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The New Federal Tobacco Tax: Who Loses?

Brief Analysis No. 670 by David Weeks August 4, 2009

The recent expansion of the State Children's Health Insurance Program (S-CHIP) was funded by an increase in federal excise taxes on tobacco products. Congress increased the federal tax on cigarettes by 61 cents per pack and raised the tax on other tobacco products, with the goal of equalizing the tax per pound of tobacco.

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As the figure shows, the resulting tax increase was much higher on some forms of tobacco:

- For large cigars, the federal tax increased 725 percent per cigar, from about a nickel to 40 cents.
- For loose tobacco, the tax increased 2,160 percent.
- For small cigars, it increased 2,653 percent!

S-CHIP will now cover up to four million additional children in families that earn too much to qualify for Medicaid. Unfortunately, there is plenty of evidence that not only will these tax hikes harm poor consumers and small businesses, they will fail to deliver the promised government revenues or public health benefits. This means that Congress will likely have to raise other taxes to cover the $33 billion estimated annual cost of the S-CHIP expansion.

The Poor Lose. Government tends to impose excise taxes on goods on which lower-income individuals spend a greater percentage of their consumption dollar. Excises are usually levied as a fixed amount per unit of volume or weight of a product, rather than on the product's value. This means that less costly products are taxed as much as high-dollar-value products.

Excise taxes are regressive. Individuals with less income bear a greater tax burden than people with higher incomes. This is especially true of tobacco taxes:

- In 2007, the poorest one-fifth of consumers spent 2.5 percent of their income on tobacco products, compared to 0.2 percent for the top 20 percent.
- The tax on most cigars is now about 40 cents per cigar (up from a nickel before the tax hike), which means that someone buying a $1.00 cigar pays the same tax as someone purchasing a $20.00 cigar.

Thus, low-income groups will pay a disproportionate share of the tax, which is inconsistent with President Obama's campaign promise not to raise taxes on the poor.

Small Businesses Lose. Millions of small retail businesses sell tobacco products. And there are many cigar manufacturers — unlike the cigarette industry, which is dominated by a handful of manufacturers and distributors. The tax increase has already affected domestic cigar producers and distributors.

- Hav-a-Tampa, maker of Tampa, Florida's well-known Jewel cigars, has announced plans to close its factory and lay off 495 employees in August, primarily in response to the new tax.

- Norman Sharp, president of the Cigar Association of America, said the tax hike may cause a 25 to 30 percent drop in large cigar sales.

The States Lose. Tobacco smugglers buy cigars and cigarettes in low-tax jurisdictions and sell them in high-tax states, such as New York and California. Increases in taxes make the illegal tobacco trade even more lucrative:

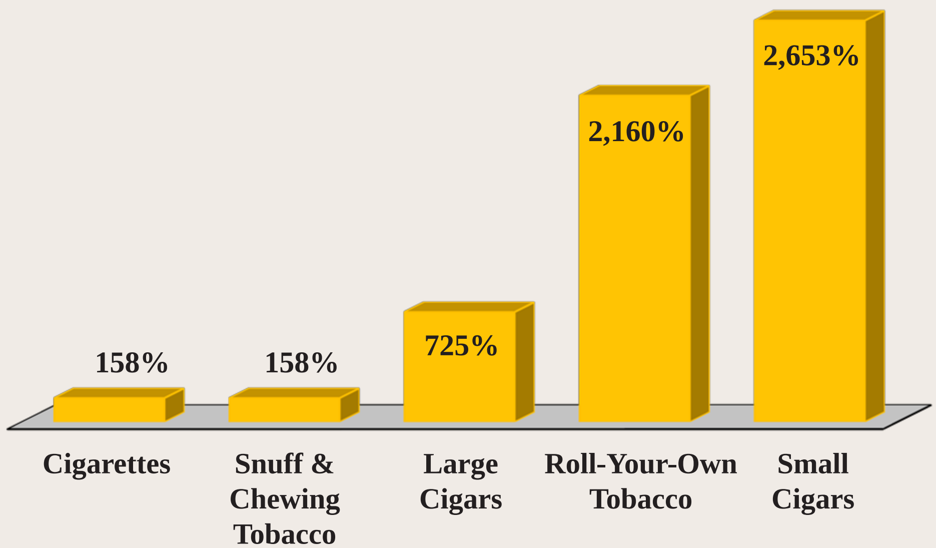
- Following a huge tax increase in New York in 2002, officials estimated that domestic cigarette smugglers could earn as much as $600,000 on a single truckload.
- In 2007, New York state and New York City lost more than $850 million in cigarette tax revenue to the black market, according to the International Consortium of Investigative Journalists.

In addition to smuggling, tax increases are likely to lead to more armed robberies and truck hijackings. For example, the Associated Press reported that, after a 1998 California tobacco tax hike, four armed robbers stole $1 million in cigarettes from a distributor's warehouse.

Children Lose. Excise taxes are not a reliable source of revenue. Because they are a fixed amount per unit, they must be increased in order to keep up with inflation. On the other hand, sales, income and property tax revenues all rise with inflation and growth**.**

Using excise taxes to fund S-CHIP is especially problematic, since the percentage of the population using tobacco products is shrinking, while the number of children eligible for S-CHIP coverage is growing. According to Heritage Foundation projections, the federal government will need 22.4 million new smokers by 2017 to pay for the S-CHIP expansion.

Percentage Tax Increase on Tobacco Products
(per pound or equivalent units)



Source: U.S. Department of the Treasury.

Smokers Lose. Some experts support a strategy of harm reduction for tobacco consumption. Smokeless tobacco products, such as snuff and chewing tobacco, pose fewer health hazards than cigarettes, according to Brad Radu and Philip Cole, researchers at the University of Alabama, Birmingham. Unlike smoking, smokeless tobacco use does not increase the risk of heart attack or lung disease, and has half the mouth cancer risk of cigarettes. Smokeless tobacco use does not create a second-hand smoke health risk for other people.

Thus, raising taxes on smokeless products makes little sense because it makes less hazardous tobacco consumption habits more expensive. Even among cigarettes, tobacco sold in loose form for roll-your-own smokers almost always contains tobacco with fewer dangerous additives. And, arguably, cigar smoking is not as dangerous as inhaling cigarette smoke.

Conclusion. Using tobacco tax increases to fund health care for low-income children is a bad idea. As the taxes imposed on tobacco products increase, revenues are likely to fall — requiring increases in other taxes. In addition, small businesses and their employees are likely to suffer, and the impact on public health is likely to be negligible, or even negative.

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