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TAXING ALL TOBACCO PRODUCTS: A PROPOSAL

by Robert Kleine, Senior Economist

All 50 states and the District of Columbia impose a tax on cigarettes, but only 23 states also impose a tax on other tobacco products: cigars, pipe tobacco, chewing tobacco, and snuff (see Table 1). Michigan taxes only cigarettes, but we propose that in the interests of equity, revenue, and health, all other tobacco products should also be taxed.

Background

Many states do not tax other tobacco products because the revenue potential is relatively small and administration is purported to be much more complicated than for cigarettes. In the 23 states that tax these products, revenues average only 3.5% of total revenues from all tobacco products (cigarettes account for 96.5% of all revenues), ranging from 1.2% in Arizona and 1.4% in Georgia (where only cigars are taxed) to 10% in Hawaii, 10.6% in Mississippi, and 11.7% in Idaho.

In Michigan a 20% tax on tobacco products was imposed in January 1960, but was repealed in June 1961 because of problems in administering the tax. In 1978, 1979, and again in 1982, Representative Joe Young, Jr. introduced bills that would have imposed a tax on cigars and smoking tobacco. The proposed tax rate was 5 1/2 mills for each cigarette (11¢ per pack) and cigar and for each 1/10 ounce of pipe tobacco. None of the bills was ever reported out of committee.

At the federal level there are two bills pending to tax other tobacco products: Senator John Chafee (RI) has introduced legislation (S. 1782) that would impose a tax on snuff and chewing tobacco--8¢ per ounce of snuff and 8¢ per three-ounce package of chewing tobacco, and the Senate budget reconciliation bill (S. 1730) contains a provision that would impose a 2¢ tax per package on snuff and chewing tobacco. The enactment of a federal tax would depress consumption and reduce the yield from a state tax on these products.

Arguments For and Against

From an equity standpoint, if cigarettes are taxed, so should all other tobacco products since their uses are similiar. In addition, there is the argument that it is in the public interest to discourage use of health-threatening products by artificially raising prices of such products through higher taxes.

TABLE 1

TAXATION OF TOBACCO PRODUCTS OTHER THAN CIGARETTES

State	Products Taxed	Gross Collections FY 1983-84 (000)	Percent of Total Tobacco Taxes	Tax Rates (As of 10/1/85)
Alabama	All	$1,663	2.3%	Varied
Arizona	All	521	1.2	Varied
Arkansas	All except snuff	3,094	4.9	16% of manuf. invoice
Florida	All except cigars	NA (eff. 7/1/85)	-	25% of wholesale price
Georgia	Cigars	1,244	1.4	Little cigars: 2 mills each; other cigars 15% of wholesale price
Hawaii	All	1,984	10.0	40% of wholesale price
Idaho	All	1,253	11.7	35% of wholesale price
Iowa	All	1,158	1.9	15% of wholesale price
Kansas	All	1,222	2.6	10% of manuf. invoice
Louisiana	Cigars, smoking tobacco	1,405	2.2	Cigars: 8% or 20% of net invoice price; Smoking tobacco: 33% of net invoice price
Minnesota	All	3,101	3.6	25% of wholesale price
Mississippi	All	3,958	10.6	15% of manuf. list price
Montana	All	692	5.0	12.5% of wholesale price
Nevada	All	850	4.6	30% of wholesale price
North Dakota	All	324	2.3	11% of wholesale price
Oklahoma	All	3,370	4.2	Varied
South Carolina	All	2,053	6.5	Varied
Tennessee	All	2,431	3.1	6% of wholesale price
Texas	All except snuff	9,819	2.8	Varied
Utah	All	668	4.9	25% of manuf. selling price
Vermont	All	572	4.4	20% of distrib. price
Washington	All	5,236	5.2	48.15% of wholesale price
Wisconsin	All	3,940	3.0	20% of wholesale price
U.S. TOTAL		$50,560	3.5	

SOURCE: The Tobacco Institute, "The Tax Burden on Tobacco," vol. 19, 1984.

NOTE: Oregon has passed legislation that will tax all tobacco products (other than cigarettes) at 35% of manufacturers list beginning January 1, 1986.

ALL=Cigars, smoking tobacco, chewing tobacco, and snuff.

The major arguments against taxing these products are that the tax would be regressive (it would fall more heavily on low-income persons than high-income persons), inelastic (the base of the tax would be unresponsive to economic growth), and somewhat more difficult to administer than the cigarette tax. Regressivity was not a convincing argument when the cigarette tax was adopted, and it is unlikely to be important in consideration of expanding the tax to all other tobacco products.

