

**EXCISE
TAXES:**

**THE
FAIRNESS
ISSUE**

530001076

EXCISE TAXES: THE FAIRNESS ISSUE

FOR STATE LOBBYISTS

THE TOBACCO INSTITUTE

530001077

EXCISE TAXES: THE FAIRNESS ISSUE

Summary

From an economic perspective, excise taxes are unfair: they place the heaviest burden on families at the lowest end of the income scale. The cigarette excise is the most regressive of all selective consumption taxes currently levied by state and federal governments. Its burden on consumers increases drastically as income decreases.

Excise taxes are also inequitable with respect to business and public policy. They hurt everyone in the economy (e.g., producers, labor and retailers) not just consumers. They single out particular industries to bear the brunt of raising general revenues. They impose a moral judgment on consumers of selected goods.

Samuel Johnson called excise taxes "hateful"; Alexander Hamilton call them "inquisitive and peremptory." And every school child knows it was an obnoxious excise tax that triggered the Boston Tea Party. The inequitable taxes on items such as alcohol and cigarettes, which we still have today, are nothing more than modern versions of the same taxes our founding fathers abhorred.

530001078

Tax Fairness

It is essential to estimate the projected revenue-raising ability of proposed tax policies in order to develop efficient, long-term solutions to fiscal problems. But the issue of tax equity is equally important.

Equity is a measure of how fairly or evenly the tax burden is distributed. A tax that falls most heavily on families at the lower end of the income scale (that is, a "regressive" tax) is viewed as unfair. On the other hand, a tax that is geared to one's ability to pay is considered a fair tax. A determination of the impact of various tax options on low- and middle-income families is critical to the ultimate adoption of an equitable tax package.

Excise Taxes and the Consumer

Conservatives and liberals alike favor broad-based revenue raising measures over excise taxes, which are selective consumption taxes on specific goods.

In 1982, two prominent conservative U.S. Congressmen condemned increases in excise taxes. Writing to the Office of Management and Budget, Jack Kemp (R-NY) and Trent Lott (R-MS) complained

530001079

that those who try to solve economic problems in this way seem to think that "because blue-collar workers will pay the tax at their taverns, stores, and gas stations, not on their 1040 forms, it does not come out of their income..." In 1984, Representative Kemp joined with liberal Senator Bill Bradley (D-NJ) in opposing excises. The following excerpt from their dialogue on tax reform in the New York Times on September 30, 1984 makes their opposition clear:

Mr. Kemp: Both of us are very critical of consumption-based taxes, because [they] would hurt the poor and families the most.

Mr. Bradley: As the debate [went] in 1913: Can a rich man consume more tobacco, or more alcohol, or whatever the [sales tax] is, than a poor man? The answer is basically that they are going to consume roughly the same amount, but the excise tax is going to be a much greater burden on the middle- and lower-income person.

Ray Denison, director of the AFL-CIO's department of legislation, recently raised similar objections to excises. In testimony to the Health Subcommittee of the U.S. House Ways and Means Committee, he opposed increasing taxes on alcohol and tobacco to raise revenue for the Medicare Trust Fund and similar healthcare programs because: "These are excise taxes, the most regressive of all taxes, which would disproportionately impact the low-income population..."

530001080

The Bakery, Confectionery and Tobacco Workers International Union echoed these sentiments in their testimony on the same subject: "Excises on alcohol and tobacco are regressive taxes which disproportionately impact low-income and working people. The effective tax rate for individuals in lower tax brackets is ten times as high as that paid by individuals who earn in excess of \$50,000 per year."

And finally, Harold Hochman, professor of economics at City University of New York, concluded his remarks before the U.S. Treasury's panel on fundamental tax reform with comments on excises and the consumer:

It is certainly no secret that many of our excise taxes are unfair when evaluated against the standard of horizontal equity. Study after study has confirmed that as income goes up, the effective tax rates on these goods go down. If by way of reform we adopt a plan to reintroduce taxation based on the ability-to-pay principle, then we must give serious consideration to...abolish[ing] existing excise taxes.

The Cigarette Excise

An examination of the cigarette excise reveals that it is one of the most unfair consumption taxes. The cigarette excise burden -- the percentage of income taken by the tax -- falls drastically as income increases. Economist Thomas W. Calmus demonstrated this in his study of excise taxes by income class published in the Quarterly Review of Economics and Business.

530001081

Calmus calculated the regressivity index of various excise taxes and found only the tax on smoking tobacco to be more regressive than the cigarette excise.

Robert Tollison, professor of economics at George Mason University, agreed with Calmus' findings. In testimony submitted to the U.S. Treasury, he wrote: "Excise tax[es] on tobacco products [are] the most regressive of the selective consumption taxes [currently] levied."

The regressivity of the cigarette excise is compounded when smoking among income levels, races and occupational groups is examined. According to economist James Savarese, former director of public policy analysis for the American Federation of State, County and Municipal Employees, in testimony submitted to the New York state legislature, "a significantly [larger] proportion of lower income individuals smoke than persons earning higher incomes. The latest survey data from the National Center for Health Statistics reveal that persons earning \$7,000 or less are 50 percent more likely to be smokers than persons earning \$25,000 or more."

