

INCREASING THE FEDERAL EXCISE TAX ON CIGARETTES

Jeffrey E. HARRIS

Massachusetts Institute of Technology, Cambridge, MA 02139, USA

Received May 1982

In the current debate on fiscal policy in the United States, many government officials have advocated an increase in the federal excise tax on cigarettes. Although opponents have argued that tobacco is already far too burdened by state and federal taxation, the case for new increases in federal cigarette levies is in fact strong.

1. The real tax burden on cigarettes is declining

In fiscal year 1970, U.S. federal cigarette tax revenues accounted for 13 percent of all federal excise tax collections and 1 percent of total federal budget receipts. By fiscal year 1980, federal cigarette tax revenues accounted for only 10 percent of all federal excise tax collections and only 0.5 percent of total federal budget receipts.¹

In fiscal year 1970, U.S. state and local cigarette tax revenues accounted for 10 percent of all state and local personal tax and non-tax receipts. By fiscal year 1980, state and local cigarette tax revenues accounted for only 5 percent of all state and local personal tax and non-tax receipts.¹

In 1970, the average adult civilian cigarette smoker paid \$91 in federal, state and local cigarette taxes, of which \$42 represented federal cigarette taxes. By 1980, the average adult civilian cigarette smoker paid \$121 in federal, state, and local cigarette taxes, of which \$48 represented federal cigarette taxes.² These changes in cigarette taxation have not kept pace with

¹Calculated from U.S. Department of Agriculture, *Tobacco Situation* 177 (Sept. 1981); Tobacco Tax Council, *The Tax Burden on Tobacco* 15 (1980); *Economic Report of the President* (Jan. 1980 and Jan. 1981).

²These calculations are based on reported federal, state and local cigarette tax revenue (see footnote 1) in combination with survey-based estimates of the number of adult civilian cigarette smokers. In 1970, there were 132.1 million civilians aged 18 and over, of whom 36.9 percent (or 48.7 million) were current regular smokers. In 1980, there were 161.2 million civilians aged 18 and over, of whom 32.6 percent (or 52.6 million) were current regular cigarette smokers. See U.S. Department of Commerce, *Current Population Reports*, Series P-25, and unpublished data for 1980; U.S. National Center for Health Statistics, data from the *Health Interview Survey*. Some analysts have suggested that interview surveys (such as that used here) have increasingly underestimated the actual percentage of adult smokers. In that case, the text calculations would overstate the magnitude of the increase in nominal taxes per smoker during 1970–80.

inflation. While the nominal federal, state and local cigarette tax burden per smoker increased by 34 percent during 1970–80, the real federal, state and local cigarette tax burden per smoker, corrected for inflation, declined by 37 percent.³

The U.S. federal excise tax rate on cigarettes, currently \$0.08 per pack, has not changed since 1951.

2. An immediate doubling of the current federal excise tax on cigarettes would raise an additional \$2.3 billion in annual U.S. federal revenues

In calendar year 1981, U.S. federal cigarette tax receipts are estimated to be \$2.4 billion, while federal taxable cigarette consumption is estimated to be 31.6 billion packs.⁴ The estimated 1981 U.S. average retail price of cigarettes was \$0.66 per pack.⁵ An \$0.08 per pack increase in the federal excise tax, if fully passed on to consumers, would result in a 12 percent retail price increase. In this issue of the *Journal*,⁶ Lewit and Coate estimate the price elasticity of demand to be about 0.4. Hence, a 12 percent retail price increase would lead to about a 5 percent decline in consumption. Federal taxable cigarette consumption would therefore decline from 31.6 billion packs to about 30 billion packs. Total state and local tax collections would decline slightly from about \$4 billion to \$3.8 billion. However, total federal excise tax collections would increase from \$2.5 billion to \$4.8 billion.

3. An immediate doubling of the current U.S. federal excise tax on cigarettes would deter approximately 1.5 million adults and 0.7 million teenagers from cigarette smoking

When total cigarette consumption declines in response to an increase in retail cigarette prices, two different phenomena are taking place. First, continuing cigarette smokers may reduce the number of cigarettes consumed. Second, the number of cigarette smokers may decline. The latter phenomenon reflects quitting by adult smokers and, most importantly, deterrence of new smoking by teenagers. As Lewit and Coate have shown,⁷ a change in the number of cigarette smokers is an important component of the total response to cigarette price increases. An immediate doubling of the federal excise tax on cigarettes, if fully passed on to consumers, would

³This calculation is based on a 112 percent increase in the consumer price index during 1970–80.

⁴Calculated from U.S. Department of Agriculture, *op. cit.*

⁵Total consumer expenditures for cigarettes in 1981 are estimated to be \$21.1 billion. U.S. Department of Agriculture, *op. cit.*

⁶E. Lewit and D. Coate, 'The potential for using excise taxes to reduce smoking', *Journal of Health Economics* 1 (1982).

