



# Policy *Perspective*

## Funding SCHIP with Tobacco Taxes

### *What the Higher Tobacco Taxes Would Mean for Texas*

**by Mary Katherine Stout**  
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**A**s Congress debates funding a massive expansion of the State Children's Health Insurance Program (SCHIP) through increased tobacco taxes, there are a number of people cheering. States looking for something to rescue them from an SCHIP shortfall, or those simply looking for new revenue to expand their programs, have enthusiastically supported the expansion and the new funds slated to come with reauthorization.

Although a program expansion would obviously add more children to the SCHIP program with consequences of its own, few have noted the impact that the federal cigarette tax increase will have on the states and their ability to generate revenue from that source. This is more than economic theory. Indeed, years of experience has shown that increases in cigarette taxes result in declining sales, making tobacco taxes an unstable source of revenue in the long run.

#### TOBACCO TAXES AND REVENUE

The tobacco settlements in the 1990s and the increasing tobacco tax rates in the decade since have created instability in tobacco taxes as a revenue source. The purchase and use of tobacco products is highly elastic, meaning that as price increases, the quantity or demand for the product generally falls. In fact, it stands to reason that increases in the price per pack of cigarettes will likely do one of three things:

- Deter smoking;
- Motivate adult smokers to quit; or
- Drive existing smokers to cheaper alternatives.

In August, *USA Today* published the results of its analysis showing the effect of increasing state tobacco taxes on cigarette consumption.

According to their review, cigarette consumption in South Carolina has fallen 5 percent since 2000, while their tobacco taxes have remained stable (and remains the lowest in the nation) at seven cents since 1977.<sup>1</sup> In neighboring North Carolina, cigarette sales declined 18 percent in 2006 after a phased-in 30 cent increase.<sup>2</sup> Industry experts report that the annual decline in cigarette sales is roughly 2 percent,<sup>3</sup> which is higher than the seven-year, 5 percent decline in sales in South Carolina, yet significantly lower than the 18 percent, single-year drop in North Carolina.

Perhaps the best example of tobacco taxes and declining sales of cigarettes comes from New York City where the city's excise tax on cigarettes increased \$1.42 and the state excise tax increased \$1.50, leading to a 50 percent decline in taxable sales volume of cigarettes in 2002.<sup>4</sup> Surveys by the New York Department of Health indicate that the decline cannot be attributed to massive declines in tobacco use, but instead confirms the predicted move to lower-taxed or non-taxed sources of cigarettes.

An increase in tobacco taxes in New Jersey shows the impact of the relationship between taxes and consumption on state revenues. To raise funds to support New Jersey's 2007 fiscal year budget, the Legislature raised cigarette taxes 17.5 cents per pack, from \$2.40 to \$2.575. But instead of raising revenue, this move cost the state money: revenue from the state's tobacco tax in FY 2007 declined by \$23 million to \$764 million.<sup>5</sup>

The Congressional Budget Office reports that smoking declines 2.5 to 5 percent for every 10 percent increase in the price of cigarettes.<sup>6</sup> As a result, massive increases in tobacco taxes mean massive declines in the sale of cigarettes. While

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many argue in favor of using the tax code to engineer behavioral changes to discourage smoking, the reality is that whether the declines are the result of decreased smoking or decreases in taxable cigarette sales, the decline in revenue is predictable.

### TEXAS TOBACCO TAXES

As of January 1, 2007, the state's cigarette tax on a pack of 20 cigarettes increased \$1 from \$.41 to \$1.41—an increase of more than 200 percent.<sup>7</sup> The increase in state cigarette taxes has driven the retail price per pack of cigarettes up to \$4.71, approximately the 16th highest tax in the country.

Texas neighboring states all have lower cigarette taxes than the Lone Star State, making its neighboring states attractive retail destinations for some people to purchase lower cost cigarettes. Compare Texas' retail price per package of cigarettes of \$4.71 to: Arkansas \$4.04, Louisiana at \$3.74, Oklahoma at \$4.14, and New Mexico at \$4.12.<sup>8</sup> Indeed, close proximity to lower-cost cigarettes may well change the purchasing habits of Texas smokers who can otherwise cross the state line to purchase them at a lower cost. While these declines are likely to continue following the most recent increase in the state cigarette tax, it may still take a few years before the full consequences of the tax increase are apparent.

**Table 1** details the annual taxable number of cigarette packages purchased in each year from 1997-2005. According to the data from the Texas Comptroller, however, taxable sales of cigarette packages increased in only two years from 1997-2005.

In addition, tobacco and cigarette taxes as a source of revenue have proven unstable, just in terms of the amount collected from the taxes on an annual basis and projecting these number into the future.

Year	Cigarette packages taxed in millions
2005	1,239
2004	1,228
2003	1,234
2002	1,270
2001	1,282
2000	1,307
1999	1,263
1998	1,382
1997	1,393

Source: Texas Comptroller of Public Accounts, Texas Production and Consumption 2994-3005. [www.cpa.state.tx.us/ecodata/producons1.html](http://www.cpa.state.tx.us/ecodata/producons1.html).

Again, the data from the Texas Comptroller's office shows the cyclical revenue cycle, indicating that in years with declines in cigarette and tobacco tax revenue, the following year generally had large positive changes in revenue growth. This instability is important for legislators to consider when planning to use such revenue to fund additional projects.

