

# IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

*IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.*

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## TOBACCO SUIT SENDING ECONOMIC STIMULUS UP IN SMOKE?

President Bush has proposed a tax cut of \$726 billion over ten years to spur the economic expansion. The Senate has voted to cut it to \$350 billion. Bowing to Senate pressure, the House allowed for a \$550 billion tax cut in its Budget Resolution, and the President reluctantly agreed.

Meanwhile, the (so-called) Justice Department has filed a lawsuit demanding \$289 billion from nine tobacco companies, to be paid over some unspecified period. If collected over the same ten years as the President's tax cut, it would take back 40 percent of the President's original tax proposal, 60 percent of the scaled back House amount, and over 80 percent of the Senate's smaller tax cut.

Does anyone notice an inconsistency in this policy mix?

Justice's new federal tobacco claim is on top of the 25-year \$280 billion settlement the companies reached with the states in 1998. President Clinton then pushed for a federal lawsuit, which we labeled "taxation through litigation instead of legislation" (IRET *Congressional Advisory*, No. 80, May 4, 1999). That suit was apparently laid to rest, but like Dracula, it has arisen undead and with impressive fangs. Presidents come and go, but the bureaucratic agenda lives on.

Modern tax theory doesn't merely measure the effect of tax changes by their dollar value. Rather, it looks at their incentive effects or their impact on resource allocation. Even on that score, this money grab would be a bad move.

The Justice Department claim would act like a selective excise tax on cigarette consumers and producers. Since the companies cannot print money or operate at a loss, the entire fine (if it survives a trial) would have to be paid by several tens of millions of cigarette smokers (via higher retail prices), tobacco farmers (lower commodity prices), company employees (lower wages) and shareholders (lower dividends).

Although the tobacco tax, or its "fine" equivalent, is widely regarded as falling on consumption, not income, increasing it would still be bad for the economy because it

falls on a single product and distorts economic behavior. People work and save to earn money to buy things. Excise taxes make consumers less able to buy the things they like in the proportions they like. For any given amount of revenue raised, excise taxes make people less happy and less willing to produce than would an evenhanded broad-based consumption tax. Excise taxes are bad tax policy.

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Of course, there are differences between a fine and an increase in the tobacco excise tax. Excise tax revenues drop if fewer packs are sold. The fine, however, would not be based on the number of packs sold. As the penalty-induced price hikes caused people to smoke less, the companies would still owe the full fine and would have to boost prices all the more to keep paying Washington. Clever Feds!

However, the reduction in smoking would cut revenues from existing federal and state excise taxes. And like a tax, the fine would boost the price per pack, which, if it boosts the consumer price index, would raise the cost of indexed Federal spending programs, including Social Security. Too-clever-by-half Feds!

The Justice Department may not care that several states have spent themselves into financial holes lately. But it should note that fining tobacco companies will reduce cigarette sales volume and state tobacco tax revenues. The states have already started down that road by imposing major tobacco tax hikes in the last year to fight their budget deficits, and are finding that volume — at least, legal volume excluding smuggling — is much more responsive to predatory taxation than they assumed.

The Justice Department does not appear to have run the lawsuit through the Administration's domestic policy coordination process. Indeed, it is not even clear that senior Department officials were kept fully aware of the tobacco task force's plans.

It's not fair that, while the Attorney General has his hands full hunting potential terrorists, part of his own Department is loosing its own surprise attack on the economy. Furthermore, cigarette smuggling goes up along with the price per legal pack, and some of the proceeds from cigarette smuggling have been supporting Al-Qaeda. One arm of the Justice Department is stabbing another.

Uncertainty over Iraq, Al-Qaeda, and accounting scandals have been blamed for the weak stock market and economy. If uncertainty is an economic negative, why is the government itself generating

excruciating uncertainty for a major industry by bringing a charge that was not expected, and requesting a fine that is beyond belief? Other industries should be nervous too. Who's next? Will there be a sudden flip-flop on global warming with penalties imposed on petroleum producers, utilities, auto makers, and other manufacturers for things they did over the last 40 years? Will the long-sought legislated asbestos settlement curb outrageous judgements, or will it let the government seize business assets equal to a year's profit for the whole corporate sector?

It's time to put the federal tobacco suit to rest with a stake through its heart. Buffy for Assistant Attorney General, anyone?

Stephen J. Entin  
President and Executive Director

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