

# THE TOBACCO INSTITUTE

1875 I STREET NORTHWEST  
WASHINGTON DC 20006  
202 457-9800 • 800 424-9876

E. J. BATTISON, Ph.D.  
Economist

August 8, 1984.

To: Fred Panzer

cc: Milway, Merin, Vinovich, Prendergast.

re: The Effect Of A Value Added Tax On the Price of  
Cigarettes.

Your request for an estimate of the effect of a value added tax (V.A.T.) on the price of cigarettes is of interest. Although only an approximation is possible, such an estimate may be useful in view of the new federal tax package expected in 1985.

A value added tax (V.A.T.) is a percentage tax on the amount of value that is added to a product by each sector involved in processing, making, distributing, or selling the product. Plainly, value added is represented directly by the income to the sector's resources in the form of wages, salaries, benefits, interest, dividends, and plant/equipment depreciation allowances (i.e. the profit after taxes and dividends). The V.A.T. is actually a sales tax. It has a serious upper spiral effect as costs and prices increase, and it is also regressive because lower income people pay out a greater proportion of their income in such taxes associated with consumption. Moreover, it is difficult to administer efficiently, and it would displace the ability of state and local governments to raise their own cigarette tax rates.

In order to estimate the price effect of a V.A.T., some reasonable assumptions are necessary. Of course, different assumptions will result in different estimates. One can start with the current average national price. One way to proceed is to assume the current allocation of price to income in the major tobacco sectors will remain constant in proportions under a V.A.T. Another assumption is that the current excise and tax rates will continue to be imposed, in which case the V.A.T. would be a "tax on a tax". A third assumption is that all prices (including cigarettes) will increase annually by a nominal rate, say 5 percent.

Obviously, one could also assume as alternatives that the income percentage allocations and the prices could change at different rates, and that the current excise taxes would be replaced entirely by a V.A.T. Finally, an assumption has to be made about the expected percentage rate of the V.A.T. This rate has traditionally been between 5 and 15 percent in European countries.

The table on the next page indicates the possible price effects of a V.A.T.

PRICE EFFECTS OF A VALUE ADDED TAX ON CIGARETTES IMPOSED IN 1985 AND 1986

<u>Basic Tax Assumption</u>	<u>Percentage Rate of V.A.T. Imposed</u>	<u>Expected Increase In Price Expected On Cigarettes From the V.A.T.</u>	
		<u>1985</u>	<u>1986</u>
<u>Current Federal excise remains in effect (16¢)</u>	5 %	5.14¢	5.39¢
	10 %	10.27¢	10.78¢
	15 %	15.41¢	16.17¢
	20 %	20.54¢	21.56¢
<u>Current Federal excise tax replaced by V.A.T.</u>	5 %	4.34¢	4.59¢
	10 %	8.67¢	9.18¢
	15 %	13.01¢	13.77¢
	20 %	17.34¢	18.36¢

Notes: Clearly, a V.A.T. at rates of 15 percent and higher will be more burdensome than the current federal excise tax rate, if it were to replace the F.E.T.  
 If the F.E.T. remains along with the V.A.T., the V.A.T. would resemble a surcharge sales tax which would be 16¢ per pack plus the amounts in the upper part of the table. This is a "tax on a tax" which is unfair, discriminatory, much more burdensome on smokers than the F.E.T. alone, and it will grow steadily worse with inflation.

*Handwritten notes:*  
 New d.  
 1.67.  
 Then...  
 tax revenue  
 elastic  
 factor.

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*Expected Depressing  
Effect On Sales*  
1985 *million packs* 1986

-609.	-639
-1218.	-1278
-1837.	-1917
-2435.	-2556
-514	-544
-1028	-1088
-1542	-1637
-2056	-2177

Notes: Clearly, a V.A.T. at rates of 15 percent and higher will be more burdensome than the current federal excise tax rate, if it were to replace the F.E.T. If the F.E.T. remains along with the V.A.T., the V.A.T. would resemble a surcharge sales tax which would be 16¢ per pack plus the amounts in the upper part of the table. This is a "tax on a tax" which is unfair, discriminatory, much more burdensome on smokers than the F.E.T. alone, and it will grow steadily worse with inflation.

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\$2 1.67.  
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