IRET Congressional Advisory

August 24, 1995   No. 49

SHOULD THE TAX CODE PUNISH CIGARETTE ADVERTISERS?

President Clinton was asked during an Oval Office interview on MTV whether he favored ending the tax deductibility of cigarette advertising costs. The suggestion delighted the President and he replied enthusiastically, "I'll look into it. It's an interesting idea. Nobody ever even raised it to me before. Maybe you [the MTV interviewer] should be here making public policy. That's great." The idea the President endorsed is a back-handed way of preempting cigarette companies from marketing their products.

Cigarette advertising costs should remain tax deductible because they are legitimate business expenses incurred in generating income.

Leaving aside the question of whether MTV interviewers would be an improvement over current White House policymakers, nondeductibility is a terrible idea because it would violate a fundamental income tax principle: it would deliberately mismeasure income. Income is not gross receipts; income is gross receipts minus the costs incurred in generating the receipts. Unless business-related expenses are deductible, the tax base will exceed actual income, perhaps substantially.

[M]any believe that smoking is the devil's device, but they should not contravene basic tax principles in order to penalize those with whom they disagree.

Among the costs that businesses incur in generating income are the costs of the services they purchase in marketing their products. One of those services is advertising. As such, the tax deduction that businesses can now claim for the marketing services they purchase, which includes advertising, is entirely proper.

Although the President was asked about cigarette advertising, the issue is much bigger than cigarettes. Many proposals have been made over the years to limit or disallow the write off of advertising costs. If cigarette advertisements become nondeductible, those seeking to restrict the advertising deduction would likely move on to other products, citing cigarettes as a precedent. In Washington, one prohibition or disallowance often leads to another. Ultimately, the deductibility of all business marketing expenses could be at risk.

More basically, many believe that smoking is the devil's device, but they should not contravene basic tax principles in order to penalize those with whom they disagree. It is a threat to fairness, liberty, and economic growth if those in power decide that the operative rule of tax policy ought to be that the end justifies the means.

Depriving businesses of the ability to deduct advertising costs would be a large, hidden income tax increase. Suppose, for example, that a cigarette producer buys a $10,000 ad. Because of that expense, it has $10,000 less income. Under current law, it can claim a tax deduction accurately reflecting that reduction in income. If, however, the government refused to allow the deduction because it involves cigarette advertising, the business's tax bill would rise by $3,500 (35 percent

Institute for Research on the Economics of Taxation

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

1730 K Street, N.W., Suite 910, Washington, D.C. 20006
Voice 202-463-1400 • Fax 202-463-6199 • Internet www.iret.org

of $10,000, assuming a 35 percent corporate tax rate). That is a $3,500 tax bill on "income" the business does not have.

When companies buy advertisements, the amounts they spend do not drop out of the tax system. Instead, advertising expenditures are revenues to sellers of advertisements, and the sellers must include those revenues in their tax bases. In the above example, while the cigarette company deducts its $10,000 expenditure under present law, those it pays for placing the advertisement (media outlet, advertising agency, etc.) must include the $10,000 in their tax bases. If the government refused to let the cigarette company deduct its expenditure while continuing to tax the providers of the advertising services on their $10,000 of revenues — the flip side of the expenditure — the government would be taxing the same $10,000 twice.

> ***Suppose...a cigarette producer buys a $10,000 ad....If the government refused to let...[it] deduct its expenditure while continuing to tax the providers of the advertising services on their $10,000 of revenues...the government would be taxing the same $10,000 twice.***

Denial of deductibility would also be inappropriate because firms advertise to increase their revenue — and any additional revenue resulting from advertisements is fully taxable. Suppose, for example, that a firm achieves $11,000 of extra revenue as a result of a $10,000 advertisement. Under present law, the $11,000 of extra revenue is taxable and the $10,000 of extra expense is deductible, causing the firm's taxable income to rise by $1,000. This correctly tracks the $1,000 increase in the firm's actual net income. If, in contrast, the revenue were taxed but the expense were disallowed, the firm's taxable income would rise by $11,000 — which is <u>11 times</u> larger than the firm's true income increase.

> ***If cigarette advertisements become nondeductible, those seeking to restrict the advertising deduction would likely move on to other products...Ultimately, the deductibility of all business marketing expenses could be at risk.***

Another fundamental tax principle is that taxes should not be hidden but should be plainly visible to taxpayers — in this case those who produce and those who purchase cigarettes. Highly visible taxes are desirable because they maximize the political accountability of elected policymakers and because they help voters understand the real costs of government services. Denying a deduction for cigarette advertising costs is such a well concealed revenue raiser that it apparently confuses even the President. Asked during the MTV interview whether he favored a federal cigarette tax (neither the President nor the interviewer made clear that the federal government already imposes a steep tax on cigarettes), the President responded that he would not push for an (increased) excise because "Congress would not adopt that" and because "the bulk of the cigarette tax is available to the states...and I don't want to...crowd that out."

If the President is so worried about gaining Congressional approval and crowding out state tax collections, why didn't he express those same concerns when asked about taking away the deduction for advertising costs? The loss of deductibility is just as much a tax hike as an explicit increase in the statutory excise rate. Indeed, the denial of deductibility can be thought of as a concealed 35 percent excise tax on cigarette advertising expenditures, given that a company would have to pay 35 cents of tax for every dollar it spent advertising cigarettes.

The President may have been excited by the non-deductibility suggestion because his Administration has embarked on a neo-prohibitionist policy with regard to cigarettes. With the President's vigorous backing, the FDA seeks to classify cigarettes as "drug delivery systems", severely restrict the conditions under which they may be sold, force cigarette companies to finance a $150 million anti-cigarette campaign, and virtually outlaw most current cigarette advertising. In answer to a question in the MTV interview about banning cigarettes outright, President Clinton hinted that these are just the opening moves in a gradually tightening series of government restrictions, "What I want to do is to phase it out over time...[I]f young people stop using cigarettes — *if we [the government] could get...[their] usage down to zero*, then eventually it will phase out... I think we just have to start with our young people. [emphasis added]" Critics charge that the FDA has greatly overstepped its authority. They also charge that the proposed restrictions trample upon the first amendment, which supposedly protects free speech. These issues are now before the courts.

One does not have to be a proponent of smoking to feel uneasy about the Administration's proposed restrictions on individual freedom or to insist that such profound intrusions into everyday life should not be made by regulatory fiat. One also wonders whether federal efforts to stamp out cigarettes will have the perverse effect of glamorizing smoking, much as Prohibition did with alcohol.

Fortunately, denial of a tax deduction for cigarette advertising cannot be done by regulation but would require formal legislation. Despite the President's responses to questions, the Administration has not yet issued such a proposal. Nor should it do so. Cigarette advertising costs should remain tax deductible because they are legitimate business expenses incurred in generating income. If cigarette taxes, which are already high, are to be increased, the increase should at least be made through a plainly visible tax rather than a hidden one.

Michael Schuyler
Senior Economist
