

# "Social Cost" Taxes On Unhealthy Foods And Bullets:

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## Abuse Of Economics And Personal Freedom

by Roy E. Cordato

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## EXECUTIVE SUMMARY

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For much of the last decade, since the Bush/Clinton tax increases of the early 1990s, interest in generalized tax increases has been on the wane. Indeed, since the Republican Party took control of Congress in 1995, most of the discussion has focused on the possibility of tax cuts in one form or another. This does not mean that the pro-tax movement in the United States has gone away. What has happened is that there has been a shift in both the justification for and kind of new taxes that are being advocated.

Economists argue that, as a general principle, tax increases do not enhance economic efficiency nor improve the performance of the economy. This has always generated a tension between those who advocate higher taxes and economists who tend to be concerned about economic growth. Latching onto a "loophole" in the economists' case against taxation, called the theory of social costs, some self-appointed societal reformers now advocate higher taxes on a host of behaviors that allegedly impose uncompensated costs on society. The would-be social engineers tout the new taxes for their potential to change people's behavior and activities in a way that will allegedly increase economic efficiency. Primarily the arguments have centered around the health effects of certain activities and the idea that unhealthy behaviors increase the demand for health care services and drive up the cost of these services for everyone.

Most people are familiar with this line of argument in the area of tobacco. What is generally not recognized is that the arguments that have been successfully used to win new taxes on cigarettes are being invoked by some advocacy groups and some academics as justification for taxing other products. Two examples focused on here are "unhealthy" foods and bullets. Arguments used for taxes in these two areas are illustrative of those that are being made to support excise taxes, regulations, and lawsuits relating to a number of products including alcohol, chlorine, soft drinks, and even latex gloves.

In arguing for taxes on fatty foods, Marion Nestle and Michael Jacobson of the Center for Science in the Public Interest state that "[t]he deleterious effects of obesity on...social costs...argue for the increased attention to the prevention of excessive weight gain starting as early in life as possible." Similarly in making the case for *The Real Cost of Handgun Ammunition Act of 1995* (S. 119), which sought to "heavily tax" .25 caliber, .32 caliber, and 9 millimeter ammunition, Senator Daniel Patrick Moynihan stated that "[t]he number of Americans killed or wounded each year by bullets demonstrates their true cost to American society." Moynihan's call for a 1000 percent tax on handgun ammunition was based on the idea that the existing price of the bullets did not reflect "the real cost to American society."

From both a conceptual and practical perspective there are serious problems with the theory of social costs. There is no way to make use of it to implement efficient social cost taxes.

To calculate the appropriate tax, policy makers would need to have information about the personal and subjective preferences of both the consumers of the social cost generating product and the individuals who are suffering from the imposition of the social costs. Policy makers would also need to have complete information concerning the value of the inputs used to make the products to society in alternative uses. This level of information is both practically and conceptually impossible to obtain.

Furthermore, an intellectually honest case for imposing excise taxes on anything would have to include an assessment of both the costs and the benefits associated with the tax. In the words of Ronald Coase, "[W]hat has to be decided is whether the gain from preventing the harm is greater than the loss which would be suffered elsewhere as a result of stopping the action which produces the harm." Also it needs to be kept in mind that although most products generate costs for producers and consumers, those internal costs have no place in the social cost argument. By willingly making and buying the products, producers and consumers voluntarily bear those costs and demonstrate in the process that their benefits exceed their costs. It is only external costs imposed on third parties outside the market that may indicate market failure.

Advocates of excise taxes on items like fatty and high sugar content foods, cigarettes, bullets, etc. too often cite *all* costs while ignoring all *benefits*. The typical approach is to simply make reference to health care and other costs associated with the problematic behavior (e.g., health costs of obesity, criminal activity if products used illegally) and to proceed with the non-sequitur that these costs justify the tax. By pointing only to the costs of certain behaviors — and by not distinguishing between internal (private) and external (social) costs — and by ignoring all benefits (e.g., individual enjoyment, enhanced personal security and crime reduction through legal product use), advocates of these taxes misapply economic theory, claiming that such taxes will actually enhance economic performance. Further, while it is true that many health-care costs are shifted to others, much of the fault lies with government programs like Medicare and Medicaid that have socialized the costs on purpose. Health care costs could be internalized by abolishing or reforming those programs, an approach in which none of the tax advocates has shown any interest. It is completely disingenuous to set up a government program designed to ensure that some people bear the costs of other people's health care, and then complain when this actually happens.

If the advocates of these taxes were required to take into account the benefits associated with the behaviors that they are attempting to discourage, they would be forced to come to terms with the real economics of their advocacy and with its moral and philosophical implications. In a free society, individuals should be regarded as being able to weigh the costs and benefits of their actions, and of making their own decisions, while being held responsible for the consequences. This is not the view of human nature that is taken in most of the social-engineering-through-taxation literature. In reality, the movement to tax behavior is not only an abuse of economic science but also an attack on individual liberty and the ethical foundation of American society.

