IRET POLICY BULLETIN

April 30, 1998
No. 72

THERE'S NO ECONOMIC EXCUSE FOR A HIGHER CIGARETTE TAX

The proposed $1.10 a pack increase in the federal excise tax on tobacco is a whopping tax hike—about $25 billion a year—that will have noticeable, adverse economic consequences. It is being justified as part of a campaign to suppress smoking. There is little doubt that the tax hike will have some impact on smoking, although the amount of the response is open to question. There are grave questions, however, about whether this is an appropriate area for federal intervention, and many flaws in the economic arguments advanced by proponents of the tax.

Excise taxes and social costs

Economists generally dislike excise taxes because they distort consumption and production. Consumers are dissuaded from purchasing the mix of products they would normally prefer, and which producers would normally provide, given available resources.

[T]obacco taxes are, in fact, more than large enough to "correct" for any reasonable measure of unintended transfers from non-smokers to smokers, or economic distortions relating thereto... [The government's] object is to raise revenue, not to eliminate smoking... As a revenue measure, the tobacco tax it is an inferior, distorting tax. It is a $500 billion tax hike on a minority of the population...[to] fund one of the biggest tax/transfer programs of recent times...

Economists of an interventionist frame of mind, however, sometimes recommend excise taxes to offset perceived cases of market failure, in which the price of a product may not fully reflect the costs incurred in its production or use. For example, a polluting factory may impose costs on its neighbors that are not passed on to its customers; third parties are injured in the production process, but consumers are not charged to compensate them, and over-consume the product. In other cases,

Institute for Research on the Economics of Taxation

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

consumers are supposed to lack adequate information about the costs to themselves of using a product; some of the costs—such as risk of illness or injury—are not in the price, and if the individual is not aware of these costs, he may over-consume the product.

In cases like these, some economists would recommend an excise tax to boost the price of the offending product to levels closer to what they estimate to be total cost, reducing production and consumption to levels that they think would obtain in a supposedly more perfect market. The economy would then be said to be operating "efficiently", even if the injured parties were not given the tax revenues as compensation. That there is no need actually to compensate the victims to obtain the "efficient" mix of output was first noted by economists J. R. Hicks and Nicholas Kaldor. All that is necessary is that they could be compensated to the efficient degree with the amount of revenue raised. Governments were quick to learn that obscure bit of economic theory, and have practiced it faithfully ever since—by keeping the money for other uses.

There are enormous problems with this theory of social costs and the attempt to correct perceived market failure through taxation. Dr. Roy Cordato has written an IRET study[1] rebutting every major category of argument employed by the social engineering school of taxation.

Economists of an interventionist frame of mind, however, sometimes recommend excise taxes to offset perceived cases of market failure...[but] there are enormous problems with this theory of social costs and the attempt to correct perceived market failure through taxation.

Cordato points out that the government never has as much information at its disposal as the free market about the wishes of consumers and the costs of production, that consumer preferences and conditions of supply are constantly changing, and that central planners are never able to outguess the market or improve on its results except by pure accident. It is virtually impossible to measure an externality, let alone offset it with precision. How much does an externality annoy its victims? The question involves the subjective feelings of thousands of people that cannot easily be quantified. The closest we could come would be to try to determine how much they would pay to avoid the nuisance, and there is no easy way to do that.

It is generally not possible to determine who bears the cost of an activity that creates an externality. By the time that the economy has finished shifting and distributing all of the costs of an activity, they are untraceable. Furthermore, if the government were to impose an excise tax to reduce the production of a product assumed to have undesirable spill-over costs, the pattern of

[1] Roy E. Cordato, *Social Costs, Public Policy, and Freedom of Choice*, Fiscal Issues No. 7 (Washington, DC: Institute for Research on the Economics of Taxation, 1992).

production would be altered across the whole range of output. Factors of production used in the targeted industry would shift to the production of other goods and services. There would be a net gain only if the value of the alternative goods and services plus the reduction of the spill-over costs of the original output exceed the value of the curtailed output of the offending product. In addition, some of these other activities might impose spill-over costs of their own.

