POLICY REPORT

The Iowa Policy Project Child & Family Policy Center

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The Merits of a Cigarette Tax, With Alternative Tax Offsets

By Charles Bruner and Peter S. Fisher

Driven partly by state budget crises, a number of states have raised their cigarette taxes. Public opinion has shown a greater receptivity to increasing "sin taxes" than most other taxes; cigarette taxes even have been raised in voter referenda.

There are other reasons for considering increases in the cigarette tax, however. Cigarette smoking has substantial social costs, in lost worker productivity and increased medical expenses. The public costs of cigarette smoking are only partially covered by the tax. Moreover, raising cigarette taxes is known to reduce cigarette consumption, particularly by reducing the likelihood that young people will start smoking.

Principles for Evaluating Iowa Taxes and Tax Proposals

1. Fairness

Taxes should be based on the ability to pay; those with similar ability to pay should have similar tax burdens. In general, tax fairness should be at the heart of tax deliberations and efforts should first be made to ensure that tax changes produce a fairer overall system.

2. Competitiveness

Iowa's overall tax system should allow the state to be competitive for business and for labor. The overall state and local tax system in Iowa is, in fact, about average both nationally and regionally. A tax system that meets the competition with tax levels that are near the average is a competitive system. Further cuts would imperil the public services that are the foundation for economic growth in the long run.

3. Public Benefit and Economic Efficiency

Tax incentives should promote some public purpose. Incentives that serve no public purpose can distort private economic decisions, making the Iowa economy less efficient.

4. Revenue Adequacy

Taxes must be capable of producing sufficient revenues to finance state and local public services.

5. Stability and Predictability

Other things equal, a tax base that is more stable and predictable over the business cycle is preferred.

6. Simplicity

The tax system should be easy for citizens to understand and taxpayers to comply with, and it should be easy for the government to collect the tax and audit compliance.

7. Accountability

Those who spend money should be accountable to those who provide the funds, through taxes or otherwise.

At the same time, as a tax on consumption, cigarette taxes are regressive. The tax burden falls more heavily upon low- and moderate-income people on the whole than upon higher income people on the whole.

There is no way to create tax offsets to reduce other taxes on low- or moderate- (or higher) income smokers in order to offset the direct impacts on them of a cigarette tax increase. There are ways, however, to offset the tax effects on income classes as a whole so that a cigarette tax will not increase the overall tax burden on low- and middle-income taxpayers, in particular. Furthermore, the impact on lower income smokers can be lessened by using of a portion of the proceeds from a cigarette tax to fund tobacco cessation programs, replacing tobacco settlement funds that were diverted from public health to other purposes.

In this report we present an analysis showing how the burden of the cigarette tax would be distributed among income groups. We then examine two proposals to use an increase in cigarette tax revenue to finance income-tax reductions. The first proposal is one that has been under consideration in the General Assembly, to provide full exemption of retirement income; this proposal would further increase the regressivity of Iowa's tax system, and it would take all of the revenue from a $1 increase in the cigarette tax just to offset the income-tax cut. The second proposal entails an increase in the personal exemption credits and the Earned Income Tax Credit (EITC); this alternative would substantially offset the regressivity of the cigarette tax instead of adding to it.

The Cigarette Tax

The Institute on Taxation and Economic Policy reviewed the impact of a potential 75-cent increase in the cigarette tax at the request of the Iowa Policy Project. ITEP analyses of Iowa's tax system already have demonstrated that Iowa's tax system generally is regressive – that the more someone earns in income, the smaller a percentage of that income is paid in state and local taxes. The main reason is Iowa's heavy reliance on sales and property taxes, which are regressive, a reliance that has grown through the 1990s while the income tax, which is the only progressive tax in Iowa, has been cut significantly.

An increase of 75 cents in the cigarette tax would raise in the neighborhood of $135 million annually in the long run, according to a model developed by University of Iowa health economist Robert Ohsfeldt.[1] The ITEP analysis looked at how the burden of such a tax increase would be spread among different income groups. As can be seen in Table 1 (Page 4), the cigarette tax is distinctly regressive; the 75-cent tax would represent a tax increase of almost 1 percent of income for the 20 percent of taxpayers with incomes under $14,000, but just one-tenth of 1 percent for those with incomes above $67,000.