On the question of inelasticity, the growth potential of this tax would be limited because the consumption of tobacco products probably will continue to decline as it has generally for the last decade. U.S. consumption of cigars fell about 15% from 1982 to 1985 and U.S. consumption of pipe tobacco declined almost 20% during the same period. However, if the tax on these products were an ad valorem tax (based on value), price increases would produce gains in revenue. The consumer price index for tobacco products other than cigarettes increased 61.9% from 1980 to 1985; a tax tied to value would generate more revenue as the prices of the products increase.

The third, and strongest, argument generally used against levying a tax on other tobacco products is that the revenues collected are not worth the administrative and other problems involved. In a 1982 analysis of HB 5371, the Michigan Department of Treasury argued that a tobacco products tax would be very difficult to administer and estimated added collection costs of $150,000. However, discussions with tax administrators in several states that levy the tax indicate that this is not the case, although they concede that the tax on other tobacco products may be slightly more difficult to administer than the tax on cigarettes for several reasons: (1) the distribution system for these products is more diverse, (2) tax indicia (stamps) are not used as is the case with cigarettes, (3) purchases from distributors in states without a tax on these products are difficult to police, (4) mail order purchase of cigars is prevalent in many states and taxes on these purchases are almost impossible to collect, and (5) since Ohio and Indiana do not impose these taxes, retailers near the border would be at a competitive disadvantage.

However, on balance, most state tax administrators believe that the revenue collected from a tax on other tobacco products, although relatively small, far outweighs the administrative headaches.

<u>The Tax Rate and the Revenue Yield</u>

In most states the tax rate is set as some percentage of the wholesale price, ranging from 6% in Tennessee to 48.15% in Washington. Others use varying rates depending on the type of tobacco product, the size, or the price, but this seems unnecessarily complicated. Setting the rate is a political process based on revenue considerations and market conditions, but it should be comparable to the tax rate on cigarettes. The cigarette tax rate in Michigan is 21¢ per pack, which equates to about 33% of the wholesale price (including federal excise tax).

Projecting the revenue yield is difficult, because Michigan consumption data for tobacco products other than cigarettes are not available, but by using national data and data from states that impose a tax on other tobacco products we estimate that at a tax rate of 33% on the wholesale price the annual yield would be between \$15.7 million and \$16.8 million,[1] before any discounts are allowed to distributors for collection expenses.

Recommendations

Although taxes on cigarettes and tobacco products have several disadvantages as revenue sources, we see no justification for taxing cigarettes and not taxing all other tobacco products. We also believe that the argument that a tax on other tobacco products is very difficult to administer is exaggerated.

For these reasons, and health policy reasons, we therefore recommend that the state impose a tax of 30 to 35% on the wholesale value of these products. The proceeds could go into the State's general fund or could be designated for some purpose that would benefit the public in a direct way, such as health promotion progams, disease research, education, or economic development seed money. Although earmarking is not usually a good idea, in this case it appears appropriate. The small amount of revenue generated by this tax would be relatively insignificant to the general fund, but it could have a major impact if earmarked for a specific purpose.

We also recommend that the state give consideration to converting the flat 21¢ per pack cigarette tax into an ad valorem tax (one based on value). The only state that now levies an ad valorem tax on cigarettes is Hawaii. An ad valorem tax would significantly increase the growth potential of the cigarette tax and sharply reduce the need for periodic tax increases. For example, from 1971 to 1981 (during which time the cigarette tax rate was 11¢ per pack), revenues increased by about \$18 million to \$140 million. If instead, a 45% ad valorem tax (equivalent to 11¢ per pack) had been imposed in 1971, revenues would have increased about \$105 million to \$225 million by 1981. (See Figure 1.) (A 45% rate on the wholesale price would have been equal to about 17.5¢ per pack in 1981 and about 29¢ per pack in 1985.) The higher price on cigarettes over this period, had the ad valorem tax been imposed, would have dampened consumption somewhat, but the effect would likely have been less than the shock effect of the 10¢ increase imposed in 1982.

Any legislation that disadvantages an industry is likely to generate strong opposition from that industry. However, the tobacco industry has had little success in stopping cigarette tax increases at the federal or state levels in recent years. This is because of the health issue and because lawmakers correctly perceive that the public is more willing to accept increases in tobacco and liquor taxes than increases in sales or income taxes.