But let us take the theory of social costs at face value, and see if it makes sense to apply it to tobacco. We will quickly see that it falls apart in the case of tobacco taxes.

The notion of economic losses from smoking

Two studies[2] by the Office of Technology Assessment (OTA), in 1985 and 1993, attempted to measure the economic costs of smoking. Most of the costs found by these studies consisted of lost wages of workers who died prematurely due to smoking. About a third of the cost was attributed to higher medical outlays. For example, the OTA's 1993 study reports total costs in 1990 of $68 billion, or about $2.59 per pack of cigarettes. Of that, $47 billion was lost wages. About $21 billion was increased medical costs, of which $12.1 billion was covered by individuals and private insurance. The remaining $8.9 billion of higher medical costs was mostly outlays of Medicaid and Medicare, with the federal share at $6.3 billion and the states paying $2.6 billion. The OTA studies did not take into account the reduction in the Social Security benefits and other retirement payments received by smokers or certain other offsets to the costs.

Overstatement of lost wages

Researchers in the field were quick to point out serious flaws in the OTA's methods and assumptions. Some of the problems were due to errors in the data, leading to overstatement of the lost wages and overstatement of the medical outlays due to smoking. For example, deaths attributed to lung cancer are often the result of cancers that metastasized and spread to the lungs. One study, involving more than 2800 autopsies of lung cancer victims, found that fewer than 750 were primary lung tumors, with the remainder having originated in other organs.[3]

Another problem is failure to correct for other factors causing lost wages. Statistics indicate that smokers miss work more frequently than non-smokers. But blue collar workers tend to miss work more frequently due to injury and less job satisfaction than white collar workers, whether they smoke or not. It is also the case that blue collar workers are more likely to smoke than white collar workers. Consequently, studies that look only at whether a worker smokes or not, and that do not correct for

---

[2] Office of Technology Assessment, *Smoking-Related Deaths and Financial Costs* (Washington, DC: Office of Technology Assessment, 1985); and Office of Technology Assessment, *Smoking-Related Deaths and Financial Costs: Office of Technology Assessment Estimates for 1990* (Washington, DC: Office of Technology Assessment, 1993).

[3] Hans J. Eysenck, "Smoking and Health," pp. 17-88 in Robert D. Tollison, ed., *Smoking and Society: Toward a More Balanced Assessment* (Lexington, MA: D.C. Heath, 1986), p.30.

the occupation of the worker, may falsely attribute absenteeism to smoking instead of to occupation. Also, people who drink tend to have a high absentee rate, and people who drink also smoke more than non-drinkers. Studies that do not correct for the affect of alcohol consumption may attribute alcohol related absenteeism to smoking. In turn, studies that correct for these other attributes find little relationship between smoking and absenteeism, and correspondingly lower economic costs of smoking.[4]

No social cost from lost wages

More important than the mismeasurements of lost wages, however, is the conceptual flaw of counting such costs at all. The OTA studies, and a recent study by the Treasury, made a fundamental mistake in failing to distinguish between losses that smokers inflict on themselves and losses that smokers impose on others. There is no case for government intervention except if one party injures another. In a free society, any cost of smoking borne by the smokers themselves is their business, not the government's.

The OTA studies, and a recent study by the Treasury, made a fundamental mistake in failing to distinguish between losses that smokers inflict on themselves and losses that smokers impose on others... In a free society, any cost of smoking borne by the smokers themselves is their business, not the government's.

It is a fundamental law of economics that factors of production are paid what they add, at the margin, to output. By and large, productive people get higher wages than unproductive people. People with high absentee rates or low productivity, for whatever reason, including smoking related health problems, earn lower wages. This may be because they are paid by the piece, or by the hour, or because failure to produce efficiently interferes with promotions, but it happens, one way or another. It is the smokers, not their employers or their co-workers, who bear the burden of their behavior. Still less is there a cost to "society" when a worker dies and ceases to earn wages. We do not work for "society". We are not cogs in a great social machine. We are individuals who work for ourselves, and are paid accordingly. There is no "external" cost of lost wages imposed by smokers on the non-smoking portion of the private sector.

