

# Six Reasons Not to Raise Tobacco Taxes

By William L. Anderson

Imagine the following scenario. You receive a summons to appear in court, with the accompanying message declaring: "On June 10, 2002, when the speed limit was 45 miles per hour on Main Street, your vehicle was observed traveling at 43 miles per hour. On June 10, 2003, the speed limit on Main Street was lowered to 30 miles per hour.

"Because your speed last year exceeded this year's maximum speed limit, you are thereby charged with traveling 43 miles per hour in a 30 miles per hour zone. The fine for this offense will be \$150. Should you choose not to appear in court, you may pay by check or money order." It is not hard to imagine the outrage that such a letter would create, especially if a large number of motorists were to receive something similar. Charges of injustice, unfairness, and outright criminality would be levied against the local governing body that chose to impose speeding fines retroactively.

Yet when the State of Oklahoma applied retroactive law against the nation's tobacco companies, very little of the same outrage was seen in the media or even among common citizens. In the name of a "settlement," state officials basically looted two groups: tobacco companies and smokers (who saw the price of cigarettes increase 45 to 50 cents per pack). However, because fewer people smoke than drive automobiles, the state legislature is considering yet another way to shake down Oklahoma's smokers.

(In case you were wondering, it would be perfectly legal for Oklahoma to retroactively fine drivers in the imaginary situation that I outlined in the first two paragraphs. Thanks to many U.S. Supreme Court decisions, retroactive law has become a staple of the modern regulatory state, as it is an important tool that governments use to shake down taxpayers and other citizens. While it may not be politically feasible to fine drivers for fast driving in the past – at least at the present time – the nation's smokers apparently lack the political clout

to make legislatures do the right thing.)

Some may say, “The tobacco settlement is something in the past, but Oklahoma’s state government needs more money right now. A new tax on tobacco products will ensure things like quality education, good roads, and no taxes levied on anyone else – and it will discourage people from smoking.”

In fact, there are many reasons why raising tobacco taxes is a bad idea. Let’s consider six of them.

First, Oklahoma doesn’t have a revenue problem; it has a spending problem. As Cato Institute scholars pointed out this year, Oklahoma tax revenue grew 82 percent between fiscal years 1990 and 2001, while population growth plus inflation plus totaled only 49 percent. In other words: It’s the spending, stupid.

The explanation for Oklahoma’s budget train wreck is simple: legislators could not tell the difference between real, long-term prosperity and an unsustainable boom fueled by a credit bubble created by the Federal Reserve System. They spent as though the good times would last forever – instead of using some old-fashioned restraint and saving the surpluses for a rainy day.

The problem is not limited to Oklahoma, of course. Instead of being able to meet the inevitable economic downturn by using saved surpluses, state legislators across the country spent wildly, creating new spending programs and trying to fund nearly every constituency possible. The inevitable economic bust left state budgets hanging out to dry, and instead of realizing their earlier mistakes in overspending, lawmakers are now looking for new sources of revenue.

Second, a higher tobacco tax will raise only small amounts of revenue. According to the Office of State Finance, the cigarette tax brought in approximately \$49.5 million in FY-2003. A higher tax would hardly be a “magic bullet” that saves the state from drowning in red ink.

Furthermore, while tobacco products generally are what economists call “demand inelastic” (usage does not decrease by much with price increases), people will still buy fewer tobacco items, with the new tax failing to raise the revenue supporters claim it will.

This creates a dual problem. First, the false security that comes with the belief that legislators can go to the tobacco well yet another time obscures the real problem: overspending by the state government. Second, by falsely relying on the promise of new revenue that won't be appearing, the Oklahoma Legislature would still be derelict in its real duty of getting the state's fiscal house in order.

Third, higher taxes would endanger revenues from the existing tobacco "settlement." By increasing taxes on tobacco products, the legislature would ensure that tobacco companies would earn even less revenue than they have at present, thus making it more difficult for them to meet the original legal obligations laid upon them by the state. After all, tobacco companies are not simply fountains of revenue; they depend upon sale of their products in order to make money. Whether or not one approves of the product is irrelevant, as the state for the time being seems addicted to the tobacco money.

Please keep in mind that the original justification that state legislatures across the nation used to deprive tobacco firms of common law defenses was that tobacco use created health-related problems that somehow fell back upon state governments. While it is true that at least some state-funded Medicaid benefits were used to deal with tobacco-related diseases, that is only part of the story.

