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Sin taxes: The sobering fiscal reality

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On April 2, 2015, the Federal Reserve Bank of Chicago and the Civic Federation held a forum to examine the use and efficacy of so-called sin taxes (e.g., taxes on alcohol, tobacco, and gambling) levied by state and local governments.

Some materials presented at the forum are available at https://www.chicagofed.org/events/2015/sin-taxes.

During the Great Recession of 2008–09 and the subsequent recovery, revenues of state and local governments were hard hit. To get through tough fiscal times, states and localities relied on short-term revenue and expenditure strategies. This pattern continued, even as economic growth restored some measure of stability to many of their budgets. Among these strategies was hiking sin taxes to bring in new revenues.

Adjustments to sin taxes are often politically easy to make. Sin taxes are intended to discourage participation in private behaviors that society deems undesirable while raising money to help compensate society for the costs incurred from such behaviors. However, the question remains: Are sin taxes guided by clear taxation principles that reduce objectionable behaviors or are they simply a convenient means to help boost state budgets? The forum addressed this and many other related issues surrounding sin taxes, including their fairness, their efficiency in raising revenues, the costs associated with enforcing them, and how states and localities allocate revenues generated from them.

Economic principles for sin taxes

Adam Hoffer, assistant professor of economics, University of Wisconsin–La Crosse, stated that since colonial times, the two primary justifications for levying sin taxes in the United States have been as follows: Sin taxes decrease the consumption of "sinful" goods (and services), and they offset any societal costs incurred by such consumption. However, sin taxes appear to have a limited impact on reducing sinful consumption, noted Hoffer. For instance, a 10% increase in the cigarette tax causes only a 3% reduction in tobacco use, he said. Moreover, as a means of offsetting societal costs due to sinful consumption, sin taxes have some problematic features. First, sin taxes tend to be regressive taxes—i.e., they tend to fall disproportionately on households at the lower end of the income distribution, raising issues of fairness. In general, low-income households spend a greater portion of their income on many products affected by sin taxes (such as alcohol and tobacco) than their higher-income counterparts. Second, sin taxes are prone to attract heavy lobbying activity by producers of sinful goods. Using the political process, these firms support lobbying efforts to minimize the impact of sin taxes on their bottom lines; for instance, there have been recent spikes in spending on lobbying costs (tens of millions of dollars' worth) by the soft drink and fast food industries, which faced tax hikes on their goods over the past few years. Hoffer also pointed out that the extension of sin taxes to soda (and other similar items) has proven to be tricky for other reasons. For example, if the goal of a sin tax is to link soda consumption to bad health outcomes (such as obesity and diabetes), should the state government tax the individual who regularly drinks soda and then has a poor health outcome requiring public health care expenditures? Or should it tax the entire group that tends to drink the most soda (i.e., the poor)? Or should it simply tax soda itself? There seemed to be no clear-cut answer, Hoffer said.

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Tobacco taxes: Benefits and cross-jurisdictional challenges

Jidong Huang, senior research scientist, University of Illinois at Chicago (UIC) Institute for Health Research and Policy, emphasized the strong evidence from hundreds of studies showing that tobacco taxes across the world improve public health. According to the numerous studies Huang discussed, tobacco tax increases are correlated with a greater number of current smokers smoking less or quitting and with fewer nonsmokers taking up smoking. Huang also discussed the economic benefits associated with tobacco taxes. Using evidence from other studies, he explained that revenues to governments generally rise with tobacco tax increases, but these revenue gains are not always sustained over time because of falling tobacco use. Next, Huang argued that the regressive nature of the tobacco tax is offset by the fact that low-income people are more likely than their higher-income counterparts to quit as a result of tobacco tax increases—and thus more likely to reap the health benefits. Moreover, if some revenues from tobacco taxes are used to fund programs targeting assistance to the poor (as recommended by the World Health Organization), this strategy helps counteract the regressivity of the taxes. Huang also noted that there is not much evidence of harm to the broader economy through job losses associated with tobacco tax increases; quite often, decreases in tobacco-dependent employment are offset by increases in employment in other sectors. That said, Huang noted that there are some costs to the broader economy from having to enforce tobacco taxation. Governments across the globe must spend resources to contend with tobacco tax avoidance (e.g., legally getting around the tax by buying lower-priced cigarettes online or in a neighboring jurisdiction) and evasion (e.g., illegally getting around the tax by smuggling or counterfeiting cigarettes). However, Huang argued that the levels of tobacco tax avoidance and evasion are generally overstated and that the costs of enforcement are controllable with strong governmental tax administrations.[1]

Brian Cooper, acting program administrator, Criminal Investigation Division, Illinois Department of Revenue, discussed cigarette taxes from a law enforcement perspective. He described the State of Illinois's efforts to prevent cigarette trafficking[2] and catch traffickers, detailing several cases. He said that large differences between Illinois's tobacco tax rate and those of some surrounding states—in particular, Missouri and Kentucky—make cigarette trafficking lucrative. Moreover, the risks for smuggling cigarettes are much less than those for smuggling illicit drugs. So, cigarette trafficking is becoming a bigger problem. Enforcement of tobacco taxation statutes is very important for preserving state tax revenues. According to U.S. Department of Justice estimates, the illicit trade in cigarettes leads to an annual loss of $5 billion in federal and state tax revenues, Cooper shared. In addition to stopping individual smugglers, the Illinois Department of Revenue is working with local police departments to break up organized crime groups that fund many of the smugglers and with the Illinois Attorney General's office to impose harsher punishments on traffickers as a deterrent, said Cooper.