### Tobacco and Cigarette Taxes as a Source of State Revenue: 1997-2006

Fiscal Year	Amount Collected	% of Total Revenue	% Change from Previous Year
2006	\$545,904,191	.8	-8.9
2005	599,368,199	.9	12.1
2004	534,577,125	.9	-8.3
2003	582,712,236	1.0	7.9
2002	540,038,314	1.0	-7.6
2001	584,586,277	1.1	9.9
2000	531,853,171	1.1	-14.7
1999	623,569,272	1.3	11.2
1998	560,923,078	1.3	-14.3
1997	654,769,113	1.5	15.5

Source: Texas Comptroller of Public Accounts, "Texas revenue History by Source," [www.cpa.state.tx.us/taxbud/revenue\\_hist.html](http://www.cpa.state.tx.us/taxbud/revenue_hist.html) and [www.cpa.state.tx.us/taxbud/revenue.html](http://www.cpa.state.tx.us/taxbud/revenue.html).

#### QuickFact:

As of January 1, 2007, the state's cigarette tax on a pack of 20 cigarettes increased \$1 from \$.41 to \$1.41—an increase of more than 200 percent.

## SCHIP AND TEXAS' TOBACCO TAX REVENUE

Under SCHIP reauthorization, the federal cigarette tax currently at \$.39 per pack would increase as much as \$.61 under the U.S. Senate's proposal to increase the tax to one dollar per pack. The U.S. House has a slightly smaller increase of \$.45, but is likely to raid part of the funds for the Medicare prescription drug benefit to help fund the rest.

For its story, *USA Today* quoted an economist and an industry representative as predicting a six percent decline in smoking if the Senate's proposed 61 cent federal cigarette tax increase passes into law.<sup>9</sup> The biggest cigarette tax increase in U.S. history, there is little doubt that such a move will have far-reaching effects and unintended consequences.

For example, as the Heritage Foundation observed in a recent study, the nation will need 22 million new smokers by 2017 to pay for this new and expanded program. Such a move puts state and local governments in an untenable position. While states have spent the last 10 years extolling the virtues of kicking the cigarette habit, states creating and expanding massive government health care programs with cigarette tax revenues have now tethered their big government plans to an unstable funding source and a behavior they once criticized.

If the U.S. Congress increases federal cigarette taxes and faces long-term declines in the sale of cigarettes as a result of the increases, so too will Texas face declining state tax revenue. ★

### TalkingPoint:

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## ENDNOTES

<sup>1</sup> Cauchon, Dennis, "Smoking declines as taxes increase," *USA Today* (9 Aug. 2007) [http://www.usatoday.com/news/health/2007-08-09-1Aled\\_N.htm](http://www.usatoday.com/news/health/2007-08-09-1Aled_N.htm).

<sup>2</sup> Cauchon, Dennis, "Smoking declines as taxes increase," *USA Today* (9 Aug. 2007) [http://www.usatoday.com/news/health/2007-08-09-1Aled\\_N.htm](http://www.usatoday.com/news/health/2007-08-09-1Aled_N.htm).

<sup>3</sup> Phillip Morris USA, "Legislation & Regulation: Tobacco Product Excise Taxes," [http://www.philipmorrisusa.com/en/legislation\\_regulation/excise\\_taxes.asp](http://www.philipmorrisusa.com/en/legislation_regulation/excise_taxes.asp).

<sup>4</sup> Kevin Davis; Matthew Farrelly, Qiang Li, and Hyland Andrew (2006) "Cigarette Purchasing Patterns among New York Smokers: Implications for Health, Price, and Revenue," New York State Department of Health. In April 2002, New York raised its cigarette excise tax from \$1.11 to \$1.50. In July 2002, New York City also increased its cigarette excise tax from \$0.08 to \$1.50.

<sup>5</sup> Greg M. Edwards, "State proving it can overtax economic activity," Asbury Park Press, Aug. 19, 2007.

<sup>6</sup> Cauchon, Dennis, "Smoking declines as taxes increase," *USA Today* (9 Aug. 2007) [http://www.usatoday.com/news/health/2007-08-09-1Aled\\_N.htm](http://www.usatoday.com/news/health/2007-08-09-1Aled_N.htm).

<sup>7</sup> [www.window.state.tx.us/taxinfo/cig\\_tob/faq\\_cig.html](http://www.window.state.tx.us/taxinfo/cig_tob/faq_cig.html).

<sup>8</sup> Campaign for tobacco free kids, [www.tobaccofreekids.org/research/factsheet/pdf0099.pdf](http://www.tobaccofreekids.org/research/factsheet/pdf0099.pdf).

<sup>9</sup> Cauchon, Dennis, "Smoking declines as taxes increase," *USA Today* (9 Aug. 2007) [http://www.usatoday.com/news/health/2007-08-09-1Aled\\_N.htm](http://www.usatoday.com/news/health/2007-08-09-1Aled_N.htm).

## About the Author

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Previously, Mary Katherine worked at the Texas Workforce Commission as a policy analyst for Diane Rath, Chair and Commissioner Representing the Public. Before the Workforce Commission, she was the Chief Policy Analyst at the Texas Conservative Coalition and the Texas Conservative Coalition Research Institute, where she worked with the Institute's task forces on the budget, health and human services, and school finance.

She has also worked at the Texas Legislative Council as a policy analyst for health and human services, and for Louisiana Governor Mike Foster. She attributes her first real interest in public policy to college internships for Senator Phil Gramm and President George H.W. Bush.

Mary Katherine graduated from Texas A&M University with a degree in Political Science. She has been an active volunteer for CASA of Travis County and Reading is Fundamental of Austin. Mary Katherine and her husband live in Austin.

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