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What is Proper Tax Policy for Smokeless Tobacco Products?

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While there exist a large literature and extensive policy discussion on the issue of cigarette taxation, smokeless tobacco has received comparatively little attention. In recent years, controversy in many state legislatures has erupted over the proper way of taxing smokeless tobacco. The goal of this Fiscal Fact is to clarify the rationale for excise taxation in general, and specifically to explain the proper method of taxation of smokeless tobacco products and how it compares to cigarette taxation.

The Fallacies of Current Tax Policy on Smokeless Tobacco Products

Even though the federal government taxes smokeless tobacco at a per unit rate based upon weight, most states tax it based upon the sale price. This can be seen in the following table of the tax rates on smokeless tobacco across the country.

Table 1: Smokeless Tobacco Tax Policy Is Highly Inconsistent Across States

State	Tax Rate on Moist Snuff Tobacco (MST)	Type of Tax
Alabama	2 cents per typical can[1]	Per Unit
Alaska	75% of wholesale price	Ad Valorem
Arizona	13.3 cents per ounce	Per Unit
Arkansas	32% of manufacturer's price	Ad Valorem
California	46.76 percent of wholesale price[2]	Ad Valorem
Colorado	40% of manufacturer's price	Ad Valorem
Connecticut	40 cents per ounce[3]	Per Unit
Delaware	15% of wholesale price	Ad Valorem
Florida	25% of wholesale price	Ad Valorem
Georgia	10% of wholesale price	Ad Valorem
Hawaii	40% of wholesale price	Ad Valorem
Idaho	40% of wholesale price	Ad Valorem
Illinois	18% of wholesale price	Ad Valorem
Indiana	18% of wholesale price	Ad Valorem
Iowa	22% of wholesale price	Ad Valorem
Kansas	10% of wholesale price	Ad Valorem
Kentucky	9.5 cents per unit[4]	Per Unit

Louisiana	20% of manufacturer's price	Ad Valorem
Maine	78% of wholesale price	Ad Valorem
Maryland	15% of wholesale price	Ad Valorem
Massachusetts	90% of wholesale price	Ad Valorem
Michigan	32% of wholesale price	Ad Valorem
Minnesota	70% of wholesale price	Ad Valorem
Mississippi	15% of manufacturer's price	Ad Valorem
Missouri	10% of manufacturer's price	Ad Valorem
Montana	85 cents per ounce	Per Unit
Nebraska	20% of wholesale price	Ad Valorem
Nevada	30% of wholesale price	Ad Valorem
New Hampshire	19% of wholesale price	Ad Valorem
New Jersey	75 cents per ounce	Per Unit
New Mexico	25% of product value	Ad Valorem
New York	37% of wholesale price	Ad Valorem
North Carolina	3% of wholesale price	Ad Valorem
North Dakota	60 cents per ounce	Per Unit
Ohio	17% of wholesale price	Ad Valorem
Oklahoma	60% of wholesale price	Ad Valorem
Oregon	65% of wholesale price	Ad Valorem
Pennsylvania	No tax	na
Rhode Island	$1.00 per ounce	Per Unit
South Carolina	5% of manufacturer's price	Ad Valorem
South Dakota	10% of wholesale price	Ad Valorem
Tennessee	6.6% of wholesale price	Ad Valorem
Texas	35.213% of manufacturer's price	Ad Valorem
Utah	35% of manufacturer's price	Ad Valorem
Vermont	$1.49 per ounce	Per Unit
Virginia	10% of wholesale price	Ad Valorem
Washington	75% of wholesale price	Ad Valorem
West Virginia	7% of wholesale price	Ad Valorem
Wisconsin	25% of manufacturer's price	Ad Valorem
Wyoming	20% of wholesale price (or 10% of retail)	Ad Valorem

[1] Alabama charges 1.5 cents per ounce of chew tobacco, and a varying rate on snuff tobacco per can, depending upon the size.
[2] Adjusted annually by the California Board of Equalization
[3] Connecticut charges a tax of 20 percent on other tobacco products besides snuff.
[4] Kentucky charges a tax of 7.5 percent on other tobacco products besides snuff.

Source: Federation of Tax Administrators; various updates compiled by Tax Foundation

As the chart shows, the lowest tax burdens on smokeless tobacco are found in the tobacco-producing South, which also imposes the lowest tax rates on cigarettes. But outside of the South, why do some states tax smokeless tobacco so heavily and some so lightly? Why do some base their tax on the weight and others on the price of the product?

To answer these questions and determine which states, if any, are practicing proper tax policy, we must develop a framework for explaining proper tax policy with regard to smokeless tobacco. Tobacco taxation policy should follow the framework of three crucial questions:

(1) Should products like smokeless tobacco have a special tax imposed?

(2) By what method should they be taxed, i.e. based on the sale price (ad valorem) or per unit?

