

Tobacco Revenues Prove Addictive

By Bruce Smith

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Preface

In 1765, the British Parliament passed the Stamp Act, taxing every sheet of printed paper used in the American colonies. The proceeds were to be used to help pay the rising cost of stationing thousands of British troops on the Appalachian frontier to defend the colonies. Many colonists found this tax to be outrageous not because of its economic cost (which was small), but because it was explicitly being used by England to raise revenues without the approval of the colonies. The resulting opposition to the Stamp Act was so great that a year later, the tax was repealed.

Like the Stamp Act, revenues from Oregon's cigarette tax fund services that benefit all citizens equally; and, like the colonists who felt they were not being fairly represented in their government, smokers only make up about 20 percent of the population, giving them little political voice. However, while the Stamp Act taxed all the colonists based on their use of paper products, a somewhat universally demanded good, cigarette taxes only tax smokers. In many ways, the cigarette tax is worse than the Stamp Act, and yet today, the colonists who refused to pay the tax on paper are called patriots, while those who don't pay the cigarette tax are called felons.

Taxes

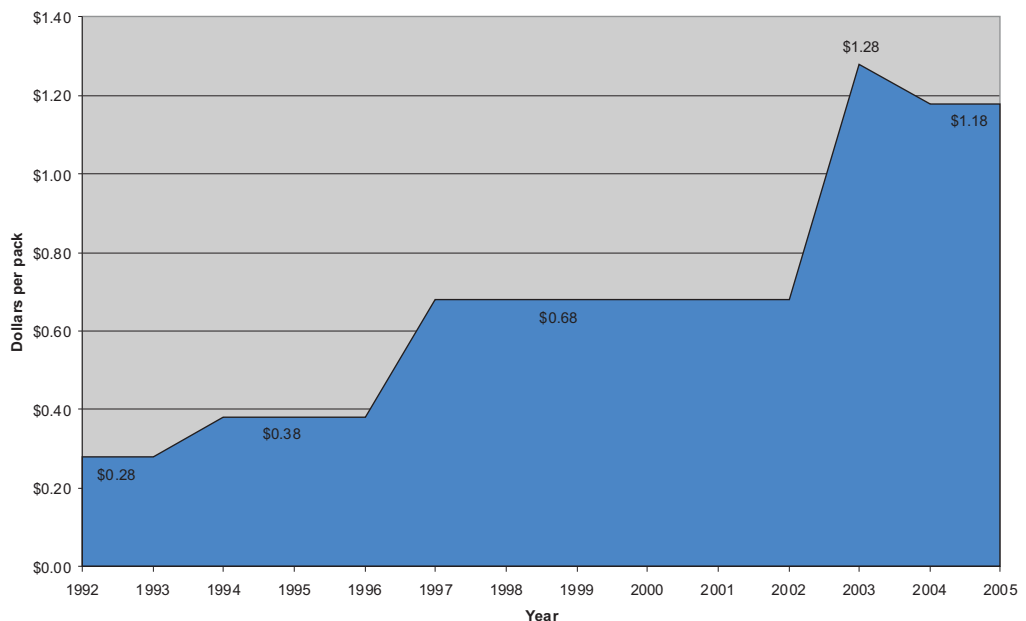
Over the past twelve years, Oregon's cigarette tax has more than quadrupled, from \$0.28 per pack in 1993 to \$1.18 in 2005. It seems that whenever a service needs extra funding, raising the cigarette tax is discussed. Most recently, four state representatives suggested it be raised another 50 percent to \$1.78 per pack.¹ With no increase, the current tax revenue, about \$220 million in 2005, could more than cover the states' health care costs incurred by smokers and fund an anti-smoking program. [Fig. 1]

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The purpose of the most recently proposed increase would be to provide health care for Oregon's poor. While this is a noble endeavor, it's not clear why smokers should be required to foot the bill. As it stands, smokers are paying almost \$190 million a year to the Oregon Health Plan in taxes.