Proposal One: Cigarette Tax Increase Coupled with Reduction in Income Taxes on Pension and Social Security Income

One proposal floated in the General Assembly is to raise the cigarette tax while simultaneously eliminating any taxes on pension and Social Security income. Under current law, about 70 percent of Social Security recipients are fully exempt from any Iowa income tax on benefits, and the remaining 30 percent (the highest-income recipients) pay tax on, at most, 50 percent of their benefits. Current law also exempts the first $6,000 of pension income for individuals, or $12,000 for married couples.

The proposed changes would exempt all Social Security and pension income for everyone. Since lower and middle income retirees currently pay little or no tax on retirement income, the proposal would benefit primarily higher income retirees. This can be seen in Table 3 (Page 6), also prepared by ITEP's tax model. Elderly taxpayers with

[1] This is the estimated long-term increase in annual tobacco excise tax revenue, taking into account an estimated 17 percent reduction in smoking produced by the tax increase, and some loss of revenue due to border crossing for purchases. Tobacco tax increases will generate more revenue in the near term (an estimated $163 million from a 75-cent increase). Because the full 17 percent reduction in smoking rates takes some time to occur, long-term revenue gains are smaller.

Adherence to Tax Principles: Cigarette Tax Increase Coupled with Reduction in Income Taxes on Pension and Social Security Income

Fairness – Makes Iowa's tax system substantially more regressive and unfair

Competitiveness – Does not impact state's competitiveness

Public Benefit/Economic Efficiency – Provides a public benefit in reducing smoking, particularly among youth

Revenue Adequacy – Provides no net gain in tax base short-term, as involves shifting of liability

Stability and Predictability – Provides less stability and revenue long-term, as cigarette taxes estimated to produce declining revenues over time and exempting Social Security and pension income estimated to produce declining revenues over time

Simplicity – Slightly simplifies filing for more well-to-do taxpayers with Social Security or pension income

Accountability – Makes smokers more accountable for the public costs they produce

Overall – Provides a public benefit in reducing smoking, but violates several other tax principles incomes under $30,000 on average save only $6 per year, while even those with income of $30,000 to $50,000 would save just $158. These two groups account for 56 percent of elderly taxpayers, but receive only 14 percent of the tax savings. In contrast, the 44 percent of elderly taxpayers with incomes above $50,000 get more than 86 percent of the benefits. Those making more than $100,000 – 11 percent of elderly taxpayers, taking 37 percent of the tax cut – see an average benefit of $1,730.

The exemption of all retirement income would exacerbate a substantial equity problem in the current tax system. Currently working families pay far more than retired couples with identical income. This is because the incomes of working families are almost entirely taxable, while the retirement income exclusions already exempt much of the income of the retired couple. This unequal treatment of equals would be increased. For example, a retired couple with $60,000 in income, mostly from pensions, Social Security, and investments, pays less than half the state income tax paid by a working couple with $60,000 income entirely from wages and salaries.[2] With the complete exemption of retirement income, that working couple would pay more than four times the tax of the retired couple.

The complete exemption of pensions and Social Security would cost the state about $169 million annually in lost revenue, according to ITEP's tax model. The proceeds of a 75-cent cigarette tax would not be enough to pay for this tax break – let alone any other priorities. An even higher cigarette tax would be required to finance a values fund approaching $900 million when combined with retirement tax relief.

Proposal Two: Cigarette Tax Increase Coupled with Increased Earned Income Tax Credit

Instead of using a regressive tax increase to finance tax relief for the richest retirees, part of the cigarette tax proceeds could be used to finance relief to those most impacted by the tax: lower and middle-income households. The Iowa Policy Project asked ITEP to model the effects of an increase of $25 in personal exemption credits and an expansion of Iowa's Earned Income Tax Credit (EITC), from 6.5 percent to 20 percent of the federal. The EITC would also be made refundable, as is the federal. This is the only way to provide tax relief to those paying higher excise taxes but little in the way of state income taxes.

The increase in exemption credits and the EITC expansion would do a great deal to offset the regressivity of the tax, while the retirement income tax relief would make the tax changes more regressive. This can be seen in the charts on Pages 4-6.