Ivan Samstein, chief financial officer, Cook County, first described the relative importance of tobacco and other sin taxes within the county's budget. In total, Cook County's taxes on cigarettes, other tobacco products, alcoholic beverages, and gambling machines make up a significant portion of its home rule taxes. (Home rule allows Cook County to levy local taxes not specifically prohibited by the State of Illinois.) He then described how the county is coping with the ongoing long-term decline in tobacco use and, therefore, reduced tax revenues, as it faces an increased need for tobacco tax enforcement on account of tobacco products being taxed at much lower rates in bordering jurisdictions. While the county has had to adjust its long-term fiscal structure to compensate for these and other fiscal stresses, it has found that its tobacco tax strategy has helped reduce youth smoking, Samstein reported.

Legalization and taxation of marijuana

Lou Lang, state representative for the 16th District, Illinois House of Representatives,[3] presented Illinois's new pilot legislation for legalizing medical marijuana use, which went into effect on January 1, 2014.[4] Lang sponsored the bill allowing individuals with one or more of over 30 qualifying conditions to receive medical marijuana upon approval from a treating physician. Lang emphasized that the patient must have a standing relationship with his or her doctor and is required to share all medical records with the state to obtain a license to purchase marijuana. This license will allow the patient to purchase a small amount of marijuana every two weeks, and the purchases will be tracked rigorously by the state.

Lang noted that it took more than six years to get this legislation passed in Illinois and that the state has yet to have the authorized dispensaries up and running. The legislation establishes a four-year pilot program with 21 growers and 60 dispensaries. The earliest the product will be available is the fall of 2015. Because of this delay, Lang said he would like to see the period for the pilot program be extended so that the four-year duration starts once the medical marijuana is available for sale. In conclusion, Lang said that while there will be economic development benefits from the program (as well as new tax revenues), the primary goal is to help sick people have a better quality of life.

Andrew Freedman, director of marijuana coordination, State of Colorado, presented the marijuana tax structure of his state following the recent legalization of recreational marijuana there. Amendment 64[5]—which was passed as Colorado law through a citizens' initiative in late 2012—established a broad-based study of the implications of legalizing recreational cannabis[6] before authorizing sales of it in 2014. Freedman explained that in his role as Colorado's director of marijuana coordination, he has been tasked to establish a regulatory system for tracking the growing, distribution, and sale of marijuana in the state.

Recreational marijuana is subject to three taxes in Colorado, noted Freedman. First, there is the regular 2.9% state sales tax (medical marijuana, which was legalized in Colorado in 2000, is also subject to this tax). Second, there is a 10% special sales tax. And finally, there is a 15% excise tax, whose proceeds are deposited in the Building Excellent Schools Today Fund. In 2014, the state collected $63 million in taxes from the sales of both medical and recreational marijuana. The bulk of the tax revenues came from recreational cannabis sales. Freedman said that over the longer term, tax revenues are estimated to be between $80 million and $120 million annually. He noted that while these yearly revenues are sufficient to cover the costs of regulating marijuana and do provide some funding to the school fund, they will not provide significant funding to the state, whose annual budget is $26 billion. Finally, Freedman characterized the first year of the regulatory tracking system for marijuana as a success. However, Freedman stated that little is known about the broader socioeconomic factors related to the legalization of recreational marijuana—such as changes in drug abuse and drug-related criminal offenses (early evidence suggests that neither is pervasive in Colorado, he said).

At the tipping point: Gambling expansions

The final panel of the day explored the question of whether gambling has become so pervasive in the United States that further gambling expansions will not significantly increase revenues to state and local governments. To begin the discussion, Lucy Dadayan, senior policy analyst, Nelson A. Rockefeller Institute of Government, went over national trends in tax and fee revenues from gambling. She first described the different kinds of legalized gambling in the United States, of which the lottery is the largest, having brought in 64% of gambling revenues in the nation in fiscal year (FY) 2014. Of particular interest, she said, is the recent trend showing that while there has been an increase in the number of casinos across the country, total revenues to states and localities from gambling sources have not significantly increased. Dadayan said that when considering gambling expansions, policymakers must keep in mind that gambling is a slow-growing revenue source and that at least some of the revenues associated with expansions represent a shift from other established gambling sources rather than net growth. Thus, gambling should not be considered a long-term solution to balancing government budgets.