# **Social Cost Taxes On Unhealthy Foods And Bullets: Abuse Of Economics And Personal Freedom**

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*By Roy E. Cordato\**

*"I recommend that we develop a militant attitude about the toxic food environment...And that leads to certain actions to change the American diet to be more healthy. The specific proposals I've made are: subsidize the cost of healthy foods so they cost less, increase the cost of bad foods so they cost more." (Dr. Kelly Brownell, Yale University)<sup>1</sup>*

*"I have introduced legislation to tax these pernicious bullets. As the terrible gunshot death toll in the United States continues unabated, so too does the need for these bills." (Sen. Daniel Patrick Moynihan (D-NY))<sup>2</sup>*

For much of the last decade, since the Bush/Clinton tax increases of the early 1990s, interest in generalized tax increases via the income tax has been on the wane. Indeed, when the Republican Party took control of Congress in 1995, most of the discussion changed to focus on the possibility of tax cuts in one form or another. This does not mean that the pro-tax movement in the United States has gone away. What has happened is that there has been a shift in both the justification for and kind of new taxes that are being advocated.

For many years the argument for new taxes was based on balancing the Federal budget, i.e., taxes were viewed strictly in terms of fiscal policy. After the budget moved into surplus, this argument disappeared. (However, the call for paying off the government debt has replaced the deficit as an excuse for why tax cuts should not be instituted. More recently, recession, war, and blatant overspending on domestic "pork" have pushed the budget back into deficit, but these events have not yet led to many calls for tax increases.) Regardless of these arguments, economists of most schools of thought argue that, as a general principle, tax increases do not enhance economic efficiency or improve the performance of the economy. This has always generated a tension between those who advocate higher taxes and economists who tend to be

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<sup>1</sup>An interview with Kelly Brownell of Yale University, "The Pressure To Eat, Why We're Getting Fatter," *Nutrition Action Health Letter*, Center for Science in the Public Interest, July-August, 1998, p. 3.

<sup>2</sup>Statement by Senator Daniel Patrick Moynihan in support of "The Real Cost of Handgun Ammunition Act," to the U.S. Senate, January 4, 1995, accessed at <http://thomas.loc.gov/cgi-bin/query/D?r104:1:./temp/r104hpTja5:e221116>:

concerned about economic growth. But over the last decade, as the perceived case for higher income taxes has dissipated, tax advocates have shifted their argument. Latching onto a "loophole" in the economists' case against taxation, called the theory of social costs, some self-appointed societal reformers now advocate higher taxes on a host of behaviors that allegedly impose uncompensated costs. The would-be social engineers tout the new taxes for their potential to change people's behavior and activities in a way that will allegedly increase economic efficiency. Their revenue enhancing possibilities are typically only discussed as a side benefit, and primarily in the context of using the revenues to subsidize "good" behavior or to pay the "costs imposed on society" by the "bad" behavior. Primarily though, the arguments have centered around the health effects of certain activities and the idea that unhealthy behaviors increase the demand for health care services and drive up the cost of these services for everyone.

The movement for social cost taxes is much more akin to the older concept of sin taxes, where the tax is imposed for the taxpayer's own good. Traditionally, the idea was to protect people from themselves, i.e., "to save people from sin," by discouraging an egregious and "sinful" activity. Consumption of alcohol is the classic example. But by reaching into the economist's toolbox and discovering the concept of "social costs," the new advocates of behavior taxes have shed the image of the paternalistic religious zealot and have repackaged their advocacy as dispassionate social science. The argument now is allegedly based on economic theory. New taxes on unhealthy activities will reduce social costs and enhance social welfare.

Most people are familiar with this line of argument in the area of tobacco. Indeed, since 1993, the most acceptable target for tax increases has been smokers and the tobacco industry. In this case very large tax hikes have been put in place both in the form of explicit tax increases on cigarettes in a number of states and via the "tobacco settlement" which amounts to a targeted \$246 billion tax increase.<sup>3</sup> The primary argument is that cigarette smoking has imposed costs on non-smokers through the health care system and that compensation is owed for these costs. What is generally not recognized is that the arguments that have been successfully used to win new taxes on cigarettes are being invoked by some advocacy groups and some academics as justification for taxing other products. The examples we will focus on here are "unhealthy" foods<sup>4</sup> and bullets. The former is part of a well publicized campaign being carried on by the left-wing advocacy group The Center for Science in the Public Interest (CSIP), with academic research on the subject being led by Yale University Professor Dr. Kelly Brownell. Former Senator Daniel Patrick Moynihan of New York introduced the latter in the form of legislation. Food and bullet taxes are offered as examples because arguments used for taxes in these two areas are illustrative of those that are being made to support excise taxes on, regulation of, and

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<sup>3</sup>To give the reader a sense of the size of this tax, the amount is almost 20 times the annual general fund budget of the state of North Carolina.

<sup>4</sup>See Marion Nestle and Michael Jacobson, "Halting the Obesity Epidemic: A Public Health Policy Approach," *Public Health Reports*, January/February 2000, Vol. 15.

lawsuits against the producers of a number of products including alcohol, chlorine, soft drinks, and even latex gloves.

