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Idea

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Raise cigarette taxes to promote public health

Each Southern state should raise cigarette taxes to the national average of \$0.92 per pack to reduce smoking and promote public health.

Background

In the last five years, every Southern state—except Florida, Mississippi and South Carolina—has raised cigarette taxes. Even though the taxes are increasing, Southern states continue to levy among the lowest cigarette taxes in the nation.

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As a public health measure, cigarette taxes—if set at high-enough levels—can reduce adult and teen smoking, and can lower expensive long-term health costs. Viewed from a tax perspective, however, cigarette taxes are highly *regressive* and represent a declining revenue stream. Thus, Southern leaders should view this tax reform as a tool for

improving public health rather than as a mechanism for financing core governmental services.

In other words, if states are going to tax cigarettes anyway, they should set the tax rate at a high enough level that it will do some public good, such as reducing the rate of smoking among Southerners. But revenues should be used for one-time costs, not continuing costs.

Cigarette taxes in the South

All Southern states charge an excise tax (i.e. cigarette tax per pack) and state sales tax on packs of cigarettes.¹ Cigarette taxes in the South range from a low of \$0.07/pack in South Carolina to a high of \$0.59/pack in Arkansas (Figure 1). Half of all Southern states charge at least \$0.30/pack.² These state taxes, combined with the federal cigarette tax of \$0.39/pack and wholesale prices, result in a Southern median retail price of \$3.61 for a pack of cigarettes.³

Figure 1: State cigarette tax rates, revenues and smoking rates, Southern states

State	2005 cigarette tax (per pack)	National rank (1=highest)	Year of last increase	FY 2004 tax revenues	Youth smoking rate (percent)	Adult smoking rate (percent)	Retail price per pack (all taxes)
AL	\$.43	39	2004	\$64.2	24.7	24.9	\$3.80
AR	\$.59	32	2003	\$128.1	29.3	25.7	\$3.82
FL	\$.34	44	1990	\$421.9	15.7	20.4	\$3.55
GA	\$.37	41	2003	\$216.2	20.9	20.1	\$3.62
KY	\$.30	45	2005	\$20.5	27.9	27.6	\$3.61
LA	\$.36	42	2002	\$130.3	25.0	23.6	\$3.65
MS	\$.18	49	1985	\$42.9	22.4	24.6	\$3.53
NC	\$.30	45	2005	\$39.8	24.8	23.2	\$3.62
SC	\$.07	51	1977	\$25.4	24.4	24.5	\$3.38
TN	\$.20	48	2002	\$110.2	27.6	26.1	\$3.56
VA	\$.30	45	2005	\$16.1	21.0	20.9	\$3.66

Bold = major tobacco production state
 Source: Campaign for Tobacco Free Kids
 Note: Revenues are for FY 2004 and thus do not reflect recent increases in the tax rate. North Carolina's tax per pack is scheduled to increase to \$0.35 in July 2006.

Since 2000, eight Southern states—including every major tobacco production state except for South Carolina—have raised cigarette taxes. In 2005 alone, North Carolina, Kentucky and Virginia increased cigarette tax rates.⁴ Nevertheless, Southern states continue to levy some of the lowest cigarette taxes in the nation. The regional average of \$0.31/pack equals just one-third of the national average of \$0.92/pack. Moreover, the average cigarette tax is even lower in the six Southern states that traditionally have been major producers of tobacco: Kentucky, Virginia, North Carolina, South Carolina, Georgia and Tennessee. The average cigarette tax in these states totals \$0.26/pack.⁵

Collectively across the South, cigarette taxes generated \$1.2 billion in revenues during fiscal year 2004. The amount of tax revenue collected in each state ranged from a high of \$421.9 million in Florida to a low of \$16.1 million in Virginia. Half of all Southern states collected at least \$64.2 million in cigarette taxes.⁶ Overall, cigarette taxes contribute a small portion of a state's annual budget. In North Carolina, for example, the revenues generated by the cigarette tax during fiscal year 2004 equaled just 0.3 percent of the state's general fund.⁷

A problematic revenue tool...