⁷Lewit and Coate, *op. cit.*; see also E.M. Lewit, D. Coate and M. Grossman, 'The effects of government regulation on teenage smoking', *Journal of Law and Economics* 24 (1981).

increase retail cigarette prices by 12 percent. On the basis of the Lewit and Coate estimates, such a price increase would lead to an approximate 3 percent decline in the number of adult smokers and an approximate 15 percent decline in the number of teenage smokers. These percentage changes translate into absolute declines of 1.5 million and 0.7 million in the numbers of adult and teenage cigarette smokers, respectively.⁸

4. An increase in the federal cigarette tax would not have unduly regressive consequences

An increase in cigarette taxes, it had been argued, is regressive because cigarette smokers come predominantly from lower income groups. This argument is incorrect for many reasons. First, the very poorest groups in the U.S. have lower smoking rates than the middle income groups.⁹ Second, although higher income men have lower smoking rates than middle income men, the prevalence of smoking actually increases with income among women.⁹ Third, many of the supposedly low income smokers are teenagers and young adults, who may be only temporarily poor. The younger age group, moreover, has the most to gain, with respect to the health consequences of smoking, from an increase in federal excise taxes. Finally, to the extent that a federal tax increase is not fully passed on to consumers, the burden of the tax increase will be shared by the stockholders of cigarette manufacturing companies, the owners of domestic tobacco allotments, and foreign sellers of imported tobacco.

5. An increase in the federal cigarette tax would not exacerbate the problem of interstate cigarette bootlegging

State cigarette taxes in the U.S. vary from \$0.02 per pack in North Carolina to \$0.23 per pack in Rhode Island.¹⁰ The resulting differentials in the retail price of cigarettes create an incentive for illegal cigarette smuggling.

Since an increase in the federal excise tax on cigarettes would apply uniformly to all localities, interstate price differentials would not be affected. The problem of bootlegging would not be exacerbated. By contrast, increases in individual states' cigarette tax rates may enhance the incentive for illegal cigarette smuggling.

⁸For this calculation, smoking participation price elasticities of 0.26 and 1.20 for adults and teenagers, respectively, have been used. See Lewit and Coate, *op. cit.*; Lewit, Coate and Grossman, *op. cit.* The calculation also relies on survey estimates that 15 percent of persons aged 12 to 19 years are current regular smokers. See U.S. Surgeon General, *The Health Consequences of Smoking for Women*, chapter 2 (1980). To the extent that surveys understate the proportion of teenage smokers, the absolute impact of a tax increase on teenage smoking is also understated.

⁹See U.S. Surgeon General, *Smoking and Health: A Report of the Surgeon General*, appendix (1979).

¹⁰Tobacco Tax Council, *State Cigaret Tax and Tax-Paid Volume*, various issues (1981).

6. Increases in excise taxation of cigarettes should not be the sole responsibility of state and local governments

Some opponents of an increase in the federal cigarette tax argue that states and local governments should have sole purview over cigarette tax increases. To abandon an increase in federal excise taxes for this reason is to relinquish an addition \$2.3 billion in annual federal revenues for the mere possibility that a few states may eventually raise cigarette taxes.

If necessary, the additional revenues from a federal increase in cigarette taxes can be shared with state and local governments. In this way, local cigarette tax revenues can be increased without risking lost revenues from cigarette smuggling.

7. Taxation of cigarettes to deter cigarette smoking is consistent with public policy

In 1975, cigarette smoking was responsible for \$7.5 billion in health care costs and \$18.2 billion in lost earnings due to sickness and early death.¹¹ Approximately \$10 billion of this amount was paid for by non-smokers through disability, pension, health and life insurance plans.¹² As a result inflation in health care expenses and in the general price level, the extent of cross-subsidization of smoking-related disease by non-smokers is now even more substantial. An increase in the federal cigarette tax is an appropriate method of allowing smokers to contribute equitably to the costs of their own smoking-related illnesses.

Increased taxation of cigarettes is consistent with the current administration's goal of raising revenues through consumption taxation rather than income taxation. A doubling of the current federal excise tax rate, if fully passed on to consumers, would lead to a one-time increase of only 0.1 percent in the consumer price index.¹³

8. Ad valorem taxation of cigarettes is the preferred long-run policy

As Lewit and Coate note, a one-time nominal increase in federal cigarette excise taxes would be much less effective than a sustained real increase in excise taxes. This suggests that cigarette taxes should be levied as a fixed percentage of the wholesale price. As the wholesale price per pack rises, so does the federal cigarette tax per pack.

The U.S. federal excise tax on cigarettes is a valuable fiscal and public health policy instrument. It is time that the U.S. Congress used it to advantage.

¹¹B.R. Luce and S.O. Schweitzer, 'The economic costs of smoking-induced illness', in *Research on Smoking Behavior*, National Institute on Drug Abuse monograph 17 (1977).

¹²J.E. Harris, 'Taxing tar and nicotine', *American Economic Review* 70 (1980).

¹³This calculation is based upon a 1.3 percent share of cigarettes in disposable personal income. U.S. Department of Agriculture, *op. cit.*