---

[4] See Robert D. Tollison and Richard Wagner, "Smoking and the Cost of Medicare and Medicaid," Center for the Study of Public Choice, George Mason University, unpublished paper. Also see W. Kip Viscusi, "From Cash Crop to Cash Cow," *Regulation*, Summer 1997, pp. 27-32.

Treasury's recent study on the economic costs of smoking, which Deputy Secretary Lawrence Summers summarized[5] for the George Washington School of Public Health, is a throwback to the OTA studies of 1985 and 1993. The Treasury study includes lost wages as an economic cost to "society", as if the wages belong to "society" rather than to the wage earner, and omits the budget savings on Social Security and pension payments, because they are transfer payments within "society". Most—over 61%— of the costs listed—lost output from shortened work lives and lost workdays—are costs borne by smokers. The "potential" costs that even the Treasury hesitated to put in the main calculation—value of reduced mortality and "possible" productivity reductions for smokers—are also costs borne by smokers through lower pay and lost leisure time and retirement

Table 1. Treasury Department Estimates of the Economic Cost of Smoking in the United States

Source of Cost	Cost of Smoking in U.S. ($1998 billions)	Possible Long Run Benefits from Legislation ($1998 billions)
Adult Medical Spending	$45	$27
Smoking During Pregnancy	$4	$2.4
Lost Workdays	$0.5	$0.3
Lost Output from Shortened Work Lives	$80	$48
Smoking-Induced Fires	$0.5	$0.3
TOTAL: SOCIAL COSTS OF SMOKING AND BENEFITS OF SMOKING REDUCTIONS	$130	$78
Additional Potential Costs		
Value of Reduced Mortality	$120	$72
Possible Productivity Reductions for Smokers	$50-$125	$20-$75

Source: Office of Economic Policy, U.S. Treasury Department, "The Economic Costs of Smoking in the United States and the Benefits of Comprehensive Tobacco Legislation," Table 1, p. 9, Washington D.C., April, 1998.

[5] Office of Economic Policy, Department of the Treasury, "The Economic Costs of Smoking in the United States and the Benefits of Comprehensive Tobacco Legislation," Washington, D.C., 1998 and Lawrence H. Summers, "The Economic Case for Comprehensive Tobacco Legislation," remarks of to the George Washington School of Health, March 25, 1998.

years. (See table 1.) Only by blurring the distinction between costs imposed by smokers on others and costs borne by the smokers themselves can Treasury create sufficiently striking cost numbers to justify the massive tax increases being discussed, and such a dramatic federal intrusion into the lives and freedoms of a quarter of the adult population.

It is possible that the Treasury is concerned about lost tax revenue on the lost wages. Government does collect taxes on a worker's wages, but the government benefits from an individual's taxes only to the extent that he is paying more in taxes than the government is giving back to him in government services. Certainly, some people pay more in taxes than they receive in government benefits, and vice versa, over their lifetimes, but in the aggregate, government is not supposed to be exploiting the whole population. Does the Treasury know something we don't? It would be a startling confession by the Treasury that government is systematically short-changing the population. It would be even more brazen to justify the excise tax hike as a means to prevent people from avoiding income and payroll taxes by dying. In any event, the Treasury study gives the impression that government regards the people as the servants of the government instead of regarding government as the servant of the people.

Shifted health care costs

Economists have long since given up on the "lost wages" theory of social cost and have moved on to try to determine if smokers are shifting costs onto the rest of the population. It is often asserted that smokers incur above average health care costs, and, in doing so, raise the cost of health insurance for others. (Ditto for life insurance, to a lesser extent.) They are further blamed for raising the costs of programs for the poor and/or the elderly, such as Medicaid or Medicare. Many of the states initiated suits to "recover" the assumed Medicaid costs imposed on them by indigent young smokers, leading to the settlement negotiated between the tobacco industry and the states' attorneys general.

