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EXTRA POINT

May 1998,
No. 9

A Tobacco Deal Looking to the Future

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Let's review the bidding. The tobacco companies cut a deal with the state attorneys general. The companies agreed to pay hundreds of billions of dollars in exchange for some limits on their exposure to class action law suits. And the companies essentially waved most of their First Amendment rights. The President, assuming the deal would go through, included the revenues and a like amount of new spending in his budget proposal. Then the Congress got involved and it ground to a halt. What happened?

Before you write off the tobacco settlement entirely, remember the President still wants a bill. Many in Congress still want a bill. The tobacco companies presumably would still like a bill if it looked much like the original agreement with their legal protections. And there's still all that new federal tax revenue to consider.

First, on a bipartisan basis folks in Congress got greedy for political points and revenues. Seeing a legitimate vehicle for beating up on tobacco companies congressional grandstanders went into overdrive. Then, figuring the companies had agreed to a tax hike of one size, some congressional "leaders" pushed for more. Much more. The tobacco companies were pushed too far and they backed out.

Then some Republicans realized that this was an enormous tax hike, whatever label the spin-meisters put on it. The tax increase dwarfed their proposed tax cuts and the remaining revenues were to fund a slew of new government programs. This is not what the Revolution was supposed to be about.

A few legislative leaders then realized that the tax increase would hit low and middle-income taxpayers hard. Based on consumption data provided by the Centers for Disease Control the Tax Foundation has calculated that about two-thirds of the tax would be paid by individuals with annual adjusted gross incomes of less than $20,000.

Finally, other industries began to wonder who would be next. What if social policy excises became the wave of the future, the beer, wine, and distilled spirits industries worried. How about eggs? They raise cholesterol. How about beef? That's not exactly health food. How about dairy products? High in fat content. Why go part way — how about a general tax on all food products based on their salt, fat, and cholesterol contents? How about computer monitors? They're bad for your eyes. And could a broad-based energy tax be far behind? Where would it end?

And so the tobacco legislation stalled, and it may be dead. Some Republicans say they are content to see the bill die because the polls show voters don't seem to care. But just wait until the Democratic National Committee starts running adds in the Fall about how the Republicans refused to protect our children from tobacco. By then, of course, it will be too late for 1998.

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Suppose somebody put humpty-dumpty

back together again, as seems likely. The biggest problem then would be what to do with the money. The President and his allies want to spend it, but that's just not going to happen.

The trick is to impose the tax on cigarettes while returning the money roughly to the same people who are paying the tax. This could be done in theory by reducing income taxes by income group according to the amount of the excise tax collected. In practice this won't work, however, because low and middle-income taxpayers pay little or no federal income tax.

The one federal tax low-income workers pay is the payroll tax. Additional tobacco tax revenues could be used to reduce the payroll tax by income level according to estimates of the incidence of the cigarette tax hike. Thus there would be no change in aggregate tax burden by income class.

Even better, the reduced portion of the payroll tax could be mandatorily redirected into retirement savings accounts under the taxpayer's direction. Thus, all low and middle-income workers would be wealth holders saving for their retirement.

Redirecting some payroll tax money into personal retirement accounts offers a number of advantages over other uses of the cigarette money. First, of course, the revenue would be returned to taxpayers, not turned into new spending programs.

Second, the bill would be revenue neutral both in total and by income class. Thus conservatives needn't worry about becoming tax increasers and no one need worry about hammering the poor with a tax hike.

Next, the tobacco settlement would take on the greater role of encouraging private saving, a goal about which there is general agreement.

By reducing the payroll tax burden the tobacco settlement would also strengthen the economy because the cost of labor to employers would decline as would the cost of employment to workers.

And, finally, the tobacco settlement revenues could be used to jump start a solution to the Social Security crisis. The finances and structure of the Social Security system may be our number one fiscal problem. The President recognized this when he demanded that we "save Social Security first." Members of Congress from both sides of the aisle are coming to recognize that we must offer our citizens a better deal on their mandatory retirement contributions. Revenues from the tobacco settlement could well be used to finance the first step in this direction. In this way, everybody wins except the defenders of the status quo, and the smokers.

EXTRA POINT is published by the Tax Foundation, an independent 501(c)(3) organization chartered in the District of Columbia. The Tax Foundation, a nonprofit, nonpartisan research and public education organization, has monitored tax and fiscal activities at all levels of government since 1937.

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