Figure 1

Oregon Cigarette Taxes

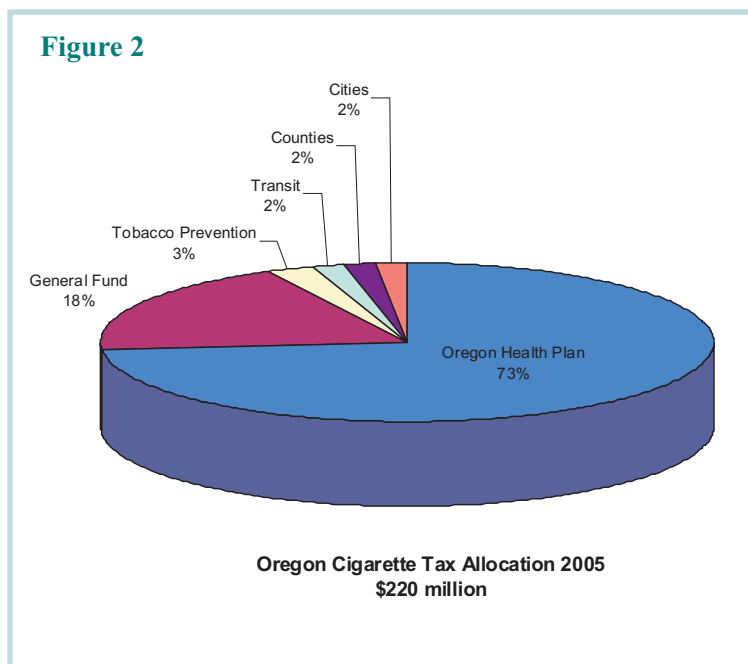


Many politicians justify funding health care with tobacco revenues by claiming that each pack of cigarettes will end up generating several dollars in future unfunded health costs. However, there appears to be no clear methodology for determining these figures. For instance, an Oregon representative recently estimated that a pack of cigarettes would spawn \$4 in future health expenditures², while four months prior, a Washington lawmaker claimed \$12.70 per pack.³

Not only are these numbers inconsistent, they are misleading. When other factors beyond health care are taken into consideration, the loss incurred by the state all but disappears.

Many of these studies take into account both internal and external costs, that is, costs to the smoker and costs to society. In most studies, the internal costs far out weigh the external costs, meaning most of the negative economic impacts of smoking are borne by smokers, not the government. Beyond that, what most politicians fail to mention is that the life expectancy of a smoker is about five to seven years less than that of a non-smoker. That means that the government is saved five to seven years of Social Security payments and general health expenses. When these and other variables are factored into most studies, the net cost of a pack of cigarettes to the government falls to about \$0.30.⁴

However, Oregon smokers are not simply being forced to pay more than their fair share for health care. Another \$55 million from cigarette taxes in 2005 will go to pay for services like education, law enforcement, and light rail. [Fig. 2]



In addition to being higher than necessary and funding services that have nothing to do with cigarettes, tobacco taxes are regressive. Those living below the poverty line are about 50 percent more likely to smoke than those living above it.⁵ This means that Oregon’s poorest citizens are the ones most likely to pay the tax.

Not only are the poor more likely to pay the cigarette tax, they are less likely to quit smoking following an increase. Rather, high-income smokers, who are less likely to take solace in a cigarette and can afford to experiment with costly cessation programs, generally quit after the tax is raised.⁶ According to the Campaign for Tobacco-Free Kids, between 1965 and 1999, the reduction in smoking rates for high-income families was almost 7 times greater than for low-income families.⁷ This means that cigarette taxes become more regressive with every increase.

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Tobacco Settlement

Taxes aren’t the state’s only source of tobacco revenues. In 1998, Oregon, along with 45 other states, entered into the Master Settlement Agreement with the five major tobacco companies. In the agreement, an estimated \$206 billion would be paid out to the states over the course of 25 years. While the agreement made no specific requirements for how the payments were to be spent, it was implied that they would go toward smoking prevention and health care.

However, most of the funds went elsewhere. The payments began at a time when many states were dealing with budget shortfalls, and the settlement payments have been largely used to fill in the gaps. In 2004, none of Oregon’s settlement revenues went towards tobacco prevention, and out of the \$68 million Oregon received in 2005, only \$700,000 was spent on tobacco prevention. The rest predominantly goes to unallocated purposes and debt payments on securitized funds (state-issued bonds). [Fig. 3]

While it is easy to predict the size of the tobacco settlement payments in the near future, the exact amount of the payments is not fixed. Like a tax, the settlement payments are loosely based on cigarette sales. Several clauses were made to adjust the payments if the tobacco companies lost market share or began selling substantially fewer cigarettes.