And according to the Bakery, Confectionery and Tobacco Workers International Union, "Blacks are more likely to smoke than their white counterparts and persons in occupations traditionally

530001082

classified as blue-collar are more likely to smoke than persons working in jobs classified as white-collar and professional."¹

Both proportionately and absolutely, the cigarette excise is borne more by low- and moderate-income people than upper-income people.

Hidden Taxes

Excise taxes, by their nature, are hidden taxes. They become part of the product price and, so, are not obvious like retail sales taxes. This means consumers are unable to maintain effective control of their tax burden. In a written statement for the U.S. Senate Finance Committee hearings on major tax reform options, Roger Kormendi, associate professor of economics at the University of Chicago, described this unfair aspect of excise taxes:

The problem that arises from hidden taxes is that without the knowledge of their true tax burden, the tax-paying public cannot exercise effective political control over their overall tax burden. People will see the resulting price increases and/or wage reductions but will generally fail to recognize the source to be hidden taxes. Constituent political pressure on [the legislature] will therefore be misdirected away from the true problem.

¹John DeConcini, "Statement of the Bakery, Confectionery and Tobacco Workers International Union to the Health Subcommittee, House Ways and Means Committee, Regarding Earmarking of Alcohol and Cigarette Excise Tax Revenues for Medicare Funding," September 13, 1984.

530001083

Excise Taxes and Industry

Excise taxes create a general drag on the economy. They are burdensome to producers, retailers and labor, as well as consumers. In their book, Five Economic Challenges, Robert Heilbroner, professor of economics at the New School for Social Research, and Lester Thurow, professor of economics and management at MIT, describe the effect:

Because the cost of the commodity is higher [with the excise tax], less of it is sold -- gasoline or liquor or cigarette sales, for example, always suffer when taxes are placed on them. It follows that the...tax must affect individuals other than just the buyers. The seller of the commodity must bear some of the tax because his sales have declined and presumably so has his income. The workers or other suppliers of services who produce the commodity will also be penalized, because less of the taxed commodity will be bought and therefore fewer people will be employed making it.

President of the U.S. Chamber of Commerce, Richard L. Leshner, said it more briefly in his statement on tax proposals submitted to the U.S. Senate Finance Committee: "Tax increases reduce consumer spending power and businesses' ability to invest, thus slowing private economic activity and raising unemployment."

In the past two years, articles in prominent news dailies demonstrated the devastating effect of an excise tax:

From the New York Times, January 22, 1983: R.J. Reynolds Industries said it was asking more than 10 percent of its cigarette workers to quit or retire early, and that it had already cut back next week's production schedule at the R.J. Reynolds Tobacco Company to four days, as a result of an expected sales decline attributable to the increase in the federal tax on cigarettes.

530001084

From the Wall Street Journal, March 5, 1984: Philip Morris, Inc....said it laid off 175 workers at its cigarette making plant...because of lower than expected sales....A spokesman said that while sales were up in the U.S. and worldwide, an increase in federal and state excise taxes on cigarettes held the sales increase below company expectations.

Indeed, excise taxes on selected goods are unfair because particular industries must bear the brunt of raising general revenues. Some 200 years ago, Alexander Hamilton warned that taxes on specific items [would lead] to "the oppression of particular branches of industry" among other evils. It is no different today.

The Minority Report of the 1982 Advisory Council on Social Security, written by Stanford Arnold, secretary-treasurer of the Building Trades Council, Michigan State AFL-CIO, and Alvin Heaps, President of the Retail, Wholesale and Department Store Union, opposed increasing taxes on alcohol and tobacco to raise revenue for Medicare because: "These are regressive taxes which would disproportionately impact the low-income population and unfairly single out particular industries."

A Richmond Times-Dispatch editorial, from December 20, 1983, criticized the excise taxes on tobacco for threatening to destroy an important American industry:

Since the settling of America, tobacco has been an important part of the nation's economy. But today it is fashionable to treat the leaf as Public Enemy No. 1, and one result is the somber news from Petersburg that Brown and Williamson will close its plant there within two years. More than

530001085

1200 employees will be affected....Company officials say that soaring taxes...are a major reason for their decision.

The beneficent economic impact of the tobacco industry is deep and widespread, and so would be the devastating effects of its destruction. But it will be difficult for the industry to survive if [it] continues to [be] leech[ed] with confiscatory taxes.

Richard A. Shoemaker, assistant majority leader in the Wisconsin Assembly, outlined the widespread economic effect of more taxes on tobacco. In an article for Legislative Policy magazine, Shoemaker wrote:

When cigarette taxes increase and demand declines, small businesses are hardest hit. Cigarette purchases -- and cigarette industry operations -- have a ripple effect on the economy that goes far beyond the direct interaction of buyer and seller....This spillover effect reaches employment as well. Nearly 400,000 persons are employed full-time in the tobacco industry. Another 1.6 million jobs exist in other industries associated with producing, wholesaling, and retailing tobacco products....National or state excise tax-rate increases lead to a decline in demand and therefore revenue, output, earnings and employment in the cigarette industry and each of its supporting sectors.