Clearly, the slippery slope that many had warned about as a result of the "war against tobacco" is upon us.<sup>5</sup> This is particularly true with the so-called "fat tax" where analogies are constantly being made to tobacco. In a *New Republic* cover story titled "The Fat Tax: Is It Really Such a Crazy Idea?" it was argued that "the number of diet-related deaths are in the same ball park as the number of tobacco-related deaths." The story concluded that "regulating fat can actually be a less intrusive policy than regulating tobacco."<sup>6</sup>

## **I. Social Costs and the Economic "Justification"**

A social cost problem arises when production or consumption costs of a product are imposed on third parties who are neither producers nor buyers of the product. Any measure of the true cost of consumption or production would need to include the costs inflicted on third parties. An appropriately imposed and calculated tax would, by discouraging the unwanted behavior or reducing the consumption of the offending products, reduce these costs to society, while the revenues could be used to compensate society for its losses. In this sense, then, consumption of the offending product or participation in the offending behavior can be seen as "damaging" society. The tax both reduces the damage because it discourages the behavior and provides an avenue for compensation via the revenues that are raised.<sup>7</sup>

In the economics literature, this is typically presented under the heading of "market failure." While economists view excise taxes as inefficient and as distorting market outcomes, many would argue that such taxes can be efficiency enhancing when they are assessed on products that impose external costs on society.<sup>8</sup> The idea is that market prices should accurately reflect all the costs and benefits associated with the production and use of a product. Only when this is the case will output levels be efficient. In certain instances markets are said to "fail," i.e., be inefficient, because some costs are imposed on people who are not part of the market for the

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<sup>5</sup>This slippery slope has taken hold with a vengeance in the area of litigation. See John Fund and Martin Morse Wooster, *The Dangers of Regulation Through Litigation* (Washington, DC: The American Tort Reform Foundation, 2000).

<sup>6</sup>Hanna Rosin, "The Fat Tax: Is It Really Such a Crazy Idea?" *The New Republic*, May 18, 1998, p. 18.

<sup>7</sup>IRET has published a more complete analysis of the social cost issue, presented in non-technical language. See Roy Cordato, "Social Costs, Public Policy, and Freedom of Choice," *Fiscal Issues*, No. 7, (Washington, DC: Institute for Research on the Economics of Taxation, 1992).

<sup>8</sup>See E.J. Mishan, "The Post War Literature on Externalities: An Interpretive Essay," *The Journal of Economic Literature*, Vol. 9, No. 8, 1971. For theoretical criticisms of this view see Roy E. Cordato, *Welfare Economics and Externalities in an Open Ended Universe*, (Boston: Kluwer Academic Publishers, 1992). Also see Ronald Coase, "The Problem of Social Cost," *The Journal of Law and Economics*, Vol. III, 1960, pp. 1-44.

product in question. Pollution is the classic example. A product is produced and in the course of production some form of air pollution is generated. The price of the product, which takes into consideration what are called "internal" costs, i.e., labor, capital, rent, etc., does not reflect the costs being imposed on the community by the pollution. These are typically called "externalities" because these costs are "external" to the market. While the producers and consumers of the product are realizing net benefits from their activities, other people in the society, who are being burdened by the "external" costs, may be experiencing net losses.

Theoretically, but, as we will see, not practically, a tax can remedy this problem and improve economic efficiency. If an excise tax that is equal to the external cost were placed on the sale or purchase of the offending product, there would be two results. First, the price would reflect the full cost of production and therefore the market participants would take into account the costs being imposed on society in their consumption and production decisions. As a result, output and consumption would be reduced to their efficient levels. Second, as noted above, revenue from the tax can be used to compensate those who might be suffering from the offending activities.<sup>9</sup>

This is the economic theory that is allegedly the underpinning of the call for new social cost taxes. In arguing for taxes on fatty foods, CSIP's Nestle and Jacobson state that "[t]he deleterious effects of obesity on...social costs...argue for the increased attention to the prevention of excessive weight gain starting as early in life as possible."<sup>10</sup> Similarly in making the case for *The Real Cost of Handgun Ammunition Act of 1995* (S. 119), which sought to "heavily tax" .25 caliber, .32 caliber, and 9 millimeter ammunition, Senator Moynihan stated that "[t]he number of Americans killed or wounded each year by bullets demonstrates their true cost to American society."<sup>11</sup> Moynihan's call for a 1000 percent tax on handgun ammunition was based on the idea that the existing price of the bullets did not reflect "the real cost to American society."

Moynihan analogized the perceived social costs associated with handgun use to those costs that are experienced with an infectious disease epidemic, where the actions of some impose unwanted harms and health hazards on others.<sup>12</sup> Describing behaviors in terms of epidemics

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<sup>9</sup>There is an aspect of economic theory, known as the "Hicks-Kaldor" compensation principle, which argues that the purpose of the tax is to generate the "efficient" price and output level in the market and that revenues collected need not be used for compensation. While not delving into the technical details of this argument it should be noted that the principle is impossible to implement in the real world because the information that is necessary is the same amount of information that is required to efficiently plan the entire economy. It has been demonstrated in the economics literature that this is impossible. (See F.A. Hayek, "Socialist Calculation III: The Competitive Solution," *Economica*, Vol. VII, No. 26, 1945. Also see Cordato, *op.cit.* at note 8.)

<sup>10</sup>Nestle and Jacobson, *op. cit.* at note 4, p. 12.

<sup>11</sup>Moynihan, *op. cit.* at note 2.

