Lawmakers Cannot Count on Sin Taxes for Budget Relief

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Key Findings

1. Raising sin taxes does not provide a stable solution to long-term budget problems.
2. Most states have found that higher sin taxes fail to produce the amount of revenue that tax increase sponsors promised.
3. After an earlier tobacco tax increase Washington's treasury received $2.5 million less tax revenue than lawmakers were told they would receive.
4. Higher sin taxes appear to do little to address social problems, but a tax increase on targeted products is often followed by a spike in smuggling and black market sales.

Introduction

Washington lawmakers are again facing a multi-billion dollar deficit, due to their decision to sharply increase spending in recent years and slower revenues resulting from a weakened economy.

In an effort to increase revenue, some lawmakers are proposing an increase in so-called "sin" taxes in hopes of killing two birds with one stone. They want to discourage people from engaging in certain behaviors, like smoking, drinking, even overeating, by making it more expensive to purchase products related to these behaviors. At the same time, they want to alleviate state budgetary pressures with the additional money they hope to collect from higher sin taxes.

The Failure of Past Sin Tax Increases

The debate about the efficacy of sin tax increases is not new. Washington Policy Center research published in 2005 documented how past tax increases in sin taxes were not successful in improving the state's long-term budget outlook. These tax increases did not bring in the amount of revenue their sponsors had promised, and they created a financial incentive for consumers to find ways of avoiding the taxes while continuing to buy the same products. That research found:

> "...actual collections under Initiative 773 [tobacco tax increase] have been $2.5 million less than expected. Cigarette sales decline about 1% or 2% each year. Raising the tax pushes consumers to seek cigarettes out of state or from Indian reservations, or it cuts how much they buy. The state Department of Revenue estimated $220 million in lost revenue in 2003 due to people buying cigarettes via semi-illicit or downright illegal means."[1]

That year Washington's legislature raised state cigarette taxes to the third highest in the nation, yet the state collected $2.5 million *less* tax revenue than lawmakers were told they would receive.

Washington's Sin Tax Base

Cigarettes are just one of the "sin-related" products taxed by lawmakers in their efforts to draw in more revenue and to curb what they see as the public's bad

[1] "Relying on sin taxes reveals contradictions in the state budget," John Barnes, Washington Policy Center, June 2005, at www.washingtonpolicy.org/Centers/Miscelaneious/05_barnes_sintaxes.html.

habits. The following table lists the main sin tax rates imposed in the 2007-2009 budget cycle.

Washington Sin Taxes: 2007-2009 (as of July 1, 2009)

Year	Cigarette Tax (per pack)	Spirits Tax (per gallon)	Table Wine Tax (per gallon)	Beer Tax (per gallon)
2009	$2.025	$26.45	$0.87	$0.26
2008	$2.025	$19.43	$0.87	$0.26
2007	$2.025	$21.30	$0.88	$0.26

Source: State Revenue Departments; Commerce Clearing House; American Petroleum Institute; Orzechowski and Walker; Distilled Spirits Council of the United States (DISCUS).

The Experience of Other States

Washington legislators are not alone in their preference for raising taxes on so-called "sinful" behaviors. Lawmakers in many states engage in the same thinking and harbor the same optimistic expectations about achieving higher revenues. Independent research by the national Tax Foundation has assessed the efforts of state lawmakers across the country to use sin tax increases as a way to solve their budget problems. Foundation researchers identified and measured the impact of this approach in a number of states:

> "Excise taxes – particularly so-called 'sin' taxes targeting politically unpopular behavior such as smoking or drinking alcohol – were also common targets for revenue grabs. Ten states increased cigarette taxes: Arkansas (new rate of $1.15), Florida ($1.34), Hawaii ($2.60), Kentucky ($0.60), Mississippi ($0.68), New Jersey ($2.70), New Hampshire ($1.78), Rhode Island ($3.46), Vermont ($2.24) and Wisconsin ($2.52). New York and New Jersey hiked taxes on alcoholic beverages."