This option would leave about $44 million annually to fund other projects. If that revenue were devoted entirely to repaying Values Fund debt, it would support a bond issue of about $550 million.

Adherence to Tax Principles: Cigarette Tax Increase Coupled with Increased Earned Income Tax Credit

Fairness – Does not negatively affect overall tax progressivity and fairness, while providing some greater horizontal tax equity by providing additional support to recognize costs of raising children in Iowa's tax code

Competitiveness – Makes employment more economically attractive for entry level positions

Public Benefit/Economic Efficiency – Provides a public benefit in reducing smoking

Revenue Adequacy – Helps increase tax base

Stability and Predictability – Provides somewhat less stability in tax base, as cigarette taxes expected to be declining revenue source

Simplicity – Both increasing cigarette taxes and increasing earned income credit do not affect filing complexity; will require some people to file a state tax form to get a refund they are owed, but this is already the case for the federal credit

Accountability – Makes smokers more accountable to the public costs they produce

Overall – Strongly meets several principles and does not violate any principles

[2] For a more complete analysis of the effects of eliminating all taxes on Social Security benefits, see the Iowa Policy Project's Policy Brief *Expanding the Social Security Benefit Exemption Under the Iowa Income Tax*, available at www.iowpolicyproject.org.

Appendix: Analyses of Various Cigarette Tax Options

Figure 1. Incidence of 75-Cent Increase in Cigarette Tax and Complete Exemption of Retirement Income: Tax Change as a Percent of Income

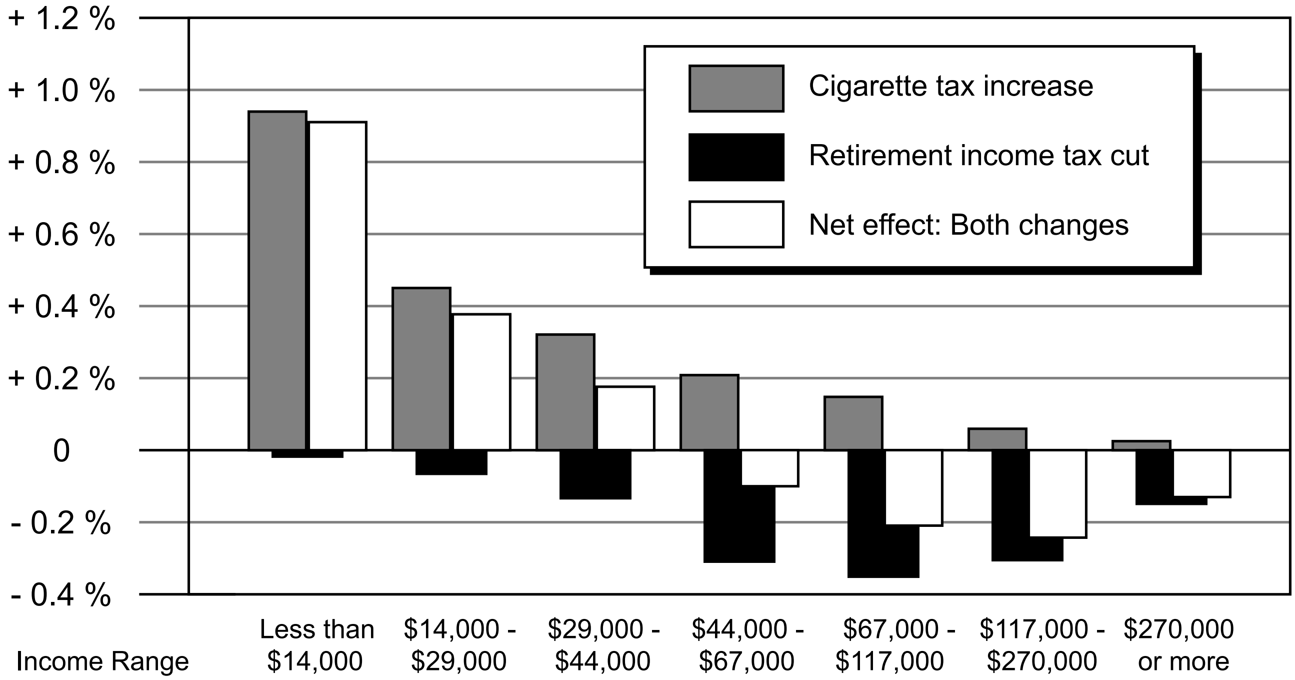

Table 1. Impact of 75-Cent Increase in Cigarette Tax and Repeal of Retirement Income Taxes

