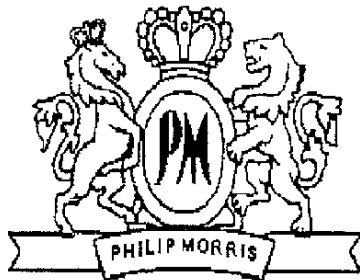


**The Likely Economic Consequences From Raising New
York's Cigarette Excise Tax By \$0.25 Per Pack***



Philip Morris Management Corp.

December 2, 1999

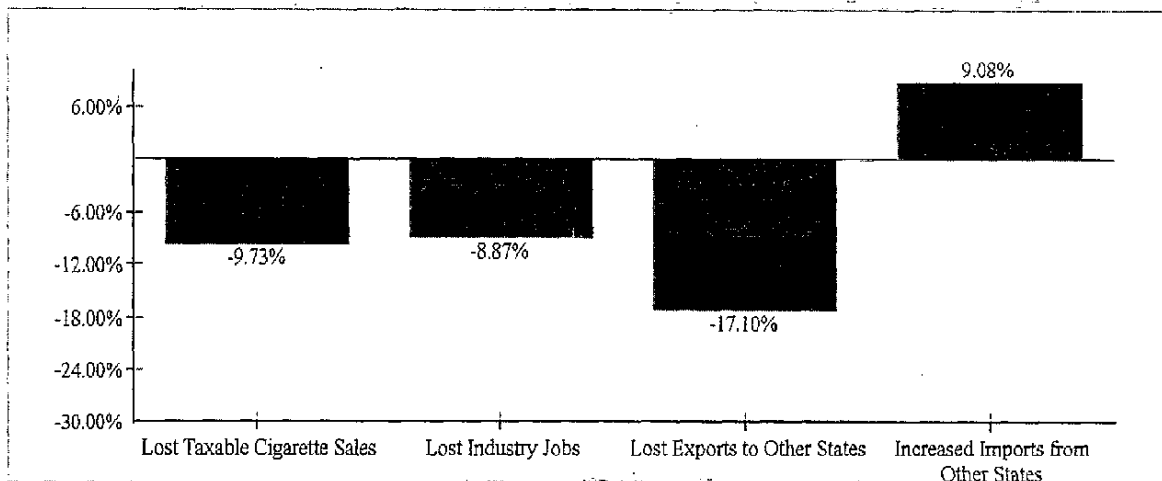
*All economic impact numbers were calculated from an econometric model prepared by the American Economics Group in October 1998 at the request of Philip Morris Management Corp.

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Job, Sales, and Income Losses

A \$0.25 increase in New York's cigarette excise tax could create significant economic effects in the state, as well as its neighbors. A \$0.25 tax increase could lead to taxable cigarette sales losses in New York of 9.73% or 114.90 million packs (see Figure 1).

Figure 1: Estimated Potential Job and Sales Losses From a \$0.25 Increase in New York's Cigarette Excise Tax



Currently, 13,450 jobs in New York are directly attributable to the cigarette industry[1]. As shown in Figure 1, if the cigarette excise tax is raised by \$0.25 per pack, industry employment could decline by 8.87% or 1,190 jobs.

Cigarette Tax Increases & Other Industries

The perverse economic effect will not just injure the tobacco industry. Figures 2 & 3 illustrate the job and compensation losses to both suppliers of the tobacco industry in New York, as well as the indirect job and compensation losses that will occur[2]. Tobacco industry suppliers, which include firms in industries as diverse as trucking and finance, risk the loss of 710 jobs, and \$20,309,400 in compensation.

¹ The cigarette industry is defined from growing tobacco, to auctioning/warehousing, manufacturing, wholesale and retail of cigarettes. See "The U.S. Tobacco Industry in 1997: Its Economic Impact In The States", American Economics Group, 1998.

² Indirect jobs include the economic benefits that arise because of the existence of the cigarette industry (what is commonly referred to as the economic multiplier).

Many firms also indirectly benefit from the tobacco industry when employees of the tobacco industry and their suppliers buy everyday items such as food, books, or family vacations. These firms risk the loss of 4,570 jobs, and \$222,456,400 in compensation from an increase in New York's cigarette excise tax.