<sup>12</sup>*Ibid.*

and infectious diseases, even when there is no issue of communicability, is common when calling for social cost taxes. As noted above (see note 4), obesity is often referred to as an epidemic in the literature calling for taxes on fatty and unhealthy foods. This is important in creating an economic justification for such taxes because the economic literature, which usually argues against government regulation of human behavior, explicitly makes an exception in the case of controlling infectious diseases, which tend to generate negative externalities. In most of the economic literature control of infectious disease epidemics is seen as a "public good" that cannot efficiently be handled by the private market. In such cases, the use of taxes and subsidies to discourage "bad" behavior and encourage "good" behavior is viewed from an economic perspective as efficient. By referring, then, to obesity, smoking, or the health problems caused by the violent use of guns as an epidemic, the tax proposal is automatically lent an air of legitimacy in economic science. But of course, this obscures reality. As Jacob Sullum, author of *For Your Own Good: The Anti-Smoking Crusade* points out, "[B]ehavior cannot be transmitted to other people against their will. People do not choose to be sick, but they do choose to engage in risky behavior. Their choice means the behavior, unlike a viral or bacterial infection, has value to them."<sup>13</sup>

## II. The Abuse of Economics

From both a conceptual and practical perspective, there are serious problems with the theory of social costs. In particular, while for some purely analytical purposes the standard theory of externalities might be unobjectionable, there is no way to make use of it to implement efficient social cost taxes. To calculate the appropriate tax, policy makers would need to have information about the personal and subjective preferences of both the consumers of the social-cost-generating product and those individuals who are suffering from the imposition of the social costs. Policy makers would also need to have complete information concerning the value of the inputs used to make the products to society in alternative uses. This level of information is both practically and conceptually impossible to obtain.<sup>14</sup>

But even if the theory could be taken at face value and these information problems did not exist, the modern advocates of social cost taxes contort and ultimately abuse the theory to justify what appears to be a predetermined policy conclusion. Two points need to be made. First, in the context of public policy, the analysis of costs alone tells us nothing about whether a particular policy is desirable. Benefits must also be considered. An activity is not undesirable as long as its costs, however great, are smaller than its benefits. Nobel Laureate Ronald Coase made this point in his classic 1960 article on social costs, "[W]hat has to be decided is whether the gain from preventing the harm is greater than the loss which would be suffered elsewhere as

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<sup>13</sup>Jacob Sullum, "The Tyranny of Public Health," in *Intellectual Ammunition*, Vol. 10, No. 2, March/April, 2001, p. 1.

<sup>14</sup>For a complete discussion of these issues see Cordato, *op.cit.* at note 7.

a result of stopping the action which produces the harm."<sup>15</sup> Analyses by academics and advocacy groups often assume there are no benefits to the targeted activities. Of course, those benefits must exist; otherwise, the activities would never be pursued. Second, all costs are not "social costs." Every purchase of every product or service involves costs to both the producer and the consumer. Social costs relate only to harms that are imposed on those not party to the transaction. Since all actions and activities have costs attached to them, simply to identify an activity as having a cost is meaningless. So, for example, to identify an activity as "imposing costs" on the health care industry — without distinguishing between internal (private) costs and external (social) costs — tells us nothing. Advocates of taxes to change people's behavior ignore both of these important points or distort the issue by analogizing behaviors to infectious diseases.

## **A. Unhealthy Foods and Health Care Costs**

### **1. The Issue of Net Benefits**

An intellectually honest case for imposing excise taxes on anything would have to include an assessment of both the costs and the benefits associated with the tax. At a minimum, this analysis would have to include benefits lost due to the marginal reduction in the activity that the tax is meant to bring about and an assessment of the benefits and costs of the policy itself. Advocates of excise taxes on items like fatty and high-sugar-content foods, cigarettes, bullets, etc. too often cite all costs while ignoring all benefits.

The typical approach is to simply make reference to "health care costs" and other costs associated with the problematic behavior and to proceed with the non-sequitur that these costs justify the tax.<sup>16</sup> The studies or proposals make no reference to if or by how much the proposed package of taxes and subsidies would reduce these costs, or to the benefits or satisfaction that those participating in the activities are experiencing. A well publicized article by Michael Jacobson and Kelly Brownell in *The American Journal of Public Health*<sup>17</sup> is typical. In the first paragraph, the authors cite a study that purports to estimate the "economic cost of diet-related diseases" at \$71 billion annually.<sup>18</sup> They conclude that these costs need to be compensated for, i.e., that the market is failing to make such compensations and that there are no offsetting benefits. "To compensate for an unhealthy food environment...foods high in calories, fat, or

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<sup>15</sup>Coase, *op. cit.* at note 8, p. 27.

<sup>16</sup>This is also typical when attempting to justify taxes on smokers. See E.M. Lewit and Douglas Coate, "The Potential for Using Excise Taxes to Reduce Smoking," *Journal of Health Economics*, Vol. 1, 1982, pp. 121-145.

<sup>17</sup>M. Jacobson and K. Brownell, "Small Taxes on Soft Drinks and Snack Foods to Promote Health," *The American Journal of Public Health*, Vol. 90, No. 6, June 2000.