The Tax Foundation found that in most cases, state lawmakers' plans failed to achieve either of the goals advanced to justify excise tax increases. The tax increases did not significantly change peoples' behavior, and they failed to generate the new revenues their sponsors predicted. The shortfall in expected revenue, combined with chronic overspending, contributes to unsustainable budgets and contributes to an ongoing sense of crisis in state finances.

Far from helping solve state budget woes, sin tax increases tended to bring in significantly less money than expected, while increasing resentment among consumers of the targeted products.

The experiences of other state provide guidance to Washington lawmakers as they consider a similar path to reducing the state's budget deficit. Following are some specific examples.

Rhode Island: Cigarette Tax Increase

Rhode Island has the highest cigarette tax in the nation. In April 2009, state lawmakers enacted a $1.00 per pack increase in the tax, bringing the total tax per pack to $3.46. Combined with other taxes, the boost raised the retail price of a pack of 20 cigarettes to $8.35. The increase was proposed to the legislature by Governor Don Carcieri as a means of closing the state's projected $357 million budget deficit.

According to Paul L. Dion, the chief of Rhode Island's Office of Revenue Analysis, "tax revenue from all tobacco sales rose from $117.3 million to $136.3 million when the tax increased to $2.46, though subsequent years showed a gradual decline."[2]

Indeed, there is already evidence that the most recent tax increase is not bringing in as much money as legislators had been led to expect. Though the full impact of the tax increase will not be clear until the end of the fiscal year, the state Office of Revenue has "confirmed that cigarette sales during the two summer months were down 19.9%, leaving the state $2.8 million short of the revenue he and others had expected."[3] These results were also reported by Steven Biron, a Burrillville convenience store owner who serves as a member of the New England Convenience Store Legislative Committee:

> "[S]tate tax figures for July and August revealed that added anticipated revenue from cigarette sales in Rhode Island came up short by about $3 million, totaling $23.5 million in new revenue compared with projections of $26.3 million."[4]

Many businesses close to state lines have been hit the hardest by the tax increase. A local newspaper report discussed how consumers buy their cigarettes in neighboring states where prices are far lower. The article stated, "[T]here are others who might look for a cheaper way to buy, such as driving to New Hampshire. They are supposed to report their purchase and pay the Rhode Island tax, but few do."[5]

It is unknown how many Rhode Island residents chose to quit smoking as a result of the higher tax, but it is clear that state officials are collecting far less new revenue than they expected. Other effects of the tax increase are a significant reported decline in business by store owners, and a sharp increase in cigarette purchases across state lines and on the internet.

Maryland: Cigarette Tax Increase

Maryland lawmakers increased cigarette taxes twice in two years, providing a rare look at how increases in sin taxes affect both state revenue and local businesses.

In 2007, Maryland's legislature increased the cigarette tax by $1.00. The result was that a year later there was a 25% drop in reported cigarette sales, and a remarkable 254% increase in illegal cigarette sales across state lines.[6]

In 2008, Maryland increased its cigarette tax again. The results were just as disappointing as they were after the 2007 increase. According to a Tax Foundation report on Maryland's cigarette tax increase, revenue was much lower than expected:

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[2] "Cigarette tax hike 'kills' business for local store owners," by Ethan Shorely, Valley Breeze, Breeze Publications, September 30, 2009, at www.valleybreeze.com/Free/MAIN-9-30-PAW-Cigarette-sales-headshot-of-Eid.
[3] Ibid.
[4] Ibid.
[5] R.I.'s cigarette tax – highest in the nation – will be what kills ya now," by Randal Edgar, The Providence Journal, April 9, 2009, at www.projo.com/news/content/CIGARETTE_TAX_04-09-09_03DVCT1_v225.393f0eb.html.
[6] "Sin tax econ – so simple, a child could understand it," by Tim Andrew and Kimberly Moogalian, Americans for Tax Reform, May 22, 2009, at www.atr.org/sin-tax-econ-simple-child-understand-a3290.