The Treasury study includes lost wages as an economic cost to "society", as if the wages belong to "society" rather than to the wage earner... Only by blurring the distinction between costs imposed by smokers on others and costs borne by the smokers themselves can Treasury create sufficiently striking cost numbers to justify the massive tax increases being discussed, and such a dramatic federal intrusion into the lives and freedoms of a quarter of the adult population.

Smokers can only impose higher health insurance costs on non-smokers in community-rated group insurance or in government programs that fail to charge smokers a higher risk premium. Smokers would not be able to shift these costs to non-smokers in a properly functioning private market. In a competitive free market, medical insurance premiums would be higher for smokers than for non-smokers. This risk adjustment is common in life insurance policies, but is blocked in the case of health insurance by state regulation or the effective community rating applied to group insurance obtained through one's employer. It is foolish for governments to complain of a non-market outcome that they are responsible for imposing.[6]

It is true that smokers often incur health problems at an earlier age than non-smokers. However, even non-smokers eventually incur medical problems, and we all will die sometime. The net increase in medical assistance and insurance costs to state or federal budgets due to smoking is the current cost of medical outlays on smokers less the present value of the state-supported medical costs that the smokers would have incurred later in life had they not smoked and lived longer. At a low discount rate, the future medical savings offsets to the current costs may be significant. At a high discount rate, there is less of an offset.

There are two difficulties in attempting this type of analysis. First, the cost of medical care has been outstripping inflation for years. Most studies of the deferred costs assume the same real prices for the future illnesses as in the year of death from smoking. If real health care costs are rising, then the apparent savings from deferring the onset of illness may be less than assumed. Second, many of the chronic conditions that may afflict people as they get older are very expensive indeed. The calculations need to consider the cost of the illnesses that non-smokers contract later in life, and which the smokers presumably would have contracted had they not smoked, not simply discount the costs of the illnesses that smokers incurred earlier in life for some presumed delay in their onset.

Nursing home care

Nursing home care is not strictly a medical outlay. State or federal programs for nursing home care for longer-lived patients are costly. Smokers who die early and do not need nursing home care reduce state and federal outlays in this area.

Social Security and pensions

Smokers who die young draw fewer social security benefits and government pensions, potentially aiding federal and state finances. At the same time, the premature deaths of smokers who were still working deprive state and federal governments of their social insurance taxes and their contributions to defined benefit pension plans. (Workers' contributions to and receipts from defined contribution plans do not affect government budgets.)

In an efficient, unregulated free market, annuity contracts would be cheaper, or the yearly benefits higher, for smokers than for non-smokers, because smokers would not live so long, on

---

[6] See Robert E. McCormick, Robert Tollison, and Richard E. Wagner, "Smoking, Insurance, and Social Cost," *Regulation*, Summer 1997, pp. 33-37.

average, and would receive fewer years of benefits.[7] Only in the government regulated Social Security system and in state regulated insurance industries do we find smokers exploited to transfer lifetime income to healthier, longer-lived non-smoking people.

If lower Social Security and pension payments by the state and federal governments are counted as an offset to the burden of medical outlays, then the lost payroll taxes and pension contributions of workers who die early should be counted as a cost to the budgets.

Findings

Several studies have concluded that, on balance, smokers do the rest of us a favor. For example, Professor W. Kip Viscusi, of Harvard Law School, calculates that cigarette smokers impose costs on non-smokers equal to $0.32 a pack at a 5% real discount rate (table 2).[8] He compares these costs with the excise taxes that smokers pay. The combined federal and state excises taxes amount to about $0.57 a pack, $0.24 at the federal level and the rest at the state level. Tobacco taxes already more than make up for the additional outlays by governments due to smoking. Viscusi concludes that there is no valid external cost argument for the states' claims against the tobacco industry.