<sup>18</sup>The authors cite a USDA study by Elizabeth Frazao, "High Costs of Poor Eating Patterns in the United States," in *America's Eating Habits: Changes and Consequences* (Washington, DC: Economic Research Service, USDA), Agricultural Information Bulletin 750.

sugar [should] be subject to special taxes and...the costs of healthful foods such as fruits and vegetables, [should] be subsidized."<sup>19</sup>

The fact is that this \$71 billion figure, accurate or not (more below), tells us nothing about whether a tax is justified. The production of everything from golf clubs to health care involves costs. To point out that the consumption of high fat or high sugar foods "imposes" costs on the health care industry is no more meaningful than to point out that the consumption of golf "imposes" costs on the golf club industry or the landscaping industry. By ignoring benefits from the activity under discussion, taxes can be justified for just about any activity, including golf.

In a free market where decisions are freely made, the analyst must conclude the consumption of "unhealthy" foods generates net benefits to both the consumers and producers of the food and the health care industries, i.e., households, farmers, doctors, nurses, hospitals, etc. Of course, all of these market participants are bearing costs. Consumers must go to the store, give up hard-earned income, and take the risk of incurring some diet related ailment etc. in obtaining and consuming the tasty snack. But clearly, if consumers make this choice freely, we must assume that from the chooser's perspective the pleasure obtained from eating the food is worth its costs, including the costs associated with the health risks.

Clearly the producers of the food feel the same way. The benefits received from the sale of the product outweigh the costs incurred in its production. These same principles apply to those working in the health care industry and their customers. Doctors, nurses, hospitals, etc. are providing a service to paying customers. To refer to what consumers of unhealthy foods pay out for health care services related to their eating habits strictly as a cost makes no more sense than to refer to the amount they pay for the foods strictly as a cost. First, the expenditures of the health care consumers are a benefit to those health care providers who receive the payments. Second, even for the health care customers, it is a cost that they are willing to incur in order to receive benefits of higher value. These benefits include both the health care received at the moment and the enjoyment associated with the behavior that led to the health problems.

What goes unrecognized is that people always make tradeoffs involving health risks and benefits. Again, as Sullum points out with regard to the view of many public health advocates: "[T]hey can't imagine why people would drink, eat fatty foods, refuse to wear seatbelts, and otherwise behave in ways frowned upon by the public health establishment. This is not because they can't help themselves; it's because, for the sake of pleasure, utility, or convenience, they are prepared to accept the risks."<sup>20</sup> The point here is that at every stage of the process, from the production and consumption of the food to the consumption and production of the health care

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<sup>19</sup>Jacobson and Brownell, *op. cit.* at note 18.

<sup>20</sup>Sullum, *op. cit.* at note 13.

services, market participants see themselves as net beneficiaries. If this is the case, then it must be concluded that no compensation is necessary.

## **2. Health Care Costs as Social Costs**

A large part of the case for excise taxes on unhealthy foods rests on the notion that costs incurred by the health care system are automatically transferred to society. There is some truth to this, but the fault lies with public policies that affect the way health care services are bought and paid for rather than with the consumers themselves. In order to reduce the social costs associated with the use of the health system, public policy should focus on reforming the system itself and not on altering the behavior of those who use it.

In fact, there is nothing inherent in the production or consumption of health care services that generates social costs. In a normal market setting, one would expect that those people who make the payments would be the people who receive the services.

The problem in the United States and in most other countries, however, is that policies have been put in place for the purpose of socializing health care costs. Government-run health care programs for the elderly and the poor, such as Medicare and Medicaid, transfer over 50 percent of health care costs from care consumers to taxpayers. Anytime that anyone uses one of these programs for the purchase of health care related services, he or she imposes costs on others, i.e. the taxpaying public. It is completely disingenuous to set up a program whose purpose is to ensure that some people have to bear the costs of other people's health care and then to complain that when people consume health care services, their consumption often imposes some costs on third parties. It is these programs, not the products, that generate social costs.

These tax-funded health-care programs also have undesirable behavioral effects. By spreading the costs to others, they lower the cost of risky behavior, such as eating fatty foods, smoking, etc., to those taking the risk. Such risk-spreading encourages the behavior that the proposed corrective taxes seek to discourage. This is known as the "moral hazard" problem. The logical answer is to reform the system so that these costs are actually internalized. The outright abolition of Medicare and Medicaid would internalize these health costs. Short of repeal there are other steps that could be taken. For example, people who smoke or are overweight by a certain amount could be refused coverage under these programs for related diseases or charged a higher premium.

The "recoupment" of costs to these programs has been the basis for lawsuits against the tobacco industry by the states and federal government. As economist Stephen Entin has pointed out "the lawsuit is simply a tax imposed by litigation instead of legislation."<sup>21</sup> The purpose, and

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<sup>21</sup>Stephen Entin, "The Federal Tobacco Suit: The Administration Carries Out its Threat of Taxation Through Litigation," *IRET Congressional Advisory*, No. 91, September 30, 1999.

the effects, of these lawsuits are the same as the taxes discussed above, i.e., to compensate for "social costs" associated with the use of Medicaid at the state level and Medicare at the federal level. The illegitimacy of such an approach is obvious. The government has first created two programs with the sole purpose of "socializing" health care costs and then pursues lawsuits to recoup social costs generated by the use of the programs. Similar lawsuits by states are being pursued or considered against the gun industry, the latex industry, and companies that once made lead based paint, illegal since 1978.<sup>22</sup>

It is not just government-run programs such as Medicare and Medicaid that have been designed through public policy to socialize health care costs. The way in which the private sector provision of health insurance is regulated and treated for purposes of the income tax also contributes to the socialization of health care costs. While a full-blown discussion of health insurance reform is well beyond the scope of this study, there are several points that should be made in the context of our discussion of social costs.