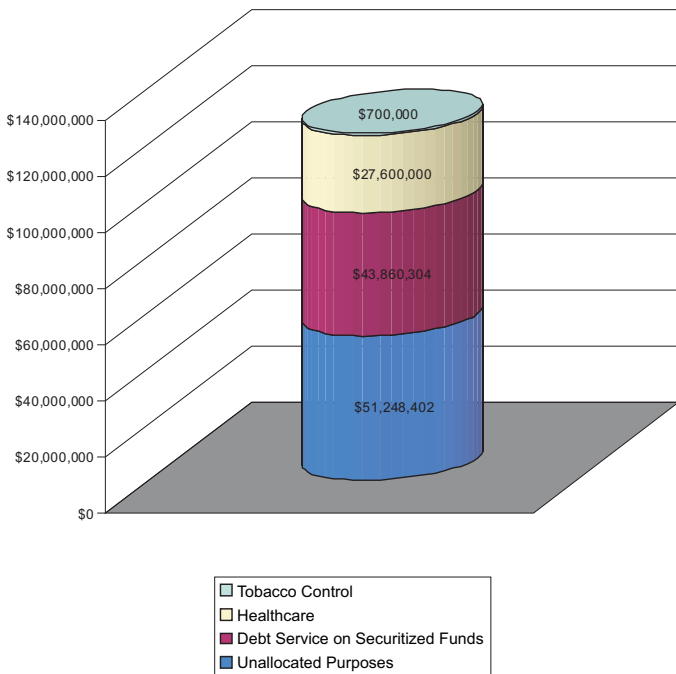
Also like a tax, the settlement payments are mostly funded by smokers. Consumers now pay roughly \$0.50 extra on a pack of cigarettes to fund the payments.

Effectiveness in Reducing Smoking and Raising Revenue

Nationwide, while cigarette taxes have almost quadrupled since 1990, smoking rates are only down 15.29 percent. [Fig. 4] The fact that cigarette taxes have proven largely ineffective when it comes to discouraging smoking stands in harsh contrast to the

Figure 3

OR Tobacco Settlement Allocation 2005



alleged purpose of a “sin tax.” In New York City, where cigarette tax increases have raised the price of cigarettes to more than \$7 a pack, smoking rates have only fallen slightly from 21.7 percent in 1991 to 18.4 percent in 2004.⁸

Cigarette taxes have been considerably more effective in raising revenue than in discouraging smoking. Still, efforts by states to raise money just by raising the tax on cigarettes have been problematic. From 1992-2000, cigarette taxes in the U.S. increased an average of 65 percent, while the revenues collected from those taxes only rose 35 percent.⁹ The trend seems to have continued through 2005. In Oregon, the cigarette tax increased 73 percent between 2001 and 2005, but revenues collected only rose 38 percent while smoking rates remained constant. [Fig. 5] It is obvious not everyone is paying the tax.

Figure 4

United States

Year	Avg. Tax	Avg. Price/Pack*	Avg. Smoking Rate
1990	\$0.22	\$2.38	25.50%
2005	\$0.83	\$3.81	21.60%
Average Change	280.73%	60.08%	-15.29%

*adjusted for inflation

Evasion

Naturally, as the price of cigarettes rises, there will be those who will find a way around the tax, and one of the most popular avenues has been the Internet. Hundreds of retailers sell cigarettes from areas not subject to United States tax law, such as Indian reservations and foreign countries. Buying online isn't illegal in and of itself, as long as the purchase is later reported and the tax paid.

Understandably, few smokers actually report these purchases. In 2004, it was estimated that fewer than 100 Oregonians had paid taxes on Internet cigarette purchases.¹⁰ As a result, state governments and the Bureau of Alcohol, Tobacco, Firearms and Explosives have pressured the major credit card companies to disallow the use of their cards when purchasing cigarettes over the Internet*, claiming that in addition to helping smokers avoid paying taxes, it provides an easy avenue for minors to buy cigarettes. However, studies have estimated that only two to three percent of underage smokers buy cigarettes online.¹¹

Figure 5

Oregon

Year	Tax Revenue	Tax Rate	Smoking Rate
2001	\$159	\$0.68	21%
2005	\$220	\$1.18	21%
% Change	38.36%	73.53%	0.00%

Recovery

Oregon has now placed ads in various media outlets reminding smokers to pay taxes on cigarettes they buy online, proclaiming, “It’s Fair, It’s the Law.” Oregon regulators estimate that the state loses over \$20 million a year to cigarette tax evasion. The problem has become so pronounced that in 2001, the state formed the Tobacco Compliance Taskforce, charged with attempting to recover lost tax revenue.