Several studies have concluded that ...[t]obacco taxes already more than make up for the additional outlays by governments due to smoking. [T]here is no valid external cost argument for the states' claims against the tobacco industry.

An earlier study by Willard Manning and colleagues[9] using slightly different methods came to a similar conclusion, a net cost of $0.33 per pack at a 5% discount rate. Gravelle and Zimmerman[10] recalculate the Manning study's result at a higher discount rate, 10%, to be a net cost of $0.42 per pack. They note that even at that extreme rate the cost is still far less than the current tobacco excise tax, and view an increase as unjustified. They suggest that a real discount rate of 7%, equal to the pre-tax return on private capital, would be appropriate.

---

[7] *Ibid*.

[8] W. Kip Viscusi. "Cigarette Taxation and the Social Consequences of Smoking," in *Tax Policy and the Economy*, 9, pp. 51-101, James Poterba, ed. (Washington DC: National Bureau of Economic Research, 1995).

[9] Willard G. Manning, Emmett B. Keeler, Joseph P. Newhouse, Elizabeth M. Sloss, and Jeffrey Wasserman, "The Taxes of Sin: Do Smokers and Drinkers Pay Their Way?" *Journal of the American Medical Association*, 261, March 17, 1989.

[10] Jane G. Gravelle and Dennis Zimmerman, "Cigarette Taxes to Fund Health Care Reform: An Economic Analysis" (Washington, DC: Congressional Research Service, March 8, 1994).

At a lower discount rate of 3%, Viscusi calculates that the savings to government budgets from lower Social Security, pension, and nursing home payments for smokers are so large that, even if there were no tax on tobacco, they more than offset added government-supported medical outlays for smokers, for a net transfer of $0.30 a pack from smokers to non-smokers. Viscusi points out that the savings to the federal government from lower pension outlays and medical costs are greater than for the states, which are somewhat nearer a break-even situation. Nonetheless, at that discount rate, he calculates that the budget savings more than compensate the states for their share of medical outlays, by a wide margin, even before excise taxes.[11]

It would be useful to see Viscusi's calculations for the states redone using a higher discount rate. At a higher discount rate, states might face net costs from smoking before excise taxes, but are probably still ahead of the game after the excise taxes are factored in. In the unlikely event that some of the states are under-compensated for medical care, and the federal government is over-compensated, it might be justified to cut the federal excise tax and increase state excise taxes, but not to enact a net increase.

Table 2. External cost of Cigarettes

Discount rate:	3%	5%
Medical care	$ 0.55	$ 0.51
Sick leave	0.01	0.02
Group life insurance	0.14	0.09
Fires	0.02	0.02
Nursing home care	-0.23	-0.08
Retirement pensions	-1.19	-0.37
Lost taxes on earnings (payroll taxes)	0.40	0.12
Total net cost per pack	-0.30	0.32

Source: Viscusi (1995), Table 4.

Other spillover costs

What of externalities due to environmental or "second hand" smoke? Recent studies have found no statistically meaningful relationship between second hand smoke and illness at work, and

[11] Viscusi, 1997.

immeasurably small effects on spouses and children.[12] Furthermore, it is widely assumed that adults make informed decisions with the best interest of their families in mind. In that event, we must assume that the family has "internalized" the cost of the smoking of one family member on other family members, diminishing the excuse for government intervention.

Information shortfalls

Another rational for excise taxes pertains to the case of inadequate information. If people are not fully aware of the cost of consuming a product, they may consume more than if they were better informed. This is often said to be especially true of young smokers.

Viscusi finds that the public's perceived risk of dying from smoking is substantially greater than the actual statistical risk, so it is not lack of education of the risks that is driving the smoking. The claim that young smokers may be particularly likely to underestimate the risk seems wrong; Viscusi reports that young smokers overestimate the risk by even more than adults.[13]

Another rational for excise taxes ... [is] inadequate information. If people are not fully aware of the cost of consuming a product, they may consume more than if they were better informed... [But] the public's perceived risk of dying from smoking is substantially greater than the actual statistical risk, so it is not lack of education of the risks that is driving the smoking...[Y]oung smokers overestimate the risk by even more than adults.

