

# TAXING

**When it comes to state taxes, sin is in.**

**BY PHINEAS BAXANDALL PHOTOGRAPHS BY REENA BAMMI** In 2002, new tobacco levies were implemented in 21 states, amounting to the largest average per-pack increase ever imposed in one year. Thanks to a new \$1.50 tax hike, a pack of cigarettes bought in New York City now costs \$7. New increases in alcohol taxes were passed in Tennessee and Alaska and were considered in 19 other state legislatures. Gaming taxes, casino revenue-sharing agreements, and new lotteries also brought in record levels of state revenue.

Taxes on “sin” have been an American tradition since the Puritans placed levies on morally suspect items like liquor, tobacco, tea, and immoderate foods like meat pies. But the modern sin tax advocate is more likely to be punching a calculator than thumping a bible. Today’s sin taxes are propelled by the twin logics of public health and budget politics. Efforts to discourage the use of tobacco and alcohol by raising their price through taxes makes the population healthier while filling government coffers. States also raise revenues through their share of the proceeds on gambling.

But these levies have problems. They are paid disproportionately by the poor. They don’t assess responsible consumers differently from irresponsible ones. And there are other policies that could also discourage harm-

# HABITS



## A 10 percent price rise leads to a 3 to 5 percent

ful consumption and improve public health. Yet, given the political realities of budget constraints and the unpopularity of other types of taxes, state governments will likely continue to find it appealing to balance their budgets by taxing sin.

### SMOKING AND PUBLIC HEALTH

Modern sin taxes are born of the economists' creed that behavior responds to price, coupled with the politicians' desire to improve society while raising revenues. But the term "sin tax" is something of a misnomer. It refers almost exclusively to taxes on tobacco, alcohol, and gambling. Each has a long-standing cultural taint as vaguely naughty—if somewhat glamorous—even to those who indulge in them. By contrast, activities that are truly reprehensible, like molesting children or torturing animals, are criminally sanctioned rather than taxed.

The fact that a single cigarette can raise as much as 7.5 cents for state governments and another 2 cents for the federal government shows what a lightning rod tobacco has been for such taxes. And for good reason. Cigarettes are the leading cause of preventable sickness and death in the United States. According to the American Cancer Society, smoking is responsible for 90 percent of all lung cancer deaths, 30 percent of all other cancers, and a significant part of respiratory and heart disease deaths. Tobacco products (of which cigarettes constitute the vast majority) are credited by the U.S. Department of Health and Human Services with one-third of all deaths during middle age. Taxes on cigarettes are also easy to administer because they are paid directly by manufacturers, of which there are only a few.