In testimony before the California state legislature, Thomas Borcharding, professor of economics at Claremont College, agreed with Shoemaker that small businesses are hardest hit by an increase in the cigarette excise tax:

Another related factor to be considered is the impact on small business. A doubling of the cigarette excise tax would create serious hardship for small retail establishments in California. Cigarettes are the key traffic builders for many of the state's 44,000 retail establishments. Among convenience stores, cigarettes are the number one selling product and account for 16.7% of gross profit dollars. The conclusion here is obvious: the real burden of a cigarette

530001086

excise tax increase will fall on large segments of the small business community, much of which is just turning to profitability since the last recession.

An article in the March 1983 issue of Convenience Store Merchandiser confirmed that small businesses, not only tobacco manufacturers, are hurt by increases in excises. Gerald Coelsh, vice president of marketing for an Ohio-based convenience store chain, was asked how the doubling of the federal excise tax on cigarettes affected his company's sales: "It is a strain. When a category that accounts for ten to 15 percent of total sales falls off, you're talking about one-half to one percent of gross store profits."

Excise Taxes and Government

We have discussed how excise taxes are unfair to consumers and to particular industries that are singled out to bear the brunt of what should be a more equitably distributed tax burden. Excises on items such as alcohol and tobacco are additionally unfair as a matter of public policy. Namely, they impose a moral judgment on consumers of selected products.

Taxes are inevitable, but at what point do they become destructive? Robert Nozick, philosophy professor at Harvard University, raised this question in his book, Anarchy, State and Utopia. In Nozick's ideal state, government would not interfere with "capitalist acts between consenting adults"; it would be required to maintain

530001087

a hands-off policy regarding the freedoms of individuals and the rights of corporations, ideally two sides of the same coin.²

An editorial in National Review, February 19, 1982, described the destructive nature of excise taxes on goods such as alcohol and tobacco:

They say that if you only wait long enough, anything will come back into fashion. Even so, who would have guessed that 1982 would see a renewed vogue for sin taxes? Until President Reagan quashed the idea, the pundits were making a tax on alcohol and tobacco sound like the freshest, most innovative scheme ever to hit representative democracy. It punished the wicked; it rewarded the virtuous; it replenished Washington's touchingly depleted coffers; and it restored discipline to what even George Will said was a sadly undertaxed nation.

Sin taxes appeal...to those with a yen for paternalism. In [this group] are some ardent Naderites who seem to support such taxes primarily as a way to change behavior -- that is, to restrict liberty -- and only secondarily to raise money.

An article in the Chicago Tribune, January 17, 1982, echoed the National Review's editorial stance:

Raising the tax on tobacco and liquor would be a cheap shot by the government. It is as if they were challenging us to complain about an excessive tax on something as bad for us as whiskey and cigarettes probably are. In putting proportionately higher taxes on those two things than on most other products, the government has already made a moral judgment. It has decided tobacco and whiskey are bad. When the government gets into deciding what's good or bad

²James Bowling, "Cigarette and Alcohol Taxes Hurt Poor Men Most," Business and Society Review, Spring 1976, Number 17.

530001088

for us, it's over its head and ought to get out. It's none of the government's business if we smoke or drink.

In 1976, Gene Haislip, deputy assistant secretary for legislation at the Department of Health, Education and Welfare, testified before the U.S. Senate Committee on Labor and Public Welfare on the "National Health Research and Development Act." In his testimony, Haislip disapproved of using excise taxes to discourage smoking:

We believe that it is inappropriate for government to intervene in the individual decision to smoke cigarettes through a tax penalty....We are not convinced that it is proper to tax individuals on the basis of their decision to smoke cigarettes any more than it would be proper to tax people to encourage physical exercise or better eating habits.

Conclusion

Excise taxes are unfair to consumers: they are regressive taxes which disproportionately have a greater effect on families with low and middle incomes. They are also inequitable with respect to business. Indeed, their present magnitude makes them oppressively burdensome to both industry and labor. And finally, as we have discussed, excises are unfair as a matter of public policy. Taxes on items such as alcohol and cigarettes impose an inappropriate moral judgment on consumers of these selected goods.

Ronald A. Pearlman, assistant secretary of the Treasury, agreed with these conclusions at a tax conference held in Washington, D.C. on December 14, 1984. "I think you will not find any economist


530001089

and you will not find me defending excise taxes as anything other than revenue raisers," Pearlman said. "They are regressive. They are industry specific. They are unsound in my judgment from any kind of economic or tax policy basis....I would not seek to defend [them] on any rational basis."

530001090

530001091



 The Tobacco Institute
1875 I Street Northwest
Washington, DC 20006
(202) 457-4800

530001092