> "As the only state to raise every major tax in 2008 to fund new spending programs, it is a good case study to follow, particularly since it's turning out to be a study of what not to do."[7]

Here is what happened. By doubling the cigarette tax Maryland lawmakers only increased revenues by 50%. In other words, Maryland collected about half the revenue it expected from the tax increase. The state's Comptroller estimated that revenue will fall again in 2010 to $403 million. At the same time, lawmakers ramped up spending based on the assumption they would receive twice as much revenue from their doubling of the cigarette tax. The Comptroller's report, however, noted that after the tax hike much of the money that would have been spent on legal cigarette sales went elsewhere.

> "Demand for cigarettes did prove to be highly elastic, as tobacco stamp sales have declined by over 25% since the rate increase took effect.... [T]obacco stamp sales are down 26% year to date, which can be attributed to a number of factors including a decline in smoking, a possible increase in cross-border and Internet sales, as well as a possible increase in smuggling."[8]

Maryland's recent experience serves as a useful pilot program of what can happen when lawmakers radically increase a tax on a targeted product: a sharp fall-off in expected revenues and a spike in illegal sales.

Kentucky: Cigarette and Alcohol Tax Increases

In early 2009, legislators in Kentucky imposed a 6% sales tax on alcohol, including the state's world-famous bourbon distilleries, and raised the tax on cigarettes by $0.60 a pack in an effort to close $456 million deficit.

The results were not what lawmakers expected. In the first month the higher taxes took effect the state experienced a 50% drop in overall alcohol tax receipts. Revenue from beer went up, but revenue from distilled spirits fell 55% and tax collections on wine dropped by some $75,000, compared to the same month a year before.[9]

In one month wholesale tax revenue, paid in large part by bourbon distillers, dropped by nearly $1.3 million. Representatives for the Kentucky Distillers Association reported:

> "This is kind of what we expected and feared would happen when this tax increase went into effect, and it represents an alarming consumer retreat from the distilled spirits industry."[10]

Legislators who supported the tax increase indicated they thought consumers would not notice the boost in the price of alcohol. Instead people in Kentucky changed their consumption patterns, for example by buying out of state or by buying cheaper brands, in an effort to avoid the higher tax. The change in consumer behavior did not lead to a reduction in total alcohol consumption, but people's response to an increase in tax rates did lower the state's revenue collections.

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[7] "Maryland's doubled cigarette tax brings in just 50% more revenue," by Joseph Henchman, The Tax Foundation, January 14, 2009, at www.taxfoundation.org/blog/show/24207.html.
[8] Ibid.
[9] "Bourbon Tax Numbers Down," by Joe Biesk, The Associated Press, May 18, 2009, at www.kypost.com/news/local/story/Bourbon-Tax-Numbers-Down/k_i3xfqN_0KGvYTnOCBE9g.cspx
10 Ibid.

The Federal Cigarette Tax

President Obama signed a tobacco tax increase into law in February 2009. The higher federal levy is administered in the form of an excise tax on tobacco companies. The legislation raised the federal tax by $0.616 per pack, or $6.16 per carton. The total federal tax rate is now $1.01 per pack, or $10.10 per carton.

The new tobacco tax revenue is expected to finance an expansion of the State Children's Health Insurance Program, or SCHIP. The expansion will cost $35 million over five years. Federal officials expect the new revenue to be enough to extend federally-funded health care to an additional four million children.

The federal cigarette tax increase has had other consequences, however. Public revenues, businesses and consumers are affected at both the state and local levels. As the federal increase affects the retail price of tobacco products and consumption shifts, states with already high cigarette taxes collect less revenue for themselves. Businesses experienced a fall in demand for their goods and smokers feel policymakers are unfairly punishing them for engaging in politically unpopular behavior.[11]

Analysts at the Tax Foundation have examined the negative impact of federal excise taxes on state revenue and found that:

> "…state and local governments will see a reduction in revenue totaling $2.3 billion in fiscal year 2010 due to the federal cigarette tax increase from $0.39 to $1.01 per pack…Tax Foundation chief economist Patrick Fleenor explains that the hike in the federal tax will depress state and local government revenues because, as Congressional authorities estimate, the sale of legally stamped tax-paid cigarettes will drop by about 10 percent – or 1.7 billion packs – in the aftermath of the tax increase."[12]

The crowd-out effect of federal cigarette taxes will fall particularly hard on Washington state revenues since, at more than $2.00 a pack, Washington already has the 11th highest incidence of tobacco taxation in the country.