From a *progressive* tax perspective, cigarette taxes are a deeply-flawed tool. Not only are cigarette taxes *regressive*, meaning they fall more heavily on low-income individuals, but they also represent a declining revenue stream that, if used inappropriately, can contribute to structural deficits.⁸

The major problem with the tax on cigarettes is its *regressive* nature. Like any consumption tax, cigarette taxes take “a greater proportion of the income of poor and near-poor households than they do of higher income households.”⁹ In fact, the Institute on Taxation and Economic Policy estimates that cigarette taxes are about 10 times as burdensome for the nation’s poorest taxpayers as they are for the wealthiest taxpayers.¹⁰ The *regressive* nature of cigarette taxes likely is magnified in the South due to the region’s relatively high rates of poverty and adult smoking.

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A second flaw of cigarette taxes is they represent declining sources of revenue. Because cigarette taxes are levied on a per-pack basis rather than as a percentage of the sales price, tax revenues fail to increase along with price increases or periods of economic growth. This means tax revenues associated with cigarette taxes only grow when demand increases or the tax rate increases.¹¹ For example, consider a state with a \$0.30 per pack cigarette tax. If the price of a pack of cigarettes increases by \$1, the state will still only receive \$0.30 when a consumer buys a pack of cigarettes. On the other hand, if the consumer decides to buy two packs of cigarettes, then the state receives \$0.60. The amount of revenues only increases if consumers buy more packs or the state raises the tax rate per pack.

Demand is not increasing, though. Data collected by the U.S. Department of Agriculture show cigarette consumption in the United States has declined in recent years—a decline attributable to such factors as higher taxes and a growing awareness of the harmful health consequences of smoking.¹² Raising the tax rate can generate more revenues, but that also can spark a decrease in demand. At the same time, increasing taxes can lead to more tax avoidance, which is caused when consumers go out of state to buy cigarettes, buy them over the Internet or through the mail, or engage in smuggling from lower-tax states.¹³ This possibility of increased tax avoidance should be a consideration in estimates of what a tax increase would generate in terms of new revenues.

A final concern deals with the use of cigarette tax revenues. In times of financial difficulty, such as the recession in 2001, it is tempting for politicians to raise more politically-popular taxes, such as the cigarette tax, rather than other broad-based taxes, such as the personal income tax. Raising the tax on a pack of cigarettes can bring additional revenues for some years, but any revenue surge will

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likely decline after a number of years if demand falls in response to the increased prices or health concerns. Since cigarette tax revenues are a declining revenue source, it is problematic when cigarette taxes are used to fund core government services, which continue to increase in cost.

Using this declining revenue source to fund services that are increasing in cost can cause structural deficits, which occur when state revenue systems cannot generate the funds needed to meet current services.

Cigarette tax revenues are better suited for one-time purposes like building state rainy-day funds.¹⁴ Other revenue sources, such as the *progressive* income tax, are more appropriate for raising general fund revenues for core government services. When states rely on cigarette taxes for general fund needs, not only do they increase the risk of creating structural deficits, but they also contribute to the growing trend of shifting the responsibility of funding government from the most affluent to those least able to pay.¹⁵

...but a potentially powerful public health measure

Despite its considerable flaws as a revenue tool, a cigarette tax can, if set at a high enough level, yield tangible public health benefits. Studies show that increases in cigarette taxes discourage smoking, especially teen smoking, and reduce public health costs.

In the South, raising cigarette taxes to the national average could generate long-term health care savings ranging from an estimated \$2.27 billion in Florida to a low of \$271.4 million in Arkansas.

