state's cigarette tax revenues can usually only grow in two ways: as a result of an increase in the tax rate, or as the result of an increase in cigarette consumption. The total number of cigarettes consumed by Americans each year has declined for the past twenty years, as the chart on the next page shows. The U.S. Department of Agriculture estimates that Americans smoked 425 billion cigarettes in 2001—fewer than in any year since 1957. This steep decline in smoking means that unless tax rates are increased, state revenues from cigarette taxes are likely to decline in the future.

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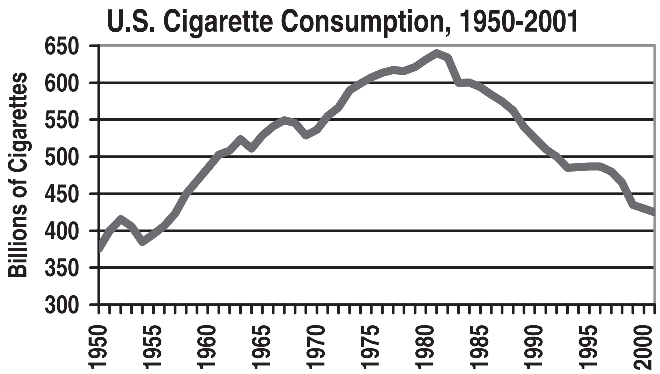
There is some evidence that tax evasion is a growing problem for cigarette tax collections. A study by the General Accounting Office found that states will lose about $1.4 billion in tax revenue from Internet tobacco sales in 2005. The study also found that most Internet cigarette vendors do not comply with state laws requiring collection of cigarette taxes, or notify their customers of such laws. While federal lawmakers are taking steps to increase compliance with cigarette taxes, tax evasion remains a potential problem for states considering cigarette tax hikes.



On the other hand, cigarette taxes are also a relatively stable revenue source—the tax is less volatile than income and sales taxes over the course of the business cycle, because economic downturns do not affect cigarette consumption as much as other types of purchases. In short, cigarette taxes are a predictably declining revenue source for state governments.

Cigarette tax revenues grow more slowly than the cost of almost any public service that could be funded using these taxes. So states that use cigarette taxes to fund public services may be disappointed in the long run.

No Federal Deductibility

Cigarette taxes also offer little "bang for the buck" in that state taxpayers cannot write off their cigarette taxes on their federal tax returns. This means that when state residents pay a dollar in cigarette taxes, the entire dollar comes out of their pockets. (By contrast, any state resident who itemizes their federal income tax return can deduct their state income and property taxes—which means that part of these taxes is effectively paid by the federal government, and ultimately does not come out of the pockets of state residents. This "federal offset" is an often-overlooked advantage of state income taxes. For more information, see ITEP Policy Brief #7, *A Primer on the Federal Offset*.)

When Are Cigarette Tax Hikes Appropriate?

Taxes exist primarily to help pay for public services. But cigarette tax revenues grow more slowly than the cost of almost any public service that could be funded using these taxes. So states that use these taxes to fund public services may be disappointed in the long run. Many states are, in fact, using cigarette taxes to support programs, such as education or health care, that have a naturally increasing need for funding. The result is that, while these taxes may bring in enough revenue to support these programs for a few years, a deficit will inevitably appear unless the cigarette tax rate is raised again. When these deficits recur, the public may be less willing to increase taxes to cover the deficit.

However, cigarette taxes are sometimes imposed not to raise revenue but to discourage smoking. To the extent that these taxes encourage consumers to stop smoking, they may be a successful social policy tool—and there is evidence that higher cigarette taxes can prompt smokers to quit. Moreover, if tax hikes do cause smokers to quit, states will enjoy savings in health care costs as smokers' health improves. Under these circumstances, cigarette taxes can be an appropriate social policy tool, despite the regressive impact of such a change. If a state is relying on the revenue from the tax to fund programs or supplement a state budget, however, cigarette taxes are a poor choice.

To find out more about this issue, contact ITEP at (202) 626-3780