Smokers, on average, have a shorter life expectancy than non-smokers, which is why life insurance companies give lower rates to people who do not smoke. Yet, much of what states pay for indigent or subsidized medical care is for elderly people. To put it bluntly, smokers generally die before non-smokers, which means that states will not have to bear the burden of caring for as many elderly smokers. At worst, the health care cost issue is a wash.

A new tax will make it more difficult for tobacco firms to make the scheduled payments, something that could become even worse if a number of other states also decide that the way to cover their spending sprees of the last few years is to tax smokers even more.

Fourth, tobacco taxes are regressive – they attempt to balance the budget on the backs of the poor. One of the mantras uttered by liberals

is that taxes should be progressive – the more one's income, the higher the rate of taxation should be. However, it seems that nearly every liberal's favorite tax is the tobacco tax. (In Maryland, where I live, Katherine Kennedy Townsend – Bobby Kennedy's daughter – in the 2002 gubernatorial race promised to balance the budget by ... raising tobacco taxes. She lost to the first Republican candidate to be elected Maryland's governor since Spiro Agnew in the mid-1960s.)

The problem is that the tobacco tax does not discriminate for income; a wealthy person who does not smoke pays nothing, while a poor smoker with a three-pack-a-day habit pays taxes like crazy. On top of that, statistics demonstrate that smokers tend to be concentrated in lower-income groups, which means if the Oklahoma Legislature were to pass yet another tobacco tax lawmakers truly would be trying to "balance the budget on the backs of the poor."

Fifth, higher taxes will hurt retailers. When governments tax and regulate, the actions often are taken in the belief that nothing else will change, as though there exists no Law of Unintended Consequences. One of the groups that would be hurt by an increase in tobacco taxes would be the small retailers, who depend upon sale of cigarettes and other tobacco products for part of their livelihoods.

While most people seem to believe that all of a new tax on tobacco products would be passed on to consumers, that really is not the truth. Much of the tax would be passed on, but retailers would be forced to absorb some of the tax, which means that a new tax actually would depress the prices that retailers would receive for tobacco sales. To put it another way, a new tax on tobacco not only would fail to achieve the announced objectives of helping Oklahoma balance the state budget, it would also lower the incomes of small retailers and their employees. What the state supposedly would "give" in one hand would be taken away by the other.

Furthermore, retailers who own shops near the borders with other states will see their own sales drop, as Oklahoma's new tax would make tobacco products less price competitive with products from states that have not raised their tobacco taxes. For example, if Oklahoma doubles its cigarette tax rate to 46 cents per pack, as some

of the more “moderate” voices are suggesting, Oklahoma’s rate would be higher than each of its bordering states except Kansas.

Sixth, higher taxes will almost certainly mean more cigarette smuggling, which means more crime. The prospects of cigarette smuggling are not idle conjecture, especially if Oklahoma were to hike its cigarette tax by a full dollar, as some anti-smoking activists are suggesting. Smuggling is already a fact of life in many American states. Like the bootleggers before them who ran illicit whiskey to large American cities, modern cigarette smugglers know that there will be large profits in breaking the law, as citizens will be willing to engage in illegal transactions in search of paying less for their smokes.

The problem with such activity – like the whiskey wars during Prohibition or the violence that accompanies the modern drug trade – is that it presents yet another opportunity for organized crime to gain a foothold in our society. Ultimately, the demand for tobacco products is what drives people to take the risks to break the law in order to meet that demand. Like it or not, if individuals believe they can receive a better deal from their friendly cigarette bootlegger than they can by purchasing such products legally, they will break the law.

At the present time, this country incarcerates about 2.1 million people, more than one-fourth of all of the world’s prisoners. Should state and local governments persist in their anti-tobacco jihads, ultimately we are going to see more people being locked up, which is going to cause serious problems for already overcrowded penitentiaries. This is not idle speculation, as we know from past experience that when governments make goods which are in demand so scarce that they are out of reach of most individuals, people will use other means to gain what they want, even if that means breaking the law.

In conclusion, by shaking down tobacco companies a few years ago, state governments made a devil’s bargain. They made portions of their budgets dependent upon the sale of products that those governments claim people should not be purchasing. If you believe this is an example of naked hypocrisy, you are correct.

If the state government really wants to set a good example for

Oklahomans, it should live within its means and stop trying to pick the pockets of smokers. 🌟

Dr. Anderson (Ph.D. in economics, Auburn University) is an occasional contributor to Perspective and an adjunct scholar of the Ludwig von Mises Institute. He teaches economics at Frostburg State University in Maryland. Readers may write to him at [banderson@frostburg.edu](mailto:banderson@frostburg.edu).