Research by the Campaign for Tobacco Free Kids finds that “every 10 percent increase in the price of cigarettes will reduce youth smoking by about 7 percent and overall cigarette consumption by about 4 percent.”¹⁶ As shown

Figure 2: Estimated impact of raising cigarette taxes to national state average

Southern state	Tax increase needed to reach national state average of 91.7 cents per pack	Number of current adult smokers who would quit	Long-term health care savings from adult & youth smoking declines
Alabama	49.2¢	16,600	\$584.0 million
Arkansas	32.7¢	7,100	\$271.4 million
Florida	57.8¢	70,700	\$2.27 billion
Georgia	54.7¢	29,600	\$1.17 billion
Kentucky	61.7¢	23,700	\$845.8 million
Louisiana	55.7¢	18,800	\$716.2 million
Mississippi	73.7¢	17,700	\$742.1 million
North Carolina	61.7¢	40,700	\$1.57 billion
South Carolina	84.7¢	30,600	\$1.10 billion
Tennessee	71.7¢	38,500	\$1.24 billion
Virginia	61.7¢	31,400	\$1.21 billion

Source: Campaign for Tobacco-Free Kids, 2006¹⁸

in Figure 2, the number of current adult smokers who quit smoking after the tax increase would be in the tens of thousands for all states except Arkansas, which already taxes at a higher rate than other Southern states. Such reductions translate into lower health costs. In the South, long-term health care savings could range from an estimated \$2.27 billion in Florida to a low of \$271.4 million in Arkansas.¹⁷

Lessons from Kentucky

In 2005, Kentucky raised the cigarette tax from 3 cents per pack to 30 cents per pack as part of comprehensive

tax reform. The increase came from a combination of two bills:

- House Bill 272, which contained reforms in the income tax and other tax structures, raised the cigarette tax by 26 cents. In an analysis of HB 272 by the Kentucky Appropriations and Revenue Committee, the state estimated the 26 cent increase would raise revenues by approximately \$172 million in FY 2006, \$151 million in FY 2007 and \$150 million in FY 2008. HB 272 also levied taxes on other tobacco products, which were expected to bring in an estimated \$4.8 million annually.¹⁹
- Another bill, HB 267, raised the cigarette tax by an additional one cent and dedicated those additional revenues to two cancer research centers. The additional one cent will bring in an estimated \$2.5 to \$3.0 million and will be matched by the universities that house the research centers.²⁰

After Kentucky raised its cigarette tax, sales decreased much more than expected, but revenues generated were 10 times that of the same period in the previous year.

An analysis of Kentucky's cigarette tax increase prior to its implementation illustrates the *regressive* nature of cigarette taxes. As shown in Figure 3, the estimate of the likely tax increase for each income group showed that those with the lowest incomes would have the highest tax hike as a percent of income. Taxpayers with incomes below \$14,000 would pay an estimated 0.8 percent more of

income in taxes, while taxpayers with the highest incomes would have virtually no tax change.²¹

Figure 3: Estimated tax increase as a percent of income in Kentucky

Income group	Tax change as a percentage of income
Lowest 20% of incomes (Less than \$14,000)	0.8%
Second 20% (\$14,000 to \$25,000)	0.4%
Middle 20% (\$25,000 to \$42,000)	0.3%
Fourth 20% (\$42,000 to \$67,000)	0.2%
Next 15% (67,000 to \$124,000)	0.1%
Next 4% (\$124,000 to \$270,000)	0.1%
Top 1% (\$270,000 and above)	0.0%

Source: Institute on Taxation and Economic Policy.

Note: The estimate includes all Kentucky taxpayers in 2006. Thus, the tax increase is an average as both smokers and nonsmokers are included.

While Figure 3 displays the downside of cigarette tax increases—the *regressivity*, recent reports on the effects of the tax increase show the benefits. Three months after increasing the tax, reports noted decreases in cigarette sales and increases in states revenues. Estimates prior to the tax increase suggested cigarette sales would decline by four percent; however, for the short-term, the actual decrease in sales turned out to be between 10 and 20 percent. In addition, cigarette tax revenues were 10 times higher than the same period in the previous year.²²

Raise the cigarette tax to promote public health

Southern legislators need to view increasing cigarette taxes as a public health measure rather than as a tool for funding core public services. Cigarette tax increases can reduce smoking and lower long-term health costs across the region. But because they also are a declining revenue source, they are unlikely to grow with the economy and adequately fund public services.