Is smoking addictive? And do people know it is going to be addictive before they start smoking? The consumption of cigarettes is somewhat price inelastic, but not a lot different from many other consumption goods. There is no economic data suggesting that smoking is a radically unusual activity. A habit-forming activity? Yes. An unexpected risk? Hardly. Most people have heard how hard the habit is to break before they take it up. And in spite of the difficulty of kicking the habit, millions do kick it. There are as many former smokers as smokers.[14]

---

[12] For a discussion of this issue, featuring a critical analysis of an EPA report that purported to find such a link, see Gravelle and Zimmerman, *op. cit.*, pp. 45-49; and Lorraine Mooney, "Smoking Out Bad Science", *The Wall Street Journal*, March 19, 1998, p.A18.

[13] Viscusi, 1995.

[14] Robert J. Samuelson, "Smoking Lesson," *Washington Post*, April 8, 1998, p. A23.

Economic consequences of the excise tax hike

The agreement with the states' attorneys general envisioned fees and excise tax increases amounting to $368 billion over 25 years. The bill reported out by the Senate Commerce Committee under Senator John McCain involves basic fees and fines of about $500 billion over 25 years, which is estimated to equal $1.10 a pack when fully phased in, plus a fund to pay damages for lawsuits of $6.5 billion a year, and potential fines for failure to achieve reductions in smoking by teenagers of uncertain amount. The total could exceed $600 billion.

The tobacco excise tax is widely understood to be regressive. Those who calculate such things usually assume that the tax is passed on to consumers. Lower-income people are more likely to smoke, and to smoke more heavily, and to spend a greater portion of their income on cigarettes, than upper-income individuals. In 1997, families with income below $30,000, comprising 49% of families with 15.9% of family income, paid 47.2% of the federal tobacco tax.[15] Viscusi estimated that, in 1990, the tobacco tax took 5.1% of the income of smokers with incomes under $10,000, 0.93% of the income of smokers with incomes of $20,000 to $35,000, and 0.39% of the income of smokers with income of $50,000 or more.[16]

The tobacco excise tax is widely understood to be regressive. Those who calculate such things usually assume that the tax is passed on to consumers. Lower-income people are more likely to smoke, and to smoke more heavily, and to spend a greater portion of their income on cigarettes, than upper-income individuals.

Most, but not all, of the burden of the tobacco tax falls on consumers. As the quantity of the taxed product shrinks, however, some of the burden falls on the producers: tobacco farmers, cigarette workers, and shareholders of the tobacco companies.[17] (How else can policy makers claim that they are acting to punish the tobacco companies?) Farmers may have to accept a lower price for their tobacco, or lower volume, or grow a less rewarding crop, affecting their income and that of their farm workers. Cigarette workers may become unemployed. At the least, they may have to shift to lower paid work; their salaries at the tobacco firms, although very much middle class, are generally above average for their region. Note that Philip Morris recently announced plans for a reduction in employment via early retirement of 12% of its U.S. workforce, or 2,000 workers. (That is a

---

[15] Barents Group LLC, "The Burden of Consumer Excise Taxes on Lower-Income Taxpayers," prepared for The Tobacco Institute, Washington, DC, May 19, 1997.

[16] Viscusi, 1995.

[17] This is true of any excise tax. For example, the unlamented and now repealed luxury tax on boats, furs, jewelry, and private airplanes fell heavily on the boatwrights, seamstresses, jewelry workers, and airplane assemblers who lost their jobs, not on the wealthy who flew abroad to do their yachting.

significant reduction; the tobacco manufacturing industry as a whole employs a U.S. workforce of only about 40,000.) Companies may see highly specialized facilities drop in value, or incur costs of shutting down facilities and transferring assets to other uses.