Figure 2: Estimated Potential Job Losses In Other Industries From a \$0.25 Increase in New York's Cigarette Excise Tax

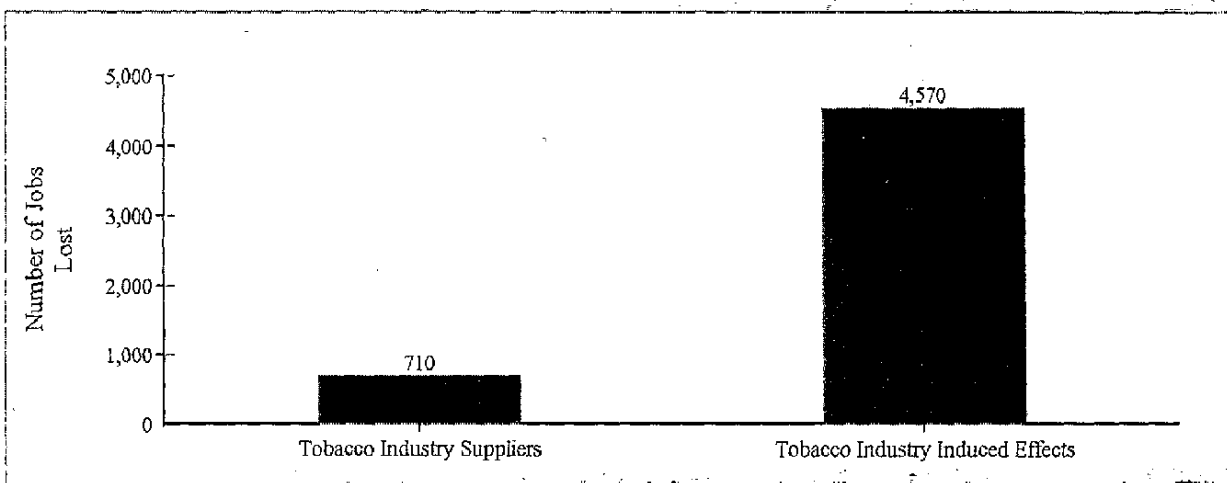
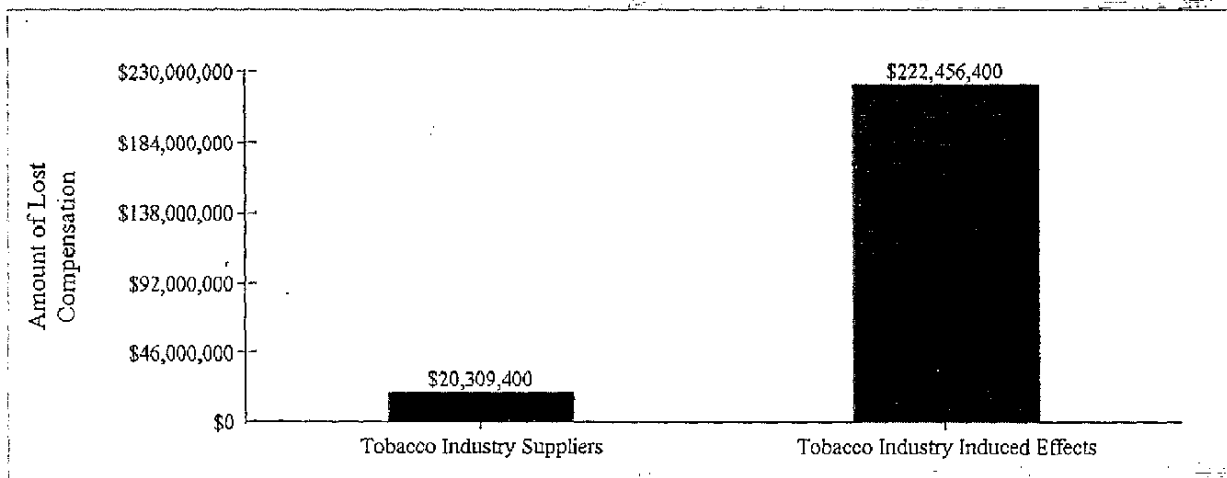


Figure 3: Estimated Potential Compensation Losses In Other Industries From a \$0.25 Increase in New York's Cigarette Excise Tax



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Total Economic Impact

In total, 72,950 jobs in New York are directly or indirectly attributable to the cigarette industry. If the cigarette excise tax is raised by \$0.25 per pack, the total employment decline could be as high as 8.87% or 6,470 jobs. These are real jobs held by real people in firms as diverse as trucking to the people working in the corner stores.