Southern progressives therefore should insist that cigarette taxes be viewed as a tool for improving public health, not a revenue measure. This means:

- Tax rates should be set at a high-enough level to achieve health benefits;
- The resulting revenues should be spent on concrete, one-time expenses, and
- The tax should not be used as a way to shift the responsibility for funding government to low-income citizens.

Talking points

- Cigarette taxes are *regressive* because they cause more of a burden on poorer people than those who have higher incomes.
- The smoking population, however, is declining, which means revenues gained from cigarette taxes are a declining revenue stream.

- Any revenues from declining streams shouldn't fund continuing needs of governments, because costs will increase as revenues decrease. That doesn't make sense economically and can lead to long-term structural deficits.
- Even though *regressive* and a declining stream of revenue, states should raise cigarette taxes to the national average to further reduce the smoking rate. Lowering the number of people who smoke will have great public health benefits—and save billions in government spending on rising future health care costs.
- While raising the cigarette tax isn't technically *progressive*, it can serve as a *progressive* tool to lower smoking rates and reduce long-term health costs.

Endnotes

¹ Author's analysis of data compiled by the Campaign for Tobacco Free Kids (www.tobaccofreekids.org). Note that Alabama and Georgia do not charge sales tax on the "portion of retail cigarette prices that is the state's cigarette excise tax." Also, state cigarette taxes are not levied on sales that occur on Indian reservations and military bases.

² Campaign for Tobacco Free Kids. See note 1.

³ *Ibid.*

⁴ *Ibid.*

⁵ *Ibid.*

⁶ *Ibid.*

⁷ Author's analysis of data presented in: Cameron, Amna, *Following the Money*. Raleigh, NC: North Carolina Budget & Tax Center, 2004.

⁸ Iris Lav, *Cigarette Tax Increases: Cautions and Considerations*, Washington, DC: Center on Budget and Policy Priorities, 11 July 2002 (www.cbpp.org).

⁹ *Ibid.*, p. 4.

¹⁰ *Cigarette Taxes: Issues and Options*. Washington, DC: Institute on Taxation and Economic Policy, April 2004 (www.itepnet.org/pb1cigs.pdf).

¹¹ Institute on Taxation and Economic Policy, note 10.

¹² Lav, p. 6.

¹³ Seaman, Bruce. "The Economics of Cigarette Taxation: Lessons from Georgia." Georgia State University, Fiscal Research Center. FRC Report No. 89. October 2003.

¹⁴ Lav, p. 12.

¹⁵ Rob Schofield, "Cutting Through The Cigarette Tax Haze." Raleigh, NC: NC Justice Center, March 17, 2003 (www.ncjustice.org).

¹⁶ Web site of the Campaign for Tobacco Free Kids (www.tobaccofreekids.org).

¹⁷ Campaign for Tobacco Free Kids. Analysis by Katie McMahon on May 10, 2006.

¹⁸ *Ibid.* Analysis included the following comments on the methodology, "These projections are fiscally conservative because they include a generous adjustment for lost state pack sales (and tax revenues) from new tax avoidance efforts after the tax increase by continuing in-state smokers, and from fewer sales to smokers from other states or to informal or small-scale smugglers. The projections are also based on research findings that a 10% cigarette price increase reduces youth smoking rates by 6.5%, adult rates by 2%, and total consumption by 4%, and assume that the state tax will keep up with inflation. Long-term savings accrue over lifetimes of persons who stop smoking or never smoke because of tax increase."

¹⁹ Kentucky Appropriations and Revenue Committee Staff. "HB 272 Free Conference Balance Sheet." Excel spreadsheet.

²⁰ White, Charlie. "Kentucky Cigarette Tax Hike Draws Praise for Cancer-Fighting Component." *State Tax Notes*. 2005 STT 110-7. June 9, 2005.

²¹ Institute on Taxation and Economic Policy. "Impact of Kentucky Tax Changes Proposed by Gov. Ernie Fletcher." February 2005.

²² White, Charlie. "Kentucky Cigarette Sales Drop but Revenue Rises Sharply After Tax Hike." *State Tax Notes*. 2005 STT 201-10. October 19, 2005.