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Tax Fairness Would Suffer under Senator Smith's Cigarette Tax Hike

by Patrick Fleenor

Fiscal Fact No. 82

On March 23 Senator Gordon Smith (R-OR) proposed raising the federal cigarette tax from 39 cents to \$1.00 per pack. This amendment to the budget resolution would force cigarette smokers to directly fund increases to the SCHIP program, a large government health program that buys insurance coverage for the children of families that earn too much to qualify for Medicaid.

Of course, all children should have health insurance, but the funding source that Senator Smith has chosen--cigarette taxes--is far and away the federal government's most unfair tax.

Tax Equity: How Fair Are Cigarette Taxes?

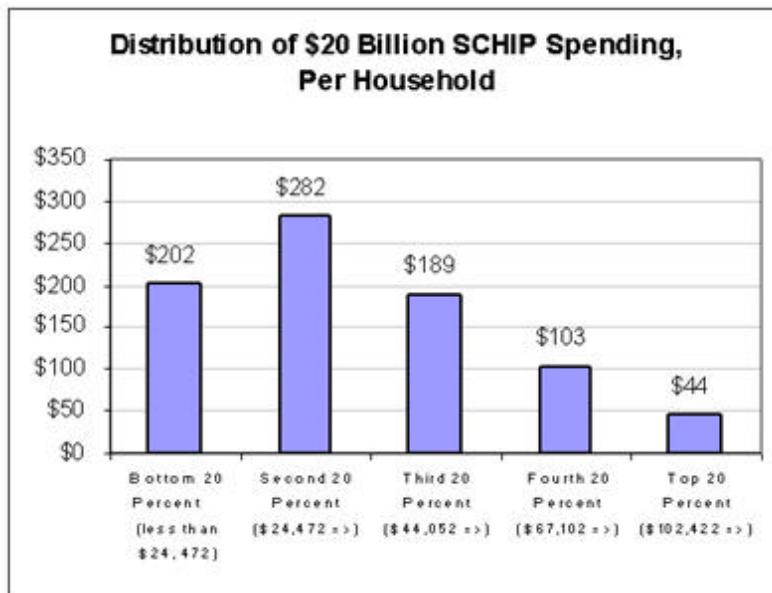
Economists usually evaluate tax equity, or fairness, in two dimensions: "horizontal" equity and "vertical" equity. A tax is considered horizontally equitable if people who earn similar incomes pay similar amounts of the tax. The reasoning behind this notion is straightforward: funds spent on a broad swath of the general public should likewise come from taxes levied on a broad swath of the population, and people with similar means should pay similar taxes. By this standard, cigarette taxes are an unfair tax because they fall only on the small share--about 23 percent--of the public that smokes. Nonsmokers pay nothing.

"Vertical" equity calls for tax burdens to rise as individuals' incomes rise. This notion is more controversial than horizontal equity because many Americans believe taxes should take the same percentage from all income levels. But on one point most agree: tax burdens should not rise as incomes fall. Yet existing federal taxes on tobacco do exactly that. In fact, under current law, individuals in the lowest-earning 20 percent of households--the first "quintile"--bear cigarette tax burdens that are 7.5 times higher than those in the top quintile.¹ Senator Smith's plan would only exacerbate this unfair distribution of the tax burden.

Fiscal Incidence of the Gordon Plan

Figure 1 shows how \$20 billion in additional SCHIP spending would flow to households in different quintiles. Households in the lowest quintile would receive \$202 in additional spending while those in the top quintile would receive \$44.

Figure 1. Distribution of \$20 Billion SCHIP Spending, Per Household



Source: Analysis conducted using the Tax Foundation's fiscal incidence methodology. See Chamberlain and Prante (footnote 1).

Although the spending varies across income groups, it seems that everyone is a winner, but that is only the spending side of the fiscal coin. If we also consider the cigarette tax payments, the picture changes considerably.² The benefits in the middle quintile and the top two are wiped out entirely, as taxes exceed SCHIP spending. Even at the low end of the income spectrum, the net gains are much lower than spending because of the high cigarette taxes paid by low-income people. The net gain is reduced to \$50 per household for the lowest quintile and to \$89 for the next lowest.