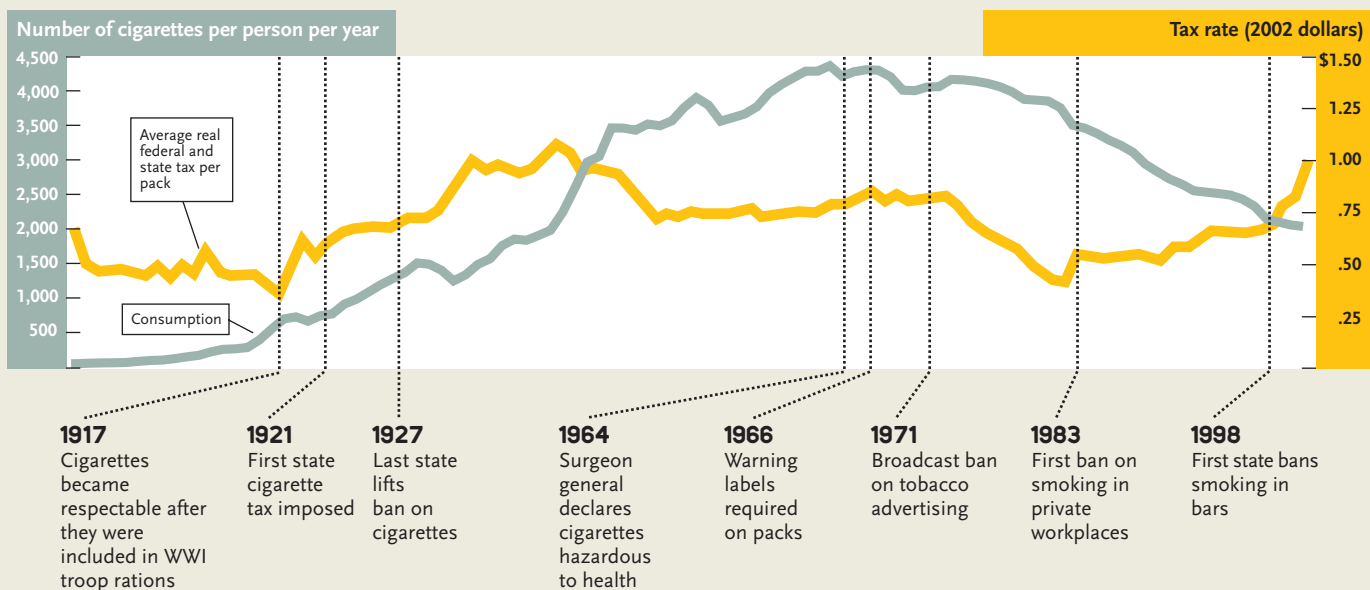
Taxes on cigarettes reduce smoking. High prices discourage people from starting to

smoke and encourage smokers to cut back or quit. Studies show that a 10 percent increase in cigarette prices will lead to about a 3 to 5 percent reduction in smoking in the short run, and a drop of about double that over longer periods of time. And cigarette taxes are especially effective at discouraging teenagers—which has enormous public health benefits since three-quarters of all cigarette smokers start before their nineteenth birthday. Because teenagers have less discretionary income, their smoking habits are more sensitive to price. Since 1998 when cigarette prices have been rising sharply, teens have given up smoking faster than adults.

Because cigarettes are addictive—the immediate craving for cigarettes is hard to ignore, even when the long-term desire is to quit—one might think that smokers would not stop simply because taxes increase the price. Instead, cigarette taxes seem to mimic

## Up (and down) in smoke

While taxes affect average cigarette consumption—since the mid 1980s, the rise in the average real tax rate has coincided with reduced smoking—other factors matter also. For example, smoking and real tax rates both dropped during the 1970s, perhaps because of legal restrictions and consumer response to health warnings.



NOTE: Consumption data for the population aged 18 and above; figures for 2001 and 2002 are preliminary. 1901–1909 tax rate is only for the packs that were priced at more than \$2 per 1,000.  
SOURCE: CDC, USDA, Orzechowski & Walker Consulting, Campaign for Tobacco-Free Kids

**drop in smoking in the short run, and even more over time**





## Alcohol is taxed by the drink, but the same drink

other ways that smokers try to quit such as by throwing away their cartons, making bets with their friends, or otherwise making the habit more costly.

Fairness is another appeal of cigarette taxes. Taxes can compensate and correct for the otherwise unpaid costs that smokers impose on nonsmokers. The healthcare costs of smokers are significant: an estimated \$12,000 more than nonsmokers over an average lifetime, according to Thomas A. Hodgson of the National Center for Health Statistics. Smokers do not pay higher payroll or income taxes to support this additional burden on the healthcare system. Nor do they pay anything to cover the costs of second-hand smoke, a problem that the Environmental Protection

Agency has determined is responsible for 3,000 lung cancer deaths a year, as well as many other health problems like asthma and bronchitis.

Are cigarette taxes now high enough to cover the costs that smoking imposes on others? There are conflicting views about the answer to this question, in part because of differences in what to count as a cost. The Centers for Disease Control estimates that the extra medical costs and lost productivity from smoking amount to slightly more than \$7 a pack—not including factors such as second-hand smoke, problems of low birth-weight babies caused by smoking during pregnancy, and damage from smoking-ignited fires. These costs are far more than the amount col-

lected through federal and state taxes, which average about \$1 a pack. By contrast, the Congressional Research Service defines costs more narrowly and subtracts health care costs “saved” by smokers’ dying prematurely. Using this procedure, they figure that smoking imposes costs on others of only 33 cents a pack. Neither study captures the pain and suffering of friends and family members over the illness and early death of people they love.