(3) What is the proper level of taxation?

Should Tobacco Products Have a Special Tax?

Assuming that the role of government is to prevent individuals from harming one another, and not to prevent individuals from harming themselves, then special taxes on tobacco products should exist only if those products impose significant costs on third parties. A frequently cited example is the healthcare costs to other taxpayers associated with tobacco consumption.[1] Another often cited external cost of tobacco products, cigarettes in particular, is second-hand smoke—both in public places and in homes where children reside. Smokeless tobacco, however, imposes no such harm. Other costs unfairly imposed on society from tobacco consumption have been cited, such as the unattractiveness of witnessing certain behavior associated with chew tobacco, and the message children receive as a result of viewing adult tobacco consumption.

To the extent that tobacco imposes undue costs on society, specific taxation of the product may be warranted. But a government official who merely desires to influence individual consumption decisions because of his own anti-tobacco sentiment cannot be justified by an appeal to principles of sound tax policy.

By What Method Should Tobacco Products Be Taxed?

There are two methods of levying an excise tax on any product. The first and most common type of excise tax is a per-unit tax. In this case, the tax is independent of the price of the product. The other type of excise tax is an ad valorem tax, which is akin to a typical general sales tax where the tax is a percentage of the sale price.

Regardless of the rationale for the government’s attempt to limit tobacco consumption via taxation—whether it is through the proper framework of controlling for negative costs imposed on others or through the authoritarian method of trying to control individual decisions—tobacco products should be taxed via a per-unit tax. The harm caused by a unit of tobacco is essentially unrelated to its price. A $5 pack of cigarettes would not impose any cost to society or harm any individual more than a $2 pack of cigarettes would. With respect to cigarettes, most tax-levying officials have properly understood this because every state imposes the tax based on the number of cigarettes, not based upon the sale price.

However, with respect to smokeless tobacco, most states have gone in the opposite direction of sound tax policy, and have imposed ad valorem taxes, which are based upon the sale price of the smokeless tobacco. Only nine states impose the tax on a per-unit basis even though the federal government taxes moist smokeless tobacco based on weight, which is essentially a tax on quantity, and is the proper way of taxing the product.

It is not logical to base the tax on the value of the product. A $6 can of premium smokeless tobacco does no greater harm to the user or to society than a $2 brand of generic smokeless tobacco, but under the current system in most states, the premium brand is charged a tax three times that of the generic brand. Much of the effect of this ad valorem tax is merely to encourage more consumption of the inexpensive brand, thereby making irrelevant much of the government policy designed to limit the quantity of tobacco consumed.

What is the Proper Level of Taxation?

Now that we have defined the conditions under which a government is justified in imposing a special tax on tobacco and explained how that tax should be levied, the obvious question is what the level of taxation should be. In standard economic theory, a tax designed to compensate for a negative externality imposed on society should be levied on a per unit basis and should equal the difference between the social cost of the good (the cost to society at large) and the private cost (the cost to individual consumers). Therefore, if the social cost of tobacco consumption is greater than the total private cost, then the tax should be set at a level that will make the two costs equal, thereby improving overall societal well-being. The problem that governments face is calculating the social cost of tobacco and comparing it to the private cost. Often, those with certain agendas try to overstate the difference between the private cost and the social cost of tobacco in order to impose their principles of morality on everyone else. What constitutes a true cost to society is therefore always a subject of disagreement and should be carefully calculated. Policymakers should be clear about the factors involved in their calculations when they recommend a level of taxation.

Summary

Even if the goal of policymakers is to reduce tobacco consumption, in a free society this should be done solely for the purposes of correcting for social costs unfairly imposed on others, not to impose some individuals' moral agenda on everyone else. Taxes should not be used to impose morality; social engineering through the tax code is never sound tax policy. Because the proper purpose of tobacco taxes is to correct for market imperfections, taxes should be levied only up to the point at which the tax per unit equals the difference between the social cost of a unit of tobacco and the private cost of a unit of tobacco. This can only be accomplished with per-unit excise taxes because the dollar value of the tobacco consumed is irrelevant with respect to reducing overall consumption of tobacco.

Footnote

[1] Some economists will note that any healthcare cost imposed on society is technically a transfer that has been created by government through a quasi-socialized healthcare

system. Moreover, while it is commonly assumed that individuals' unhealthful habits must necessarily impose healthcare costs on society, this is not at all the case. A field of economics known as social cost accounting attempts to discern the aggregate fiscal effects of different types of behavior, and its findings are often counterintuitive. Smoking, for example, has been found to not impose healthcare costs on nonsmokers. To the contrary, current federal, state, and local fiscal regimes have been found to transfer tens of billions of dollars from smokers to nonsmokers. See, for example, Patrick Fleenor, "Who Bears the Ancillary Cost of Tobacco Use?," *Tax Foundation Background Paper*, No. 36 (January 2001).

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