Some tax recovery efforts have been successful. In Oregon, two large tobacco distributors were recently convicted on charges of tax evasion and racketeering, and were ordered to pay almost \$3 million in unpaid taxes. Attorney General Hardy Myers trumpeted the convictions as a triumph for the state, saying “These criminal enterprises are stealing critical funding for essential state programs such as the Oregon Health Plan, the State School Fund and state law enforcement services.”

Crime

As in the days of Prohibition, several smuggling operations have formed to provide smokers with tax-free cigarettes. In areas like Michigan and New York City, where cigarette taxes are extraordinarily high (\$2 and \$3 per pack respectively), organized crime rings have formed that deal exclusively in the importation and sale of bootleg cigarettes.

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Most of these bootleggers buy cigarettes from low-tax states like North Carolina (\$0.05 tax per pack), and ship them back to high tax areas, where over \$30 profit can be made on one carton of cigarettes. It has even been said that in New York, it is more profitable to hijack a cigarette truck than an armored truck.

Unfortunately, some have taken that advice to heart. As New York City’s most recent cigarette tax was going into effect, the ATF noted a “marked increase”¹² in hijackings of cigarette trucks involved in interstate transportation. Other cigarette-related crimes have been on the rise in New York City as well, and at least four murders have been directly linked to turf disputes. In 2002, the ringleader of an interstate cigarette smuggling ring was convicted in North Carolina for sending millions of dollars in bootlegging profits to Hezbollah.

These crimes can hardly be blamed on smokers. They have chosen a reasonable recourse to paying an unreasonable tax. It is really the government that has allowed these crimes to occur by creating such a large disparity between the taxed price and the true cost of cigarettes. If a product can be bought, transported and resold for a profit, it will be. Instead of portraying smokers who don’t pay the tax as immoral cheaters, the government should take a close look at the underlying rationale for taxing cigarettes.

Moral Hazard

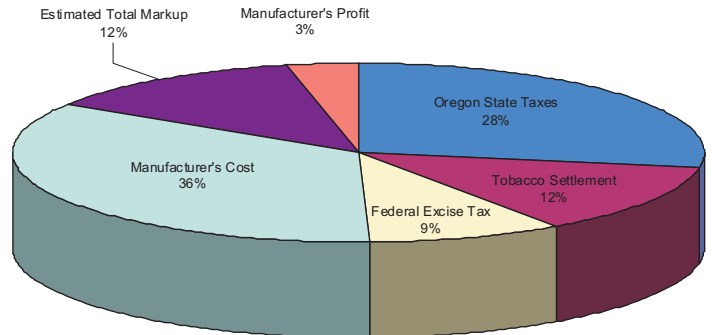
In Oregon, when asked to comment on a proposed cigarette tax increase to fill budget gaps in 2002, future-Governor Ted Kulongoski remarked that such an increase would be ineffective because it would only discourage consumption.¹³ It must then be questioned whether the government is using cigarette taxes as a method of discouraging consumption or just another stream of revenue.

By using the monies from cigarette taxes and settlement payments to pay for health care, education, and law enforcement, Oregon has created a tremendous moral hazard. With so many

essential state programs dependent on cigarette taxes, it has become in the state’s interest to keep smokers smoking. By issuing bonds backed by future payments from the tobacco settlement, Oregon must now see to it that people are smoking years down the road.

Anti-tobacco activists make a point of demonizing tobacco companies for profiting off of a product that kills people. However, according to one tobacco company, the State of Oregon makes 12 times more than a tobacco company does on the sale of a pack of cigarettes. [Fig. 6] While politicians maintain they would like to see smoking eradicated, the truth is that if everyone in Oregon were to quit smoking, the state would lose a steady stream of revenue and be left with a yearly \$288 million budget gap.