### JUST A GLASS OF WINE?

Sin taxes are levied on things that are fun. Even smokers who are interested in quitting generally find it enjoyable to light up and inhale. But while the social costs of smoking may outweigh these benefits, the calculus for alcohol is somewhat more complex. Only a fraction of those who drink abuse alcohol or suffer health problems, and many enjoy health benefits. The risks that drinkers pose to others may have less to do with how much alcohol they consume and more to do with how much they drive.

An estimated 18.5 million Americans abuse alcohol. This not only affects the health of the person drinking, especially in increased liver disease, but it can also impose costs on others in the form of lost work time, higher healthcare costs, and strains on family relationships. As with cigarettes, taxing alcohol can improve public health to the extent that higher prices reduce excessive consumption and abuse. But medical research also shows that for many people, responsible drinking can be healthful. People who drink moderately—both red wine and other types of alcohol—have reduced rates of heart disease, strokes, and dementia.

The risks of alcohol consumption are amplified greatly when the drinker gets behind the wheel of a car. For example, according to a study by economists Steven Levitt at the University of Chicago and Jack Porter at Harvard University, drivers who have been drinking are about seven times more likely to cause a fatal car accident than drivers who have not been drinking. Most of the people killed in al-

## Taxing other sins?

To some, the focus of sin taxes on cigarettes, alcohol, and gambling is both arbitrary and incomplete. There are other untaxed products that pose equally serious health risks or impose costs on non-users. Sugary and fatty foods contribute to obesity, which causes 300,000 premature deaths a year and greater healthcare costs than tobacco. According to the American Lung Association, charcoal starter fluid used in the backyard barbecue is a smog menace. And antibacterial soap breeds resistant strains of bacteria that can endanger public health.



Over the past few years, a host of new “sin” taxes have been proposed. Bills were recently introduced in California to extend sin taxes to ammunition for firearms and high-calorie soda. If they had passed, the monies would have gone to fund the hospital care of gunshot victims and for physical education in schools. And Wisconsin and California legislators tried to impose a tax on pornography similar to one in France in which sexually explicit material faces higher tax rates than other products. But these measures stalled when lawmakers were unable to agree on what constitutes smut. It is apparently easier to raise tax rates on old sins than reach the consensus necessary to create new ones.

**can pose different risks depending on the situation**





## Unlike alcohol and tobacco taxes, state lotteries

cohol-related accidents are the drinking drivers and their passengers, but the authors estimate that in 1994 drinking drivers were responsible for 3,000 deaths outside their own automobiles.

Moreover, while alcohol is taxed by the bottle or the drink, the same drink imposes very different risks depending on the situation. A 21-year-old college student whose weekly intake consists of seven beers while

driving on Friday night, for instance, pays the same levy as a 40-year-old who drinks a beer each night with dinner. The heaviest-drinking 6.5 percent of adults, who consume half of all alcohol, end up paying the majority of all alcohol taxes. But even many of them drink without risk to themselves or others. It's hard to imagine a taxing scheme sophisticated enough to distinguish between the problem drinkers who impose costs on others and the rest of us who are drinking to good health.

### Prohibition

An alternative approach to discouraging the consumption of certain products is legal prohibition. At the end of the nineteenth century, one might have predicted that cigarettes rather than alcohol would be banned, as the National Anti-Cigarette League expanded its efforts. By 1890, 26 states had passed laws banning sales to minors; and by the end of 1909, 17 states prohibited cigarette sales altogether. The turnaround came during World War I. Soldiers seeking relief from the stress of war were given cigarettes as part of their rations because they could be smoked more easily in the trenches than pipes or cigars. A cigarette in the mouth became an identifying feature in patriotic depictions of the “Yank,” and smoking became respectable.