The excise tax will cut production of cigarettes and cost thousands of jobs in the tobacco industry. Not all the displaced workers will find new employment, and many who do will have to take a pay cut. It is commonly understood that, whenever an excise tax is imposed, the production and consumption of the taxed product will decrease. Most of the resources released from the production of the taxed product will eventually find employment elsewhere. "Eventually" may take awhile, however. Furthermore, resources specific to the industry may not find other uses, or uses of comparable value. There is a dead weight social loss from the distortion of output, and it is permanent.

Most, but not all, of the burden of the tobacco tax falls on consumers. As the quantity of the taxed product shrinks...some of the burden falls on the producers: tobacco farmers, cigarette workers, and shareholders of the tobacco companies.

Other businesses will lose sales as well, and other workers will be affected. Since the demand for cigarettes is mildly price-inelastic, with estimates ranging from -0.4 and -1.0, the tax increase will result in more, not less, total spending on cigarettes. As smokers pay more for their smokes, they will have less money to spend on other goods and services. Businesses selling other products to smokers and displaced tobacco workers will be injured too. The effect of the tax will be most pronounced on the tobacco industry and in the tobacco producing regions, but will not be confined to them.

What happens to the resources directly displaced by the tax, and what further adjustments occur, will depend on what government does with the tax revenue. Smokers will find that the income they earn will not be sufficient to purchase the same basket of goods and services as before the tax hike. Their income will afford them less satisfaction, because the cost of the cigarettes they continue to buy will have risen, or they will have been induced to switch their consumption to products they formerly considered to be second best alternatives. Since the value of an added dollar of their wages or other income will be less, the incentive to work will be lower than before the tax increase, encouraging them to work less and take more leisure. The result will be a drop in the labor supply and gross domestic product (GDP).[18] The government could minimize the damage to work effort

---

[18] Some economists might argue that the "substitution effect" of a less valuable wage inducing less work and more leisure might be offset by an "income effect" inducing smokers to work more to make up for the lost income. The reduction in smokers' incomes, however, will be matched by an opposite income effect for the recipients of whatever transfer payments or other government spending is paid for by the tax revenue; the recipients will have less need to work (their income effect) and no added incentive to do so (no "substitution effect"). The net effect, nationwide, must

and output by using the revenue from the excise tax to cut marginal tax rates on income. A cut in tax rates would partially restore work incentives to smokers, and increase incentives for non-smokers.

Alternatively, the government might spend the revenue on personnel, materials, and services to expand its own services to the public. This government output is counted as part of GDP at cost, whether the public appreciates the product or not. Therefore, simply maintaining the level of measured GDP does not mean that people are as happy or well off as before the tax hike. Some recipients of the federal largesse may be happier, but smokers surely will not be. In general, since people are not clamoring for higher taxes and outlays, it is doubtful that an additional dollar of government outlay is worth an additional dollar of tax.

If the additional government services are valued, and viewed as substitutes for privately purchased goods and services, people will feel less need to work, and total output will fall. If they are not appreciated, then the net reduction of income among taxpayers may induce some added work to repair the income loss. However, giving up increasing amounts of leisure is not costless, and the population would only choose partially to recoup its lost purchasing power. There must be a general decline in people's perceived living standards.

Some people simply like to smoke. Policy makers should accept that, and mind their own business. Unfortunately, the Administration, the Congress, and the states are clearly eager for a massive excise tax increase. After struggling to balance the federal budget, the pressure to spend is intense.

Revenue consequences

When Treasury and the Joint Tax Committee do revenue estimates of excise taxes, they make allowances for the reduction in the consumption of the taxed product. They even assume that the tax revenue will not be available for consumers to spend on other goods and services, and that prices and wages will fall across the board as a result, cutting revenue from other sources.[19] They do not assume any loss of revenue from smuggling, but they should.

be a drop in the labor supply and GDP.