	All Iowa Taxpayers, 2002						
Income Group	**Lowest 20%**	**Second 20%**	**Middle 20%**	**Fourth 20%**	**Top 20%** Next 15%	**Top 20%** Next 4%	**Top 20%** TOP 1%
Income Range	Less than $14,000	$14,000 - $29,000	$29,000 - $44,000	$44,000 - $67,000	$67,000 - $117,000	$117,000 - $270,000	$270,000 or more
Average Income in Group	**$ 8,500**	**$21,100**	**$35,700**	**$55,100**	**$85,400**	**$158,000**	**$633,900**
75-Cent Cigarette Tax Hike							
Tax Change as % of Income	+ 0.9 %	+ 0.4 %	+ 0.3 %	+ 0.2 %	+ 0.1 %	+ 0.1 %	+ 0.0%
$ Avg. Tax Increase	$ 80	$ 95	$ 114	$ 114	$ 124	$ 95	$ 114
% of Tax Increase	15 %	18 %	22 %	22 %	18 %	4 %	1 %
Eliminate Income Taxes on Pension Benefits, Social Security							
Tax Change as % of Income	- 0.0 %	- 0.1 %	- 0.1 %	- 0.3 %	- 0.4 %	- 0.3 %	- 0.2%
$ Avg. Tax Change	- $ 2	- $ 15	- $ 51	- $ 173	- $ 309	- $ 490	- $ 975
% of Tax Decrease	0 %	2 %	8 %	28 %	37 %	16 %	8 %
Effects of Both Changes							
Tax Change as % of Income	+ 0.9 %	+ 0.4 %	+ 0.2 %	- 0.1 %	- 0.2 %	- 0.3 %	- 0.1 %
$ Avg. Tax Change	+ $ 78	+ $ 80	+ $ 63	- $ 59	- $ 185	- $ 395	- $ 861

Source: Analysis by Institute on Taxation and Economic Policy, April 2003

Figure 2. Incidence of 75-Cent Increase in Cigarette Tax Coupled with $25 Increase in Exemption Credits and Expansion of the EITC: Tax Change as a Percent of Income