Peter Matuszak, senior policy analyst, Civic Federation, examined the State of Illinois's gambling revenue trends, which have been fairly flat or on the decline (depending on the kind of gambling) over the past several years. He described the different kinds of gambling implemented by the State of Illinois—with a particular focus on video gambling, authorized in 2009[7] as a source of revenue for the state's multiyear capital improvement program (to build or upgrade roads and bridges while generating construction jobs). Matuszak also discussed a recent gambling expansion proposal that would have created casinos in Chicago and other locations around the state, as well as "racinos" (allowing video gambling terminals at racetracks). According to Matuszak, the revenue impact of the expansion was projected to be mixed: a large one-time revenue increase from the upfront sales of licenses to establish new gambling venues coupled with declines in revenues from existing casinos.

Mark Ostrowski, director, Illinois Gaming Board, explained the purpose of his organization and how its creation and function were tied to the State of Illinois's legalization of riverboat gambling in the early 1990s. He provided a history of legalized gambling in Illinois and then focused on how the gaming board implemented the rollout of video gambling in Illinois over the past few years and the difficulties associated with policing thousands of terminals spread across the state. He said that the current number of video gambling terminals is equivalent to 26 casinos. The consequence of so much legalized gambling is that Illinois is seeing actual casinos starting to fail. He noted the state's total tax revenues from gambling were flat, despite the video gambling expansion.

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State budgets and trends in sin taxes

Scott Pattison, executive director, National Association of State Budget Officers (NASBO), provided a keynote address on current state budget conditions and sin tax trends among states. Pattison noted that the moderate improvement in states' fiscal conditions have mirrored the modest growth in the national economy. According to Pattison, while states' fiscal conditions have stabilized, both their expenditures and revenues when adjusted for inflation are anticipated to stay below pre-recession peaks in FY2015. Moreover, for FY2015, aggregate general fund spending by states is expected to increase by only 3.1%, and state budget reserves are predicted to decline to 7.3% of expenditures from 8.9% in FY2014.

In discussing trends for sin taxes, Pattison remarked that over the period 2000–15, there were 111 increases in tobacco taxes and 23 increases in alcohol taxes. In contrast, there were only four decreases in tobacco taxes and eight decreases in alcohol taxes over this span. According to U.S. Census Bureau figures, state and local governments' tobacco and alcohol tax revenues totaled $17.6 billion and $6.5 billion in FY2012, respectively, Pattison said. However, combined these tobacco and alcohol tax revenues represented less than 3.6% of total state general fund revenues for that fiscal year, which amounted to $672.8 billion (according to NASBO data). Similarly, in Washington and Colorado (states in which recreational marijuana is legal), marijuana tax revenues represent a small percentage of total state general fund revenues. Pattison noted that sales and income tax revenues, along with federal transfers, make up the lion's share of state revenues.

Tax revenues from gambling sources face special challenges, Pattison said. According to figures from the Nelson A. Rockefeller Institute of Government, total tax revenues from all gambling sources was $27.3 billion in FY2014, shared Pattison. But more concerning is the fact that the growth rate of these revenues is either flat or declining. Pattison concluded that sin taxes are not a solution for major budget problems, but they can be useful insofar as they provide a limited amount of extra funds to government, pay for governmental mechanisms necessary to regulate the production and sale of sinful goods (and services), and discourage to some degree the sinful activity being taxed.

Conclusion

Sin taxes are often the subject of attention when states and localities find themselves in tight fiscal conditions. However, as the presentations at this forum demonstrated, sin taxes often offer limited revenue growth and, in some cases, are costly to enforce.

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[1] Huang's presentation showed that tobacco tax administration can be strengthened with new technology to monitor production and track shipments, as well as new powers to issue, suspend, and revoke mandatory licenses for all parties involved in tobacco production and distribution. Moreover, it noted that tax enforcement might be improved through regional and international collaborations to monitor tobacco production and distribution.

[2] Cooper defined cigarette trafficking as buying cigarettes in bulk in a state with a low cigarette tax and smuggling them into a state with a higher cigarette tax to sell at a discounted rate.

[3] For details on State Representative Lang and the 16th District, see http://www.housedem.state.il.us/members/langl/.

[4] For details, see http://www.ilga.gov/legislation/ilcs/ilcs3.asp?ActID=3503&ChapterID=35.

[5] For the final version of the amendment to the constitution of Colorado, see http://www.sos.state.co.us/pubs/elections/Initiatives/titleBoard/filings/2011-2012/30Final.pdf.

[6] http://www.colorado.gov/cms/forms/dor-tax/A64TaskForceFinalReport.pdf.

[7] Within Illinois, legalized video gambling outside casinos did not actually start until the fall of 2012 because of administrative delays.