It is true that one of the purposes of insurance of any kind is to spread risk. Therefore to some extent a system dominated by third party insurance payments will always generate some social costs. Some of these costs are related to moral hazard. In a typical insurance market, though, these social costs tend to be minimized because people's risky behavior is taken into account when establishing premiums. Homeowners policies are more expensive when people live in high-crime neighborhoods, life insurance premiums are higher for smokers than non-smokers, and auto insurance premiums are higher for people who have a history of reckless driving. For the most part, though, the current health-insurance system is not allowed to operate like a typical insurance program. First, because most people receive health insurance as a form of untaxed employment compensation, there is an incentive to overuse health insurance. There are both more people covered by health insurance than would otherwise be the case and the plans that are typically available have low deductibles and cover low-value and routine health care costs rather than just high-cost catastrophic events. Second, because of the employer based system, most people do not own or shop for their health insurance policies, as they do with life insurance, homeowners insurance, or auto insurance. The insurance company's customer is the employer, not the patient. Coverage, therefore, is not tailored to what the patient is individually willing to pay for.

Furthermore, in large part because of coverage that is mandated by state law, many costs are covered that would not typically be considered an insurable risk. Indeed, they may not be related to uncertainty at all. These are health care costs that people choose to incur, such as the routine costs of pregnancy, cosmetic surgery, and dental check ups. Again, premium payments are not linked to the likelihood that a particular person or even a class of patients will use these services. Employers and employees pay the same premiums regardless of utilization or risk. Adding to this problem is recent legislation that requires insurance companies to cover

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<sup>22</sup>See Fund and Wooster, *op. cit.* at note 5.

preexisting conditions when workers change jobs. Insurance companies cannot legally charge higher premiums to individuals because of these conditions, so the costs are socialized. Again, the initial problem is caused by the fact that people do not own and shop for their own policies and therefore must change insurance plans when they change employment.

If one wants to have a system where health care costs are not socialized through health insurance, then policy makers should be trying to reform the system in a way that links insurance payments to risk. Laws that prohibit such linkages should be abolished. The bias in the tax code against personal and in favor of employer ownership of policies should be eliminated. Eligibility for tax-free medical savings accounts, in which people shop for and own their own policies, should be expanded. Penalizing politically disfavored behaviors through taxation does nothing to solve the underlying social cost problem brought on by socializing health care. The arguments used to tax politically incorrect behaviors today can just as easily be used to tax any other activities that may result in health care costs being incurred. This would include athletics of all kinds, certain kinds of sexual behaviors, riding bicycles, riding in cars, etc. Indeed, this line of reasoning would lead to arguments for taxing nearly all human activity, or at least most of those activities that make life fun and interesting.

The studies on the social costs associated with unhealthy eating habits also emphasize what are referred to as "indirect costs." For example, \$9 billion of the \$72 billion cited by Jacobson and Brownell as a justification for their tax proposal is from "lost productivity," i.e., lost work days associated with eating habit related illness and death.

At first glance this might appear to be an uncompensated cost to society. But to present it in this way, as it usually is,<sup>23</sup> is to ignore the fact that the costs are borne by the worker. If during the career of an unhealthy eater, he or she is less productive because of those eating habits, that person's compensation will reflect the reduced productivity. Employers base pay on productivity and do not pay for something they are not getting; they pay less to workers who produce less. As a result, the loss in output from unhealthy eating habits falls directly on the worker and his or her family, not on society at large. Consequently, when people choose to eat pleasurable but "unhealthy" foods, one of the costs they must weigh against the benefits is the possibility of lost wages due to lower productivity. If people decide the benefits to them exceed the costs, they choose to eat the food. The point is that the full costs of the food are already reflected within the market; they are not external social costs.

Another angle from which to view the "lost productivity" argument is to ask if the government should intervene when a person chooses to retire early or take a long vacation or work fewer hours in order to have more family time or work in an enjoyable job rather than a better-paying job. In each of these cases, as in the "unhealthy" foods case, there is "lost productivity". Should we place a lifestyle tax on retirement communities and vacation resorts

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<sup>23</sup>See Frazao, *op.cit.* at note 19.

and part-time workers? The answer, of course, is that we should not. When people make lifestyle decisions, they are already weighing the possibility of lost wages among the costs and benefits. If they elect to make a lifestyle choice that forgoes some production, that is because the benefits of the lifestyle choice outweigh the costs. The decision they make on their own behalf is economically efficient. Efficiency does not require people to produce past the point at which the sacrifice exceeds the gain. Nor do people "owe it" to the government to maximize their productivity. In a free society, when people make such lifestyle choices, the government has no business intervening.

Furthermore, if the worker were forced through taxation to alter his eating habits he would experience a loss in personal satisfaction. This loss would also have to be factored in as part of the analysis. This would be an "indirect cost" of forcing people to eat healthier foods. Implicitly, Fazio and others,<sup>24</sup> take the materialistic view that more output is always better. Even with respect to health care costs, the implicit assumption is that the problem with people spending more on health care is that there is less left over to produce and spend on other things. But production is valuable only because it satisfies individual wants. The efficient level of output will reflect the desires of both consumers and those working to produce it. One of the first rules of economic analysis is that we accept people's preferences as a given. Given free will, if some workers choose eating habits that lead to them being overweight and consequently earning less income, then as social scientists we must accept this individually made trade-off. In this case, economic analysis would have to lead us to conclude that the productivity level of unhealthy eaters is efficient. Indeed, it would be inefficient to pursue policies to alter this outcome.