Combined with a high federal levy, Washington state's high cigarette tax creates a strong incentive for consumers to engage in systematic tax avoidance, through increased internet purchases, out-of-state trading, and black market sales. For example, Washington's state cigarette tax is nearly 20% higher than Idaho's state tax, and more than 70% higher than Oregon's state tax.[13]

Conclusion

The research consistently indicates that as levy rates on certain products rise, consumers become increasing resilient and creative in avoiding so-called "sin" taxes. Past experiences in Washington, Rhode Island, Maryland and Kentucky provide ample evidence of this economic effect. Most of the excise tax increases imposed by states since 2003 have failed to meet revenue expectations.

If taxes are raised to punitive levels and people do not want to change their behavior, they will find ways to avoid paying the tax. The growing black market

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[11] "Smokers feeling abused as federal tax hike hits," reported by CNN, April 1, 2009, at www.cnn.com/2009/US/04/01/cigarette.tax/.
[12] "Federal cigarette tax increase means nearly $2.3 billion reduction in revenue for states," news release, The Tax Foundation, April 1, 2009, at www.taxfoundation.org/press/show/24560.html.
[13] "State Cigarette Excise Rates per 20 Pack," Issues and Research, National Conference of State Legislatures, November 2009, at www.ncsl.org/IssuesResearch/Health/StateCigaretteExciseTaxes/tabid/14349/Default.aspx.

in cigarettes and alcohol makes this point abundantly clear. A 2008 report on cigarette smuggling made the following conclusion:

> "[State] policymakers should reassess the value of cigarette taxes as a revenue and public health tool. States with high cigarette taxes, for instance, may want to consider reducing those taxes to reduce the smuggling incentive and the attendant ancillary crime.
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> "States with lower cigarette tax rates should be cautious about increasing the taxes, especially with an apparent growth in international smuggling. State policymakers should also recall that cigarette taxes are regressive, and that cigarette tax revenues are best spent on programs that mitigate the cost of smoking, not on general programs that would be more properly financed by the general taxpayer."[14]

Policymakers are tempted to believe that sin taxes are an easy and seemingly limitless source for tax revenue. However, evidence from past years in Washington and around the country shows state lawmakers are mistaken in thinking they can tax targeted products at ever-increasing rates with no detrimental economic effects. When any tax gets too high, lawmakers will inevitably see a significant decline in expected tax collections, and a concomitant rise in tax-avoidance strategies, including smuggling across state and international borders.

Finally, even if policymakers accept the idea of punitive taxation as a means of social engineering, it is not an effective way of raising more revenue on a consistent basis. Legislators cannot expect to accomplish both policy goals at once, because they conflict with one another. If citizens change their behavior and stop buying the "sin-related" product, tax revenues would drop to zero. If revenue rises as lawmakers expect, it means citizens are continuing to engage in their "sinful" ways and legislators have failed to advance their social goal.

In practice, however, lawmakers seem to end up with the worst of both worlds. Citizens continue to consume tobacco and alcohol, while creatively seeking ways to avoid paying the rising tax burden associated with these products. The result is an increase in out-of-state and illegal sales, transactions which are not captured by Washington's tax system.

The research indicates that increasing sin taxes does not offer a reliable solution to either changing unwanted social behavior or to raising anticipated new revenue. For these well-documented reasons, lawmakers can more effectively solve Washington's long-term budget problem by controlling government spending, rather than seeking a short-term fix by increasing sin taxes.

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[14] "Cigarette Taxes and Smuggling, A Statistical Analysis and Historical Review," by Michael Lafaive, Patrick Fleenor and Todd Nesbit, Ph.D., The Mackinac Center for Public Policy, 2008, at www.mackinac.org/archives/2008/s2008-12.pdf.