[19] Alternatively, the Federal Reserve might increase the money supply to accommodate the excise tax, in which case the consumer price index (CPI) would rise. That would trigger additional outlays for Social Security COLAs and other indexed federal programs. It would reduce federal revenues due to the indexing feature of the federal income tax. In either case, the federal government would face a partial offset to the increased revenue from the higher excise tax.

The revenue estimators, however, make a major error by assuming no drop in real GDP; they assume that resources released from production of the taxed product quickly will find comparably productive and remunerative employment. Consequently, they assume no loss in income and payroll tax revenues from reduced employment or reduced real value of output due to a shift of resources to second best uses.

These latter omissions are clearly wrong. Real GDP will fall. The McCain bill admits as much by setting aside $28 billion for aid to farmers and displaced workers. Most of the resources will eventually be re-employed, of course, but there will be some permanent loss of real output. Therefore, there will be some offset to the revenues expected under the proposal. Between the revenue loss and the outlays for relief, a non-trivial portion of the projected revenue gains will be unavailable for funding other programs, or for cutting other taxes.

Conclusion

Gravelle and Zimmerman of the Congressional Research Service sum up the social cost argument nicely:

> While the available evidence will not support precise findings or conclusions, the proposition that efficiency improvements justify the proposed tax is subject to question: existing taxes exceed some reasonable estimates of the social cost of smoking; and the average smoker appears to have made the smoking decision while in possession of adequate information, at least with regard to health hazards. For those smokers who make poor decisions because of inadequate information, such as the young, increased education and regulation might be more effective market corrections and have fewer undesirable economic effects than a tax.[20]

There is no economic justification for the massive intervention in the affairs of the people that the proposed tobacco excise tax increase represents. Some people simply like to smoke. Policy makers should accept that, and mind their own business.

Unfortunately, the Administration, the Congress and the states are clearly eager for a massive excise tax increase. After struggling to balance the federal budget, the pressure to spend is intense. Witness the pork-laden highway bill making its way through Congress. Furthermore, having taken it upon themselves to usurp the private market for health care, the federal and state governments are finding that the bills are coming due for Medicare and Medicaid, and they are far higher than the policy makers ever envisioned. Tobacco excise taxes, falling on a despised minority of the population, seem an easy way out.

The federal government has been taxing tobacco since at least 1865, and states began taxing it in the 1920s, long before anyone realized the dangers of smoking. The tax was a "sin" tax, imposed

---

[20] Gravelle and Zimmerman, *op. cit.*, p.iii.

in the hope that the vice would be hard to discourage and would be a cash cow. Now, the tax authorities are disappointed to learn that the revenue from the tax, and many other taxes, is being gobbled up by insatiable entitlement programs. Although the tobacco taxes are, in fact, more than large enough to "correct" for any reasonable measure of unintended transfers from non-smokers to smokers, or economic distortions relating thereto, they are no longer the free revenue stream which state and federal treasuries enjoyed for so long. It is to restore that free cash flow that the tax hike has been recommended. That the object is to raise revenue, not to eliminate smoking, is beyond dispute. At least one state official has expressed concern that the Congress may go too far with the tax hike, and bankrupt one or more of the tobacco companies, reducing the anticipated flow of taxes and fines.

The federal government has been taxing tobacco since at least 1865, and states began taxing it in the 1920s, long before anyone realized the dangers of smoking. The tax was a "sin" tax, imposed in the hope that the vice would be hard to discourage and would be a cash cow.

As a revenue measure, the tobacco tax it is an inferior, distorting tax. It is a $500 billion tax hike on a minority of the population at all income levels. It will fund one of the biggest tax/transfer programs of recent times, equal to a year's total outlays on Social Security and Medicare combined. Indeed, the proposed tax hike has been seized upon to pay for cutting other taxes, saving Medicare, funding anti-tobacco campaigns, biomedical research, relief for farmers and displaced workers, roads, smaller school classes, state child care, and who knows what else. It has been spent several times over in the minds of lawmakers. Many of them will be disappointed. So will their constituents, especially those hit with the tax increase.

Stephen J. Entin
Executive Director and Chief Economist

Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.