## **B. The Bullet Tax: Missing the Social Cost Target**

It is inappropriate to use the economic concept of social cost or externality to justify regulating guns via a "bullet tax." In the standard definition of the problem, an externality occurs as an unintended byproduct of an otherwise legitimate consumption or production process.<sup>25</sup> Intent is important. Intentional infliction of uninvited personal injury is not part of the standard definition of legitimate economic or social activity. While guns are used to harm others, this harm is not something that occurs as part of the legitimate use or production of the product, i.e., the harm is not inflicted by lawful producers or users. Furthermore, even if it were a legitimate use of the concept of social costs, placing a tax on bullets would cast the net too wide. To tax the bullets of those who do no harm is not only unjust, but would cause inefficiencies of its own. It would reduce gun ownership and non-harmful uses of guns such as target shooting, hunting, etc., and therefore reduce social welfare. The reality is that the intentional infliction of harm with a gun, or any other instrument, is already illegal. If the desire is to reduce the incidence

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<sup>24</sup>See A.M. Wolf and G.A. Colditz, "Current Estimates of the Economic Costs of Obesity in the United States," *Obesity Research*, Vol. 6, 1998, pp. 97-106.

<sup>25</sup>This point is made throughout the literature. See Mishan, *op. cit.* at note 8.

of these illegal activities, then the solution is to increase the penalties associated with carrying them out. There is no economic theory that even suggests that the costs of illegal activities should be born by anyone other than the persons who are generating them.

In addition, economic analysis of the affects of gun ownership on crime would seem to suggest that the taxation of bullets itself might have a negative impact on society, primarily because it would penalize those who are using the weapons legitimately. It has been argued that the possession and use of guns for self defense by some actually conveys a social benefit. The possibility that a potential victim might be armed and be willing to use a gun in self defense has a deterrence effect for criminals and leads to a reduction in gun crimes. This is the thesis of Professor John Lott's book, *More Guns Less Crime*. As Lott argues, "Of all the methods studied so far by economists, the carrying of concealed handguns appears to be the most cost-effective method for reducing crime."<sup>26</sup> In these cases people who do not own guns benefit from the fact that others are carrying concealed weapons and that potential criminals have no way of knowing which citizens are carrying and which are not. On a more general note, Lott also shows a strong negative correlation between rates of gun ownership and violent crime rates among states.<sup>27</sup> In a recent talk before the Association of Private Enterprise Education, he cited statistics that strongly suggest that this relationship also holds internationally.<sup>28</sup> The point here is that while attempting to curtail social-cost-generating behavior, bullet taxes and other gun control measures that discourage gun ownership may actually be generating social costs by encouraging violent crime.

### **III. The Social Costs and Ethics of Limiting Freedom of Choice**

Within the context of a free society where all people are considered to have "Creator endowed" rights to pursue "happiness," the kinds of taxes being contemplated here take on an ethical dimension that should not be overlooked. The right to pursue happiness means nothing if it does not include the right of a citizen to choose the risks he or she is willing to take in exchange for a particular level of happiness that will be received. Our nation places considerable social value on both individual liberty and individual responsibility for one's actions. The movement to alter people's behavior "for their own good," either through taxation, regulation, or litigation, is an attempt to limit people's rights "for their own good," and is at odds with our national tradition. Throughout the "public health" literature on these issues, no value is ever placed on either the actual choices that people make to consume or purchase the disfavored products or on the individual's right to make those choices. In fact, the idea that choices are a product of individual decision making and the exercise of free will is, in large part denied,

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<sup>26</sup>John R. Lott, *More Guns Less Crime: Understanding Crime and Gun Control Laws* (Chicago: University of Chicago Press, 1998), p. 20.

<sup>27</sup>*Ibid.*

<sup>28</sup>Annual Meetings of the Association of Private Enterprise Education, Arlington, VA, April 8-10, 2001.

particularly in the literature on food taxes. In an often-cited 1998 article by Yale University researchers Katherine Battle Horgan and Kelly Brownell, all responsibility for what people eat is shifted away from the individual. They argue that "[the cultural environment] produces excessive pressure to be thin coupled with pervasive inducement to eat."<sup>29</sup> The authors never explain why the forces to eat are not overcome or balanced out by the forces to be thin. In fact they never attempt to scientifically demonstrate that either force is predominant; they simply assume that the eating impulse wins.