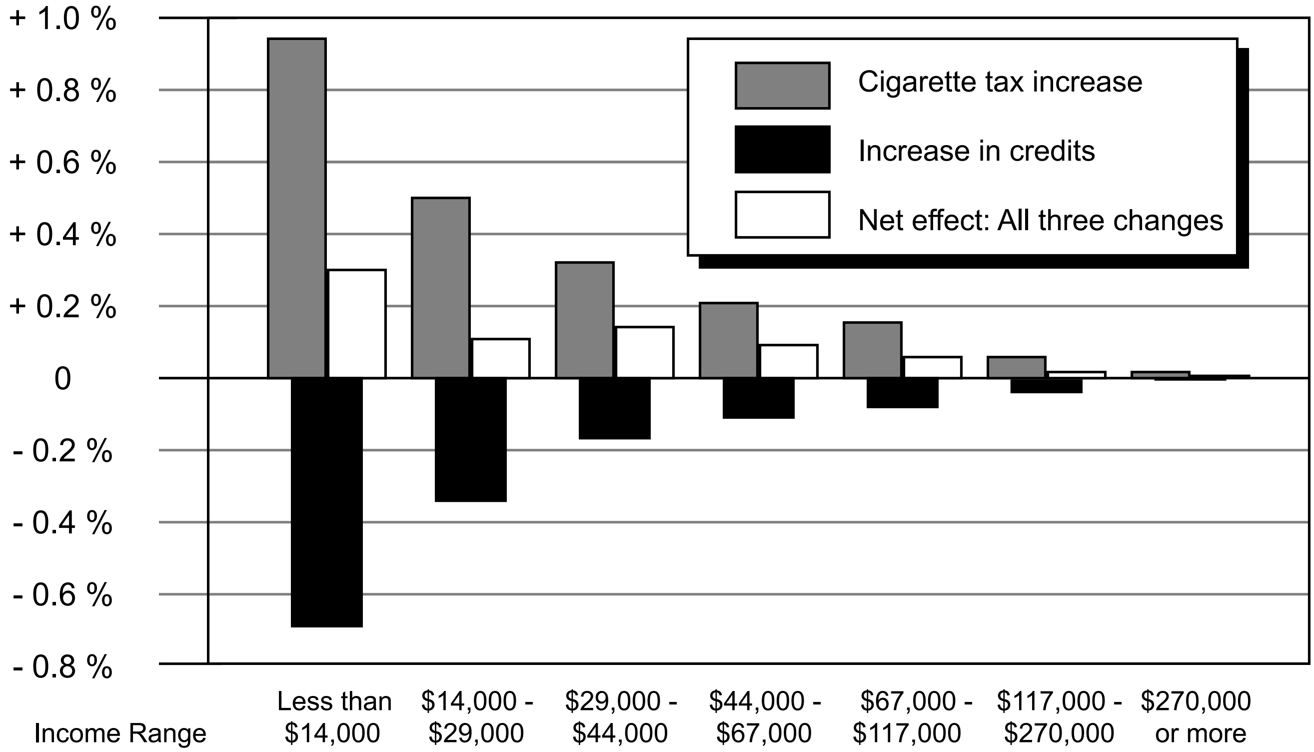

Table 2. Impact of 75-Cent Increase in Cigarette Tax and Offsetting Income Tax Cuts

	All Iowa Taxpayers, 2002						
Income Group	**Lowest 20%**	**Second 20%**	**Middle 20%**	**Fourth 20%**	**Top 20%** Next 15%	**Top 20%** Next 4%	**Top 20%** TOP 1%
Average Income in Group*	**$ 8,500**	**$21,100**	**$35,700**	**$55,100**	**$85,400**	**$158,000**	**$633,900**
75-Cent Cigarette Tax Hike							
Tax Change as % of Income	0.9 %	0.4 %	0.3 %	0.2 %	0.1 %	0.1 %	0.0%
$ Avg. Tax Increase	$ 80	$ 95	$ 114	$ 114	$ 124	$ 95	$ 114
% of Tax Increase	15 %	18 %	22 %	22 %	18 %	4 %	1 %
Add $25 to Exemption Credit							
Tax Change as % of Income	- 0.1 %	- 0.1 %	- 0.1 %	- 0.1 %	- 0.1 %	- 0.0 %	- 0.0%
$ Avg. Tax Change	- $ 7	- $ 21	- $ 41	- $ 64	- $ 74	- $ 72	- $ 73
% of Tax Decrease	3 %	10 %	20 %	31 %	27 %	7 %	2 %
Expand EITC to 20% Refundable							
Tax Change as % of Income	- 0.6 %	- 0.2 %	- 0.1 %	–	–	–	–
$ Avg. Tax Change	- $ 52	- $ 52	- $ 20	–	–	–	–
% of Tax Decrease	42 %	42 %	16 %	–	–	–	–
Effect of All Three Changes							
$ Average Tax Change	+$ 21	+$ 22	+$ 52	+$ 50	+$ 50	+$ 23	+$ 41
Tax Change as % of Income	+0.2 %	+0.1 %	+0.1 %	+0.1 %	+0.1 %	+0.0 %	+0.0%

* Income Range cited in Table 1.
Source: Analysis by Institute on Taxation and Economic Policy, April 2003

Figure 3. Impact of Exempting All Pension and Social Security Benefits: Tax Change as a Percent of Income