Affects on Other States

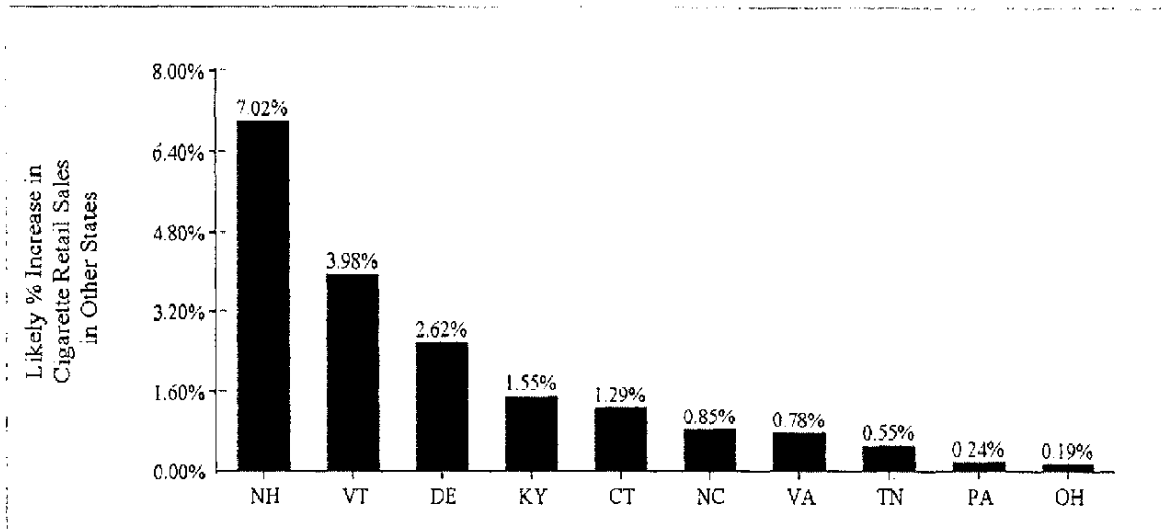
A \$0.25 increase in New York's excise tax could simultaneously encourage individuals to find other alternative lower-tax cigarette sources. The harmful effects to New York's economy will be increased because taxable cigarette sales will be lost to increased cross-border, illegal smuggling, and other alternative cigarette source activities. The economic harm is compounded further because individuals who find alternative cigarette sources typically purchase many other products as well[3].

Figure 4 illustrates that the retail sales of taxable cigarettes in:

- New Hampshire would likely increase by 7.02% or 14,167,100 packs
- Vermont would likely increase by 3.98% or 2,273,800 packs
- Delaware would likely increase by 2.62% or 2,526,800 packs
- Kentucky would likely increase by 1.55% or 10,341,400 packs
- Connecticut would likely increase by 1.29% or 3,184,600 packs
- North Carolina would likely increase by 0.85% or 7,873,100 packs
- Virginia would likely increase by 0.78% or 5,483,600 packs
- Tennessee would likely increase by 0.55% or 3,494,900 packs
- Pennsylvania would likely increase by 0.24% or 2,618,400 packs
- Ohio would likely increase by 0.19% or 2,206,000 packs

³ For an example of this "market-basket" buying phenomenon see DeFranco, Laurence, Lilley, William, and Dunham, John "The Case of the Transient Taxpayer: How Tax-Driven Price Differentials for Commodity Goods Can Create Improbable Markets", *Business Economics*, July 1998, p. 43-49.

Figure 4: Estimated Potential Lost Cigarette Sales To Other States From a \$0.25 Increase in New York's Cigarette Excise Tax



There are many other perverse economic aspects to cigarette excise taxes including the distortions cigarette excise taxes can create in the economy, the tendency for cigarette excise taxes to have a greater impact on the poor, and the unstable nature of cigarette excise tax revenues. In addition, most state governments are operating in surplus and, consequently, do not need new revenue.

Economic Distortions

Increases in cigarette excise taxes set in motion a *chain reaction* which can impact all consumers, whether they smoke or not. This chain occurs as follows:

- Step 1** Adults who choose to smoke take into account everything else they may want to buy when they buy cigarettes.
- Step 2** Increasing cigarette excise taxes change the price of cigarettes relative to all other products.
- Step 3** Since cigarettes are now more expensive but the income of adults who choose to smoke has not increased, the total amount of money they will spend on cigarettes versus the total amount of money they will spend on other goods will change. This can create many unintended and unwanted economic consequences.
 - Many people can be made worse off as a result of the higher cigarette excise tax. For example, in order to afford the higher cigarette excise tax, a smoker might forgo a cup of coffee from a local coffee vendor. This coffee vendor (who would otherwise seem wholly unrelated to the cigarette industry) will be harmed by the increase in the cigarette excise tax;

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- Restaurateurs, bar owners, and retail store owners are worse off if smokers purchase less cigarettes or spend less money at their establishments;
- The profitability of bootlegging and illegal sales could increase. In fact the GAO has stated that Smuggling cigarettes from low- to high-tax states, or interstate smuggling, prominent in the 1970s, may now be a reemerging problem.[4]

Regressivity

The additional tax burden from higher cigarette excise taxes is not only unfair because it singles out one group of constituents to pay government costs that are everyone's responsibility, but its costs fall more on the poor than on higher income residents.