Figure 6 Average Retail Price as of 11/04: \$4.25



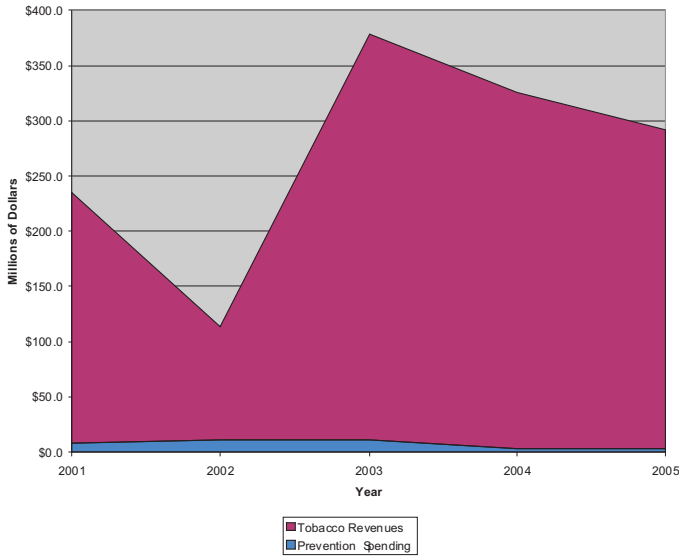
Prevention

For that reason, perhaps it’s not so surprising that the one thing that receives almost no cigarette revenues is smoking prevention. Out of the \$288 million Oregon received from cigarettes in 2005, only \$3.5 million went to anti-smoking programs. This is only 16 percent of what the Centers for Disease Control recommends for a program to be effective. [Fig. 7]

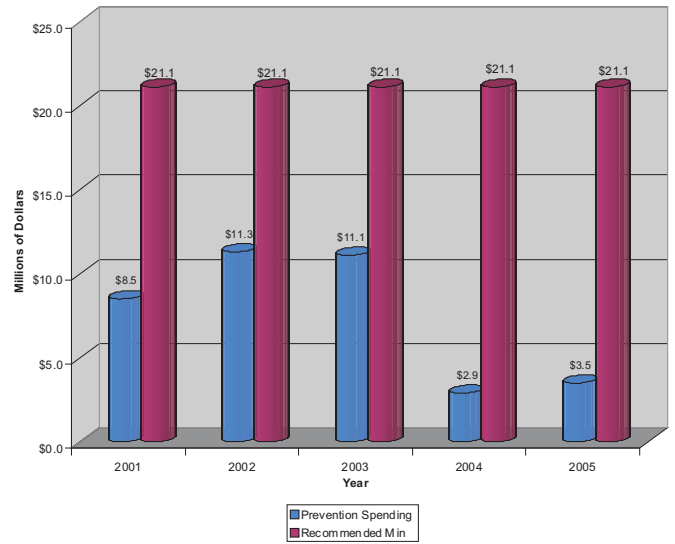
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Figure 7

Prevention Spending versus Total Tobacco Revenues in Oregon



Prevention Spending vs. Recommended Minimum



Oregon isn't the only state under-funding its tobacco prevention program. In fact, only three states, Delaware, Maine, and Mississippi (the second poorest state in the nation), meet the CDC's minimum funding level for an effective program. [Fig. 8]

If Oregon's goal is to recoup losses incurred by treating smoking-related illnesses and fully fund a smoking prevention program, a \$0.15 tax per pack (in conjunction with continued tobacco settlement payments) would more than suffice. Yet taxes remain several times higher than necessary while smoking prevention and cessation programs remain a low priority.