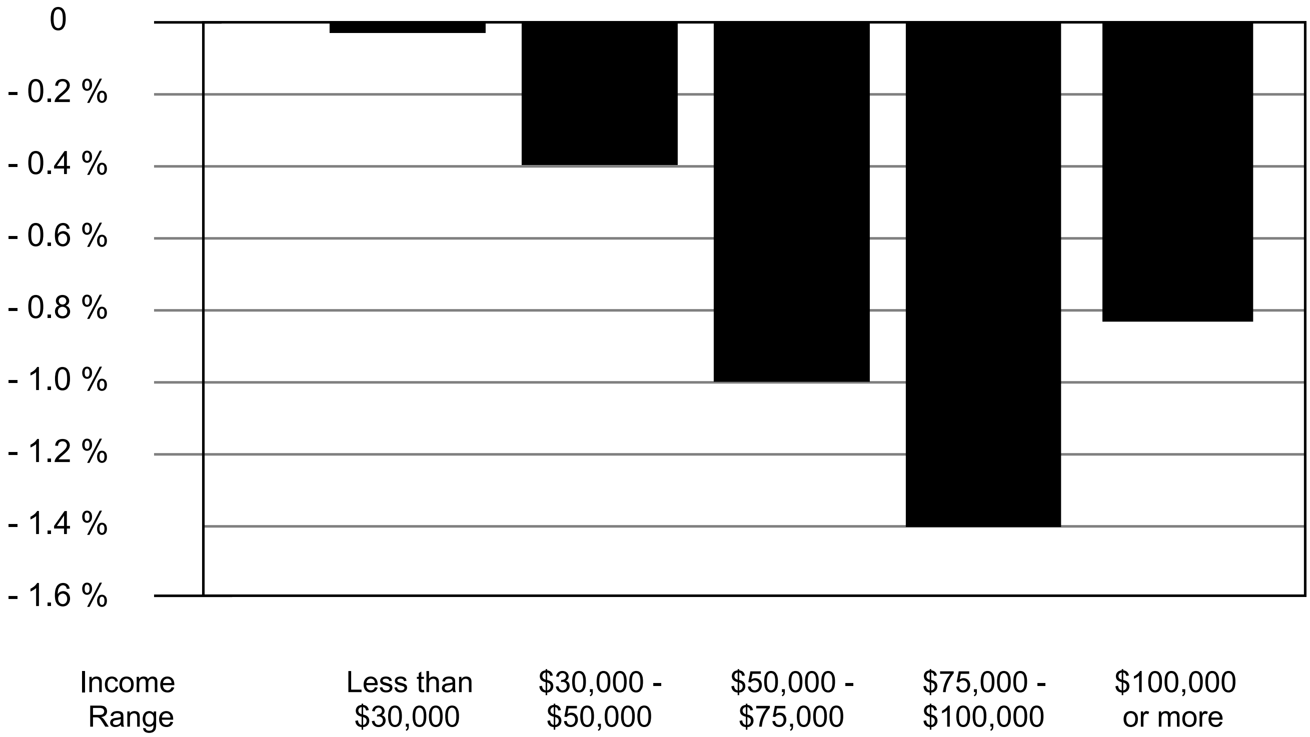

Table 3. Impact of Exempting All Pension and Social Security Benefits

	Elderly Iowa Taxpayers, 2002				
Income Range	Less than $30,000	$30,000 - $50,000	$50,000 - $75,000	$75,000 - $100,000	$100,000 or more
% Taxpayers in Group	18 %	38 %	24 %	8 %	11 %
Average Income in Group	**$ 19,650**	**$39,604**	**$60,503**	**$87,258**	**$207,169**
Exempt Tax on All Pension & Social Security Income					
Tax Change as % of Income	- 0.0 %	- 0.4 %	- 1.0 %	- 1.4 %	- 0.8 %
$ Avg. Tax Change	- $ 6	- $ 158	- $ 629	- $ 1,229	- $ 1,730
% of Tax Cut	1 %	13 %	30 %	20 %	37 %

Source: Analysis by Institute on Taxation and Economic Policy, April 2003

Dr. Charles Bruner is executive director of the Child & Family Policy Center in Des Moines. Established in 1989 "to better link research and policy on issues vital to children and families," CFPC is on the web at www.cfpciowa.org.

Dr. Peter S. Fisher is research director of The Iowa Policy Project, a non-profit, non-partisan research organization based in Mount Vernon. IPP reports are on the web at www.iowapolicyproject.org.

This report, and a two-page summary, are available to the public, free of charge, at www.iowapolicyproject.org.