Instead alcohol was banned with the passage of Prohibition in 1919. Temperance was framed as a family issue and a socially acceptable goal of the early women's movement before women won the right to vote in 1920. Support was also fed by anxiety about immigrants in growing urban centers. Rural, largely Protestant citizens often viewed these mostly Catholic newcomers and their drinking habits with alarm. Immigrants congregated in saloons to reaffirm their culture, but others feared that saloons were becoming centers of local political corruption, gambling, and prostitution that should be closed down. National prohibition of alcohol might also have been averted if beer and wine producers had opposed early temperance laws, instead of wrongly supposing that they could continue to gain market share from state-level restrictions that targeted only hard liquor.

The failures and unpopularity of Prohibition, which was repealed in 1933, are well-known. Prohibition drove business into the hands of organized crime and sent drinkers to speakeasies and to hard liquor, which was easier to conceal than beer or wine. But while it wasn't able to eliminate alcohol consumption, Prohibition was more successful than most realize at reducing it. Historians have no measures of illegal consumption, but they can track hospital admission rates for alcoholism and cirrhosis, and arrest rates for public drunkenness—all of which fell as a result of the ban. Based on these data, they estimate that the consumption of alcohol (in pure volume) fell by between about 30 percent and 45 percent in 1921 and 1922, when enforcement was strict and punishments severe.



A law enforcement official, surrounded by onlookers, breaks open casks of illicit alcohol during U.S. Prohibition.

### THE ART OF PLUCKING A GOOSE

State legislators undoubtedly care about public health, but often the more pressing problem is how to close the holes in state budgets when voters are hostile to other ways of raising money. Before income taxes were introduced in 1913, for example, taxing sin was one of the main ways that government activities were financed. Alcohol and tobacco levies provided 37 percent of the federal budget in 1910, but only 2 percent today.

Over the past several decades, with demands on state governments increasing and other taxes unpopular, state legislators once again looked to sin as a way to balance their budgets. State revenues from alcohol had been fairly stable in real terms since the mid 1980s. And while tax rates and revenues from cigarettes and tobacco were rising, their success in reducing smoking limited the proceeds going to state coffers. States turned to gambling—excise taxes on gambling proceeds, revenue-sharing agreements with state-sanctioned casinos, riverboats, and restaurant slot machines—and especially state lotteries to raise new revenues.

The first state lottery in the nation was established in New Hampshire in 1964. Faced with a huge budget deficit, Governor John King was determined not to raise taxes and instead launched a limited “sweepstakes” linked to horse racing. Today's state lotteries offer incomparably greater convenience, speed, and variety. Unlike taxes on smoking or drinking, government gambling arrangements are not

are not designed to reduce vice



designed to reduce the vice that provides the funding. State governments actively advertise and promote their lotteries—to the tune of \$400 million per year. And revenues from lotteries have increased five-fold between 1980 and 2000, exceeding the sum of cigarette and alcohol tax revenues.

The allure of sin taxes has grown even greater since 2001 as state governments, facing sudden deficits, have needed new sources of funds. Legislators grew accustomed to rising tax receipts during the long boom of the 1990s, and committed state governments to higher spending levels. Some cut income taxes, tolls, or licensing fees, and many (although not the New England states) let their rainy-day funds dwindle. When state revenues fell, states—required by law to balance their budgets—had to scramble to find money where they could. Connecticut Governor John Rowland signed a 61-cent-per-pack cigarette tax increase. Rhode Island passed new taxes on tobacco that will automatically increase by 10 cents a pack every year.

These taxes are a relatively popular way to raise government funds because they are viewed as voluntary user fees that also have beneficial side effects. “Taxation,” said King Louis XIV’s finance minister Jean-Baptiste Colbert, “is the art of trying to pluck the most feathers from a goose while producing the least hissing.”