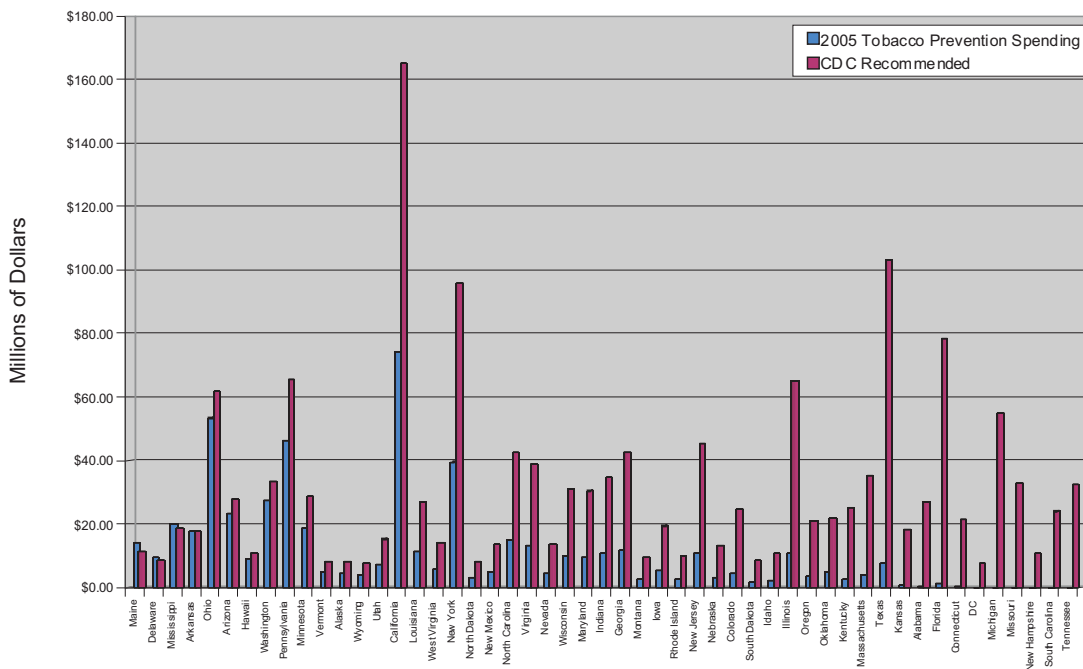
Conclusion

Using a cigarette tax to combat smoking and raise revenue, as Oregon claims to be attempting, is not possible. These are two mutually exclusive goals; for one to succeed the other must fail.

It is apparent that Oregon has chosen revenue generation over the health of its citizens, a decision that should be reversed. If cigarettes are to be taxed at all, the revenues should only fund programs directly linked to smoking.

Figure 8

Tobacco Spending by State



[Fig. 1]

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2. RTI International Research, State Cigarette Excise Taxes: Implications for Revenue and Tax Evasion-Final Report, May, 2003, http://www.rti.org/pubs/8742_Excise_Taxes_FR_5-03.pdf
3. Centers for Disease Control: Morbidity and Mortality Weekly Report, Tobacco Tax Initiative - Oregon 1996, March 21, 1997, <http://www.cdc.gov/mmwr/preview/mmwrhtml/00047031.htm>
4. The Tax Foundation, State Sales, Gasoline, Cigarette, and Alcohol Tax Rates by State, 1999-2004, <http://www.taxfoundation.org/files/95f0b441db48e23de812a22802b8f5a4.xls>

[Fig. 2]

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[Fig. 3]

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<http://www.rjrt.com/legal/gao2005.pdf>
(amounts shown include carry-over funds)

[Fig. 4]

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2. CDC: Morbidity and Mortality Weekly Report, Cigarette Smoking Among Adults-United States, 1990, May 22, 1992, <http://www.cdc.gov/mmwr/preview/mmwrhtml/00016738.htm>
3. Drug Store News, http://www.findarticles.com/p/articles/mi_m3374/is_n8_v13/ai_10673674

[Fig. 5]

1. Campaign for Tobacco-Free Kids, December 2, 2004
2. U.S. Department of Health and Human Services: Steps to a Healthier US: Addressing Lifestyle Changes, <http://www.healthierus.gov/steps/summit/prevportfolio/programs/tobacco.htm>

[Fig. 6]

R.J. Reynolds: Tobacco Taxes and Payments for Oregon,
<http://www.rjrt.com/legal/taxStateView.asp?State=or>

[Fig. 7]

Campaign for Tobacco-Free Kids, December 2, 2004

[Fig. 8]

Campaign for Tobacco-Free Kids

About the author: Bruce Smith completed this paper as part of his 2005 summer research internship at Cascade Policy Institute. He is a student at William and Mary College.

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2. Rep. Ben Westlund, http://www.kgw.com/politics/stories/kgw_062305_politics_cigarette_taxes.39acbab8.html, 06/2005.
3. Rep. Rodney Tom, http://www.kgw.com/business/stories/kgw_021805_health_cigarette_tax.c0a448a8.html, 02/2005.
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