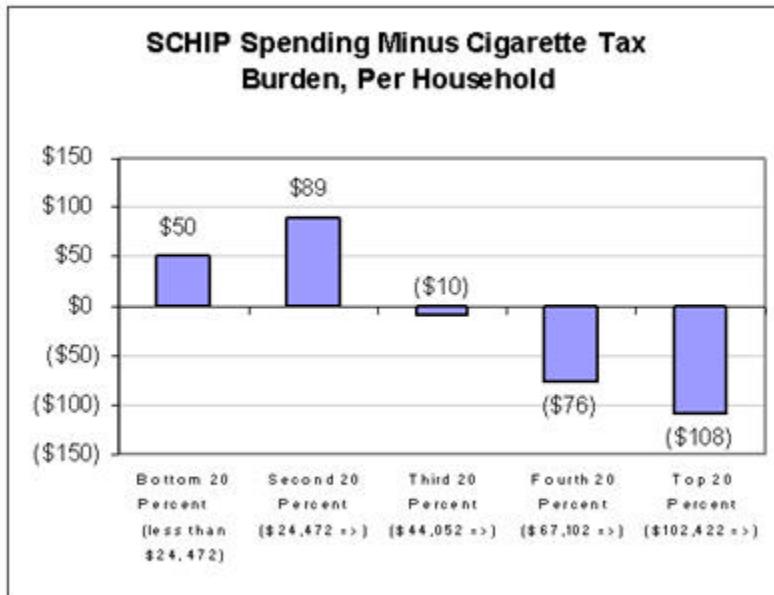
Compensating Nonsmokers

The punishing effect of cigarette taxes on the poor is well known, so why would Senator Smith propose a higher tax on the poor? The most common rationalization is that cigarette taxes aren't really "taxes" but more like fees to compensate nonsmokers for the high economic costs that smoking imposes on society. Frequently, \$7.18 per pack is cited as the cost to society, but this is an erroneous figure that has gained currency only because smoking is so unpopular.³

Over the past couple decades evidence has accumulated showing that smokers cost society only a small amount more than nonsmokers. Peer-reviewed studies throughout the 1990s from economists such as Harvard's Kip Viscusi and Willard Manning Jr. from the University of Chicago demonstrate that nearly all the costs of smoking--healthcare, higher insurance premiums, lower productivity at work--are borne by smokers themselves.

Most studies find that over their lifetimes, smokers impose an extra cost on society that amounts to about 32 cents per pack of cigarettes. That's far below the current tax level on cigarettes. The average combined federal and state tax rate is currently \$1.34 cents a pack, so any increase in the federal cigarette tax would certainly add to the already unfair tax burden that low-income smokers already face.

Figure 2. SCHIP Spending Minus Cigarette Tax Burden, Per Household



Source: Analysis conducted using the Tax Foundation's fiscal incidence methodology. See Chamberlain and Prante (footnote 1).

Conclusion

The SCHIP program is a popular government program, but earmarking tobacco taxes to fund it is highly inequitable. Smokers should not be required to fund the lion's share of a program that provides broad public benefits. Federal cigarette taxes are already a disproportionate burden on low-income households, and we should not exacerbate that problem by raising the tax.

Notes

1. Andrew Chamberlain and Gerald Prante, "Who Pays Taxes and Who Receives Government Spending? An Analysis of Federal, State and Local Tax and Spending Distributions, 1991-2004," *Tax Foundation Working Paper*, No. 1, p. 42, 2007.
2. Analysis conducted using the Tax Foundation's fiscal incidence methodology. See Chamberlain and Prante, *ibid*.
3. Patrick Fleenor, "Who Bears the Ancillary Cost of Tobacco Use?" *Tax Foundation Background Paper*, No. 36, 2001.

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