Excise taxes are regressive because the dollar tax burden is equal and consequently accounts for a higher percentage of a poorer family's income than a wealthier family's income. A 1996 study by Citizens for Tax Justice[5] found that the poorest 20 percent of American families pay, on average, 16.7 times more of their income toward excise taxes on gasoline, cigarettes, and beer than the richest 1 percent of American families. Cigarette excise taxes are especially regressive because not only is the tax a larger burden for poorer individuals, but the average smoker tends to have less income.

Stability

A good tax generates major revenues that do not decline significantly over time or during economic downturns. Cigarette excise taxes do not fit this criterion and are ill-suited for funding important government programs[6]. Consider the following:

- Cigarette excise tax revenues are sensitive to the overall consumer demand for cigarettes, which has been declining since the mid-1960s[7].
- Cigarette excise taxes are levied on a narrow (and shrinking) tax base -people who choose to smoke.
- Projected revenue increases are reduced because sales at alternative non-tax sources and lower-tax jurisdictions tend to increase following an excise tax increase.

⁴ "Cigarette Smuggling: Information on Interstate and U.S.-Canadian Activity", Statement of Robert A. Robinson, Director, Food and Agriculture Issues, Resources, Community and Economic Development Division, GAO Congressional Testimony, May 4, 1998. For a related discussion see, "The Impact of Excise Taxes on Michigan, Indiana, and Ohio" Tax Research Analysis Center TRAC-00037, Nov. 1996.

⁵ Ettliger, Michael et. al., "Who Pays? A Distributional Analysis of the Tax System in All 50 States", Citizens for Tax Justice and the Institute on Taxation & Economic Policy, June 1996.

⁶ See "Tax Policy Handbook For State Legislators", National Conference of State Legislatures, December 1997, p. 27-28. In this guidebook NCSL states that cigarette and tobacco taxes are not reliable (stable), are regressive, are not economically neutral, and are hidden. Such features make cigarette excise taxes an undesirable tax source. Also see TRAC 1996 for a discussion of the negative effects from a cigarette excise tax.

⁷ For instance, although the 1996 federal cigarette tax is 300 percent higher than the 1980 level, the revenue raising effectiveness of the cigarette tax for the federal government has fallen by 27 percent (each penny of the federal tax raised \$32.6 billion in cigarette excise taxes in 1980 but only \$23.7 billion in 1996).

New Revenues Are Not Necessary

According to a recent State Policy Reports analysis, 49 states[8] ended FY1998 with a budget surplus averaging 9 percent[9]. In addition, tax reduction proposals across the 50 states over the past several years have totaled \$15 billion[10]. New tax revenues are hardly necessary in such an environment.

Tax Policy Is One Of The Most Important Responsibilities Of New York's Legislature

According to the National Conference of State Legislatures[11], state taxes should

- Be broad-based with rates as low as possible;
- Take vertical and horizontal equity into account;
- Be simple to comply with and easy to administer;
- Be spread over as many forms of economic activity as possible; and,
- Provide appropriate and timely revenues."

Cigarette excise taxes are not broad based, are inequitable, are narrowly targeted over one specific type of economic activity (cigarette sales), and are unstable revenue sources. In short, cigarette excise taxes do not meet the criteria of a sound financing mechanism.

Conclusion

Cigarette excise taxes inflict a significant cost on the economy while providing an unsound state financing mechanism. Public policies that are deemed valuable and necessary deserve a more equitable, more stable, and less distortionary revenue source.

⁸ Hawaii is the exception.

⁹ See State Policy Reports, Volume 16, Issue 14, July 1998.

¹⁰ "The Fiscal Survey of States", National Governors' Association & National Association of State Budget Officers, May 1998.

¹¹ "A Review of State Economic Development Policy: A Report From the Task Force on Economic Incentives", National Conference of State Legislatures, March 1998, p. 44.