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Don't Index Excises

Among the tax-raising gimmicks presented to the tax-writing committees of the Congress is a harebrained scheme to increase the excises on alcoholic beverages and tobacco products and to index these taxes to the Consumer Price Index. Tax indexing is supposed to protect against inflation's increasing the rates and burdens of taxes. This off-the-wall excise indexing proposal would instead insure that the rates and burdens of these taxes increase with inflation. It's an idea whose time should never come.

It would be difficult for most of us to think of anything in favor of making taxes go up automatically with inflation, but the staff of the Congressional Joint Committee on Taxation was able to dream up five arguments for this plan. Weird notions often flourish in the public policy forum, so let's get rid of these arguments before they take hold.

One reason given for this plan is that higher excise tax rates are appropriate now because the effective tax rates on alcohol and tobacco products have fallen over the years. Had these excises been indexed to the CPI, their present rates would be much higher. The tax on a package of cigarettes, for example, would be 34 cents instead of 16 cents.

This is a wonderfully peculiar argument. Literally, it says that if these excise tax rates had been raised in the past, they would now be higher than they are. It's difficult to dispute such elegant reasoning.

A related and equally elegant argument is that pro-inflation indexing of excise tax rates would maintain their real burden as the general price level rises. This is undoubtedly true but maintaining the real burden of any tax certainly is not a credible objective of tax policy.

No principle of taxation argues that the real value of any tax should be maintained. On the contrary, good tax policy should insulate tax rates and tax burdens from inflation. In the case of selective excises, the most distorting taxes in the federal tax system, the erosion of their effective rates by inflation somewhat moderates the adverse effects of these taxes. Arguing for pro-inflation indexing of excises is arguing for increasing their adverse economic effects.

Obviously sensitive to the charge that excise taxes are regressive, the JCT staff observes that the regressivity argument is less persuasive than one might think in the case of the excises on alcoholic beverages and tobacco products. The reason is that these taxes are imposed on discretionary purchases instead of necessities.

This creaky old argument is as wrong as it can be. There is no meaningful distinction between a necessity and a discretionary purchase, i.e., a luxury -- something that some people think other people should do without. The distinction is relied on by elitist public policy advocates who would like to impose their preferences on others. The free market makes no such distinction.

Perhaps the argument seeks to distinguish between necessities and discretionary purchases in terms of differences in their elasticities of demand, i.e., the amount of necessities people buy responds little to changes in their prices while discretionary purchases are much more sensitive to price changes. Should tax policy be based on presumed differences in the price elasticities of demand among products and service? If this were the case, we should now be seeking to reduce the excise tax rate on cigarettes for which the price elasticity of demand is widely estimated to be quite low. Were they tempted to make any such distinction, policy makers would be well advised to recognize that price elasticities are not constant; at different points on the demand curve for any product or service, the price elasticity differs. Lower its price enough and a necessity will become a luxury, in these terms; raise its price enough and a luxury will begin to look like a necessity.

The regressivity of a tax doesn't depend on whether the taxed product or service is deemed to be a luxury or a necessity. The burdens of the same amount of taxes on different products or services purchased by a low income person can't be distinguished on the basis of whether the products are deemed to be "luxuries" or necessities.

Are you ready for this one? Would you believe that increasing the tobacco and alcohol excise taxes can be justified as a means of imposing a user fee to offset the costs of administering the programs of the Bureau of Alcohol, Tobacco, and Firearms?

Excise taxes are excise taxes, no matter what name you give them. Increasing the excise tax on cigarettes or alcoholic beverages and using the revenues to finance a government agency doesn't convert the excise into a user fee. What services of BATF are demanded by tobacco growers, cigarette manufacturers, tobacco wholesalers, retailers, or cigarette smokers? If BATF didn't do what it does, would any of the above look for a business establishment to provide any of the BATF services? If so, would they be willing to pay anything like the

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present amount of the cigarette excise for those services? Come on now.

Finally, there's the argument that increasing these excises -- and keeping them rising -- is consistent with other federal government policies to discourage smoking and alcohol abuse because of the health hazards and social costs they impose.

This argument obviously depends on whether public policy should be concerned with smoking and consumption of alcoholic beverages, which, in turn, depends on showing that the production, sale, or consumption of these products imposes costs on others. The argument is shaky, at best.

However good or bad is the evidence that smoking causes any particular disease or is a prime cause of death, such evidence has no bearing on whether smoking imposes social costs. If they lose more hours of work than nonsmokers, smokers incur private costs. Their lost pay or lost vacation time or, indeed, lost jobs are costs they bear, not costs for society.

If there are, in fact, social costs entailed in smoking, appropriate public policy is to find some means for requiring those who impose these costs to internalize them. An arbitrary increase in the cigarette excise and its pro-inflation indexing is far too crude a measure to assure internalizing of any social cost. The usefulness of this sort of tax measure for this purpose would depend on showing that all smokers impose social costs, irrespective of their smoking habits and proclivities. It would also depend on showing that the increase in the private costs incurred by smokers, retailers, wholesalers, manufacturers, and tobacco growers was just equal to the reduction in the social costs of smoking.

The social cost argument regarding alcoholic beverages rests heavily on the drunk driving case and the family breakdown with resulting public dependency resulting from alcoholism. There may well be little reason to challenge the view that drunkenness contributes significantly to traffic injuries and fatalities, imposing costs on people other than the drunk drivers. There may be little reason to doubt that alcoholism frequently results in loss of jobs, income, and the ability to discharge responsibilities to one's family, turning them into public charges. There is also little reason to believe, however, that increasing the tax on alcoholic beverages and reducing aggregate consumption of these beverages will significantly reduce the incidence of alcoholism and of drunk driving, with their attendant social costs.

Excise tax increases do not seem to be the right kinds of devices for internalizing social costs. For this purpose, they just aren't selective enough.

Apart from the weakness of the arguments for raising excises and pro-inflation indexing them, there is a powerful argument for not doing so. The underlying reason to consider any such tax hike is to reduce the federal budget deficit. If we are to raise taxes to reduce the deficit, it is because we believe deficit reduction is necessary in the interests of the entire economy. If there is merit in the argument that budget deficits injure the economy, reducing the deficit presumably would benefit everyone, not merely selected groups in the economy. Certainly no one would argue that reducing the deficit would merely improve the economic circumstances of producers and consumers of alcoholic beverages and tobacco products. Unless this were the case, however, we certainly should not ask them to pick up the chips for all of us. If the deficit is to be reduced by raising taxes, everyone should share in the burden of the tax increases.

The additional revenue from any tax increase enacted to reduce the deficit should come from the largest possible number of real, live human beings. The tax increase should have the broadest possible reach in the population, and its burden should be as clearly as possible identified by those paying the increased taxes. Excise tax increases and pro-inflation indexing should be ruled out on the basis of both of these conditions.

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