Lawmakers know that new sin taxes arouse far less voter hostility than broader-based taxes. Taxes on income or property are far more visible and affect more taxpayers. They also seem to punish “good” things like making a living or owning a home. A growing number of voters since the 1990s tell pollsters that they dislike taxes; yet the majority support higher cigarette taxes. Smokers may resent being singled out, but they are a minority who garner little sympathy. In Connecticut, one poll showed that 71 percent of residents supported a large increase in cigarette taxes, even though a majority said the tax would be unfair to smokers.

#### **POOR SINNERS**

One downside of balancing budgets on sin is that the money raised is paid disproportion-

ately by the poor. The tax on a \$4 bottle of wine is the same as that on a \$40 bottle, so those who buy top-shelf liquor (or premium cigarettes) pay a smaller portion of the price in taxes. Poor people don’t drink more than the affluent, but the alcohol taxes they pay are a far larger portion of their incomes. For cigarettes, the problem is exacerbated by the fact that the poor do smoke more than the better-off. According to Harvard Law School Professor Kip Viscusi, over 30 percent of people earning less than \$10,000 a year were smokers in 1990, compared to less than 20 percent of those earning over \$50,000 annually.

State-organized gambling acts as “an astonishingly regressive tax” that draws disproportionately from those with lower incomes, according to the 1999 National Gambling Impact Study Commission. State lotteries are the most regressive of these activities, and a disproportionate number of lottery outlets are located in poor neighborhoods. Lottery players with incomes below \$10,000 spend almost \$600 a year on tickets, more than any other income group. High school dropouts spend four times as much as college graduates; blacks spend five times as much as whites. Since those who gamble are overwhelmingly likely to lose money, some characterize gambling as a tax on bad math, or—more sympathetically—as a tax on those with limited prospects. In either case, the money comes mostly from those who are least able to pay.

#### **ADDICTED TO SIN?**

There are a number of reasons to think that sin taxes could continue to grow. By international and historic standards, American sin taxes are still low. The World Health Organization estimates that the tax burden on cigarettes in the United States was only one half as high as that in the rest of the developed world. Alcohol taxes are far higher in many other wealthy nations. But even if we can agree that there is too much smoking and too much problem drinking, and that taxes are effective at reducing consumption, increased sin taxes are not the only tool for solving these problems.

Direct legislative restrictions can also reduce consumption and abuse, and the costs

that go with them. These measures cost money to enforce and are more difficult to administer than simply raising the tax rate, but they target the consumption that is most costly to society—such as drinking among teens or drivers, or smoking around nonsmokers. Drunk driving is reduced by such things as low legal blood-alcohol levels, mandated training of servers in bars and restaurants, and policies that make it easier to rescind driving licenses, according to the National Institute on Alcohol Abuse and Alcoholism.

Similarly, restrictions on smoking force smokers to take the time and effort to move outdoors or face fines, while simultaneously providing zones of comfort to nonsmokers. And economists William Evans, Edward Montgomery, and Matthew Farrelly estimate that bans on smoking in private workplaces reduce the number of smokers by about 5 percent and bring consumption down by 10 percent.

Nontax measures also express social disapproval, whereas taxes can convey a kind of tacit acceptance—especially when education budgets depend on them. Tellingly, the first state-level taxes on cigarettes were not passed at the height of anti-cigarette fervor at the beginning of the twentieth century, but in the 1920s, when cigarettes first became socially acceptable.

Setting tax levels on sin depends on weighing different goals: public health, virtue, and the desire to raise revenue, against efficiency and the impact on the poor. Sin taxes can be simplistically portrayed as “win-win” because they raise revenues at the same time as saving lives or promoting economic development.

But there are tradeoffs. Insofar as policies discourage alcohol and cigarette consumption, they also cut off potential sources of revenue. Punishing those who create social costs also disproportionately punishes the poor. And singling out a vice for taxation indirectly promotes the activity as a virtuous contributor to the public purse. Sin taxes may or may not be good policy, but so long as they remain one of the few acceptable ways to raise revenue, governments are likely to continue to depend on them. \*