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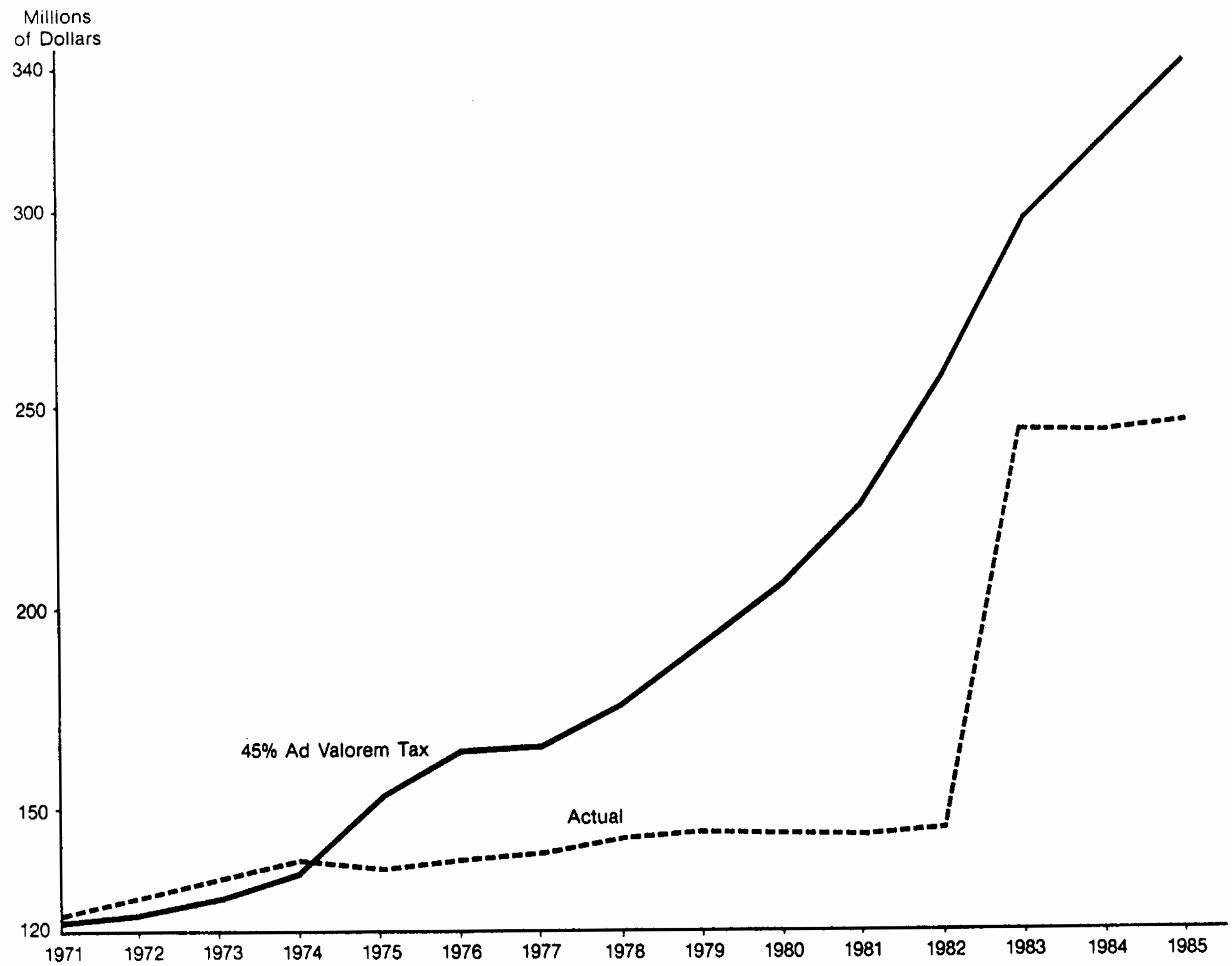
[1] If we assume that the Michigan-to-national ratio for consumption of other tobacco products is roughly the same as it is for cigarettes, we estimate that the annual wholesale value in Michigan is \$51 million or \$5.60 per capita. Another method of estimating the value of these products is to look at consumption in states that already impose a tax. The average per capita wholesale value for the ten states that use the wholesale price as the tax base is \$4.37. The average cigarette consumption, however, in these states is 16.5% below the Michigan average. If an adjustment is made for this difference, one arrives at an estimate of \$5.23 of wholesale value per capita, about 6.5% below the first estimate.

FIGURE 1

CIGARETTE TAX COLLECTIONS,
ACTUAL AND ON AD VALOREM BASIS, 1972-1985



NOTE: The large increase in collections in 1983 is due to the ten-cent cigarette tax increase.