Ultimately, the assertion of the right to intervene in others' lives is an expression of a moral attitude toward individual liberty. If people are not responsible for their choices then there is no moral obligation to uphold their rights to make those choices. This automatically leads to the advocacy of public policies that limit freedom for the individual's own good. In justifying the idea that it should be within the purview of public policy to alter behavior, Horgan and Brownell conclude, "[I]f the environment is responsible for these problems to a significant extent, the environment is the natural place to look for solutions."<sup>30</sup>

Obviously, this ethical view has economic implications. As noted, it leads to a complete discounting of all benefits to the individual in the analysis. Furthermore it also eliminates any consideration of social costs that are associated with limiting freedom of choice.<sup>31</sup> The purpose of taxes on fatty foods, guns or bullets, tobacco products, etc., is to limit consumer choices in these areas by making the products relatively more expensive. What makes people better off in a free society is that they are allowed to use their resources as they see fit. A free market economy, i.e., the network of exchanges that develops as a result of this freedom, will generate the maximum number of consumer choices given the relative scarcity of resources. The more options consumers have the better off they are. By reducing freedom of choice, the advocates of these "behavior taxes" are themselves generating a social cost. But so long as those who propose these taxes refuse to acknowledge that freedom and individual autonomy are in and of themselves value enhancing, these social costs will never be considered.

## Conclusion

As noted at the outset of this paper, the movement for taxes has taken on a new dimension. Traditionally, even among those who have been advocates of higher taxes, taxation has been viewed as a necessary evil, the price we must pay to obtain government services and programs. The movement for social cost taxes has changed this emphasis. By pointing only to

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<sup>29</sup>Horgan and Brownell, "Policy Changes as a Means for Reducing the Prevalence and Impact of Alcoholism, Smoking, and Obesity," in Miller and Heather ed., *Treating Addictive Behaviors*, 2nd ed., (New York: Plenum Press, 1998), p. 107.

<sup>30</sup>*Ibid.*, p. 108.

<sup>31</sup>See Cordato, *op. cit.* at note 7.

the costs of certain behaviors, social or private, and ignoring all benefits, advocates of these taxes misapply economic theory, claiming that such taxes will actually enhance economic performance.

Advocates such as Kelly Brownell of Yale University and Michael Jacobson of the Center for Science in the Public Interest, and others, ignore the obvious fact that a discussion of costs alone, even if the numbers are accurate, tells us nothing about the validity of any policy proposal. To make any sense, the advocates of these taxes must first distinguish between internal (private) and external (social) costs. That is, they must recognize that many of the costs of the offending products are borne by the producers and consumers, not by third parties. Second, the advocates of intervention must acknowledge that the people consuming the offending products are experiencing benefits as well as costs, and that the consumers are weighing the costs and benefits and coming to the conclusion that they would rather consume the products than do without them. Finally, they must recognize that intervention by government to alter that consumer behavior would thwart the freely expressed will of the consumers, and would be an infringement on personal freedom that should not be undertaken without a truly compelling reason. In a free society, individuals should be regarded as being able to decide what is best for themselves and to manage their own affairs, provided they are not harming others and are responsible for the consequences of their actions.

Only by facing up to all these facets of the analysis would the advocates of intervention come to terms with the real economics and with the moral and philosophical implications of their policy proposals. Unfortunately, that understanding of economics and respect for personal freedom is almost totally absent from the social-engineering-through-taxation literature. Instead, the movement to tax behavior is not only an abuse of economic science. It is also an attack on individual liberty and the ethical foundation of American society.

## ***ABOUT IRET***

IRET was founded in 1977 as a 501(c)(3) public policy research organization dedicated to the belief that constructive, free-market economic policies are essential for the nation's economic progress. To this end, IRET conducts research and analysis of the economic effects of tax, budget, and regulatory public policy initiatives. IRET is a leader in offering guidance to policy makers regarding fundamental tax reform that would eliminate the bias against saving and investment in the current tax system, including elimination of the estate tax, taxation of capital gains, and the double taxation of corporate income. IRET is also researching ways to replace Social Security with personal saving for retirement.

IRET has a reputation as a no nonsense resource for policy makers and opinion leaders. IRET relies on contributions from individuals, foundations, and corporations to perform its work. It accepts no government funding. IRET is the leading public policy institute in Washington focusing realistically on the growth aspects and economic consequences of federal policy changes.

IRET's resident and contributing economists prepare books, studies, bulletins, and Congressional advisories for publication and distribution to the Congress, the media, and the public. IRET scholars testify at Congressional hearings and consult with Members of Congress on legislation and economic issues, write opinion pieces for journals and newspapers, make radio and television appearances, and speak at conferences on economics and public policy.

IRET's late founder, Norman B. Ture, was a distinguished tax advisor to Congress and served as Under Secretary of the Treasury for Economic Affairs in the Reagan Administration. Dr. Ture played a central role in the development of the Economic Recovery Tax Act of 1981. IRET's current President and Executive Director is Stephen J. Entin. Mr. Entin is a recognized expert on taxation and Social Security. He was Deputy Assistant Secretary for Economic Policy at the Treasury Department in the Reagan Administration, and was instrumental in the development of the 1981 tax cuts, in particular, the "tax indexing" provision that keeps tax rates from rising due to inflation. Mr. Entin represented the Treasury Department in the preparation of the Annual Reports of the Board of Trustees of the Social Security System, and conducted research into the long run outlook for the system. He advised the National Commission on Economic Growth and Tax Reform (the Kemp Commission), assisted in the drafting of the Commission's report, and was the author of several of its support documents. Prior to joining Treasury, Mr. Entin was a staff economist with the Joint Economic Committee of the Congress, where he developed legislation for tax rate reduction (the Kemp-Roth bill) and incentives to encourage saving. Mr. Entin is a graduate of Dartmouth College and received his graduate training in economics at the University of Chicago.