Time May be Ripe for N.C. to Increase Tax on Cigarettes
by Andrew Brod
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It's budget time again in the General Assembly, and one of the proposals under consideration is an increase in the state's excise tax on cigarettes. Only Virginia and Kentucky have lower taxes than North Carolina's five cents per pack, and Virginia's tax will rise to 30 cents next year. As the accompanying table shows, taxes are over a dollar per pack in a number of states, with New Jersey's $2.05 leading the, um, pack.

Raising cigarette taxes has become quite popular in recent years. Since 2000 the federal government has increased its tax from 24 cents to the current 39 cents per pack. In 2001 only three states levied taxes of a dollar or more per pack, but now 15 states do so. The raw average of all states' excise taxes in 2001 was less than 42 cents per pack. Now it's over 72 cents.

Of course some people here in North Carolina prefer no increase at all. Others are willing to match Virginia's 30-cent tax. Still others, including the North Carolina Alliance for Health, are pushing for a tax of 75 cents per pack. A tax increase that large would raise prices from 20 to 30 percent, depending on the brand.

According to the Alliance, a 70-cent tax increase would discourage smoking significantly *and* raise huge revenues for the state government. The figure being tossed around in Raleigh is $386 million per year, which is quite significant given that the state projects a shortfall in next year's budget of $500 million to $800 million. Could a tax increase on cigarettes accomplish both of these goals simultaneously? Or should the state settle on one goal or the other?

Anytime a government policy alters a price, its effectiveness depends on how responsive the product's demand is to price changes. Economists call this the *elasticity* of the demand for that product. Anyone who's ever taken an economics class has probably just fainted upon reading that word, but don't worry. You won't be tested on this.

Products with many good substitutes in the eyes of consumers tend to be quite responsive to price. For such a product, a price increase of five percent might reduce consumption by 10 percent. But for products for which consumers feel there are few good substitutes, the situation is reversed. A price increase of five percent might cut consumption by only two percent.

Okay, the economics lecture is over. How does all this apply to cigarettes? At first blush, it would seem that smoking has been tied quite closely to price changes over time. Since 1980, the inflation-adjusted price of a pack of cigarettes has more than doubled, while cigarette consumption has been cut nearly in half.

(Much of the price increase has occurred since 1998, when the major tobacco companies and attorneys general from 46 states signed a landmark agreement that requires the companies to pay large sums of money to the states, in part to reimburse them for the costs of treating smoking-related illnesses.)

But numerous factors other than price have been at play, including restrictions on where and when people can smoke, health warnings, and peer pressure. A recent report by the U.S. Department of Agriculture doesn't quantify the effect of these other factors, but it concludes that "only some of the decline in cigarette consumption can be explained by higher prices during the last three decades" and that factors other than price have played "a major role in deterring consumers' desires for cigarettes."

Raising the price will decrease the consumption of any product, and cigarettes are no exception. But price matters little to most non-smokers, who are unlikely to pick up the habit even if the price were to be cut in half. Smokers are also fairly unresponsive to price. Whether we think cigarettes are addictive or merely habit-forming, they have few good substitutes in the minds of smokers. Therefore, raising the price of cigarettes generates only modest reductions in consumption.

And this is precisely why governments are so attracted (should I say addicted?) to cigarette taxes. If it were true that tax increases cut smoking dramatically, they could actually cause tax revenues to *fall*. And then you'd find few state senators willing to support an increase.

So if the goal is to raise revenues, taxing addictive products is definitely the way to go. But what about that other goal? Is a tax the best way to go about reducing smoking?

I won't get into whether the government *should* try to reduce cigarette consumption. That strikes me as a value judgment, and a rather nanny-ish one at that. Moreover, claims about the economic costs of smoking cut both ways, because smokers tend to do the rest of us a favor by dying before collecting on their years of Social Security contributions.

And the fact that we have a big tobacco industry here in North Carolina isn't relevant to this issue, because producers would avoid most of the burden of the tax. Because cigarette demand is so unresponsive to price, it would be smokers, not the tobacco industry, who would get hit hardest by a tax increase. So let's just accept that the state wants to reduce cigarette smoking.

According to various studies, rising cigarette prices have indeed cut smoking. Overall, each 10 percent increase in price has reduced consumption by about four percent. This includes reductions in the number of smokers as well as reduced consumption by those who continue to smoke.

The smokers who are the most responsive to price are those earning lower incomes and with less education. In addition, young smokers appear to be more responsive to price than older smokers. By one estimate, each 10 percent increase in price raises by three percent the probability that young smokers will quit altogether. That isn't a particularly big percentage, but it has long-run implications because it affects the number of smokers.

The bottom line is that increasing cigarette taxes would indeed generate a lot of tax revenue for our state legislators in Raleigh to spend on us. It would also reduce smoking, though not dramatically. Those who continue to smoke would be hurt by the higher prices, but the state's tobacco industry is unlikely to suffer much.

If the studies on smoking and prices are applicable to North Carolina, matching Virginia's tax cut would reduce cigarette smoking in the state by about three percent, and the proposed 70-cent tax increase would cut smoking by a little less than 10 percent. That may not be a lot of reduction in return for such a big tax increase, and there are probably more effective ways to reduce smoking. But because of the positive effect on state revenues, a higher cigarette tax seems like a policy whose time has come. So smoke 'em while you got 'em.