Tax Foundation
1325 G Street, NW, Suite 950
Washington, DC 20005

Testimony on Taxes on Tobacco and Tobacco-Related Products before the West Virginia Joint Select Committee on Tax Reform

September 15, 2015

Jared Walczak
Policy Analyst, Tax Foundation

Chairman Hall, Chairman Nelson, and members of the committee, thank you for the opportunity to testify before you today regarding taxes on tobacco and tobacco-derived products, including e-cigarettes.

In some ways, I suppose that I am an unusual choice as someone to testify on anything pertaining to tobacco. I've never bought a pack of a cigarettes; for that matter, I've never smoked a cigarette. Fifty years ago, that would have been atypical. In 1965, not only had most adult Americans at least tried cigarettes, but 42 percent were regular smokers. Today that number stands at 19 percent and falling, according to the CDC. The Department of Health and Human Services is targeting a 12 percent rate for 2020.[1] In West Virginia, the percentage of smokers is higher—estimated at 27.3 percent, the highest adult smoking rate in the country, compared to the national average of 19 percent[2]—but the rate is still falling. Any discussion of tobacco taxes must proceed from this fact: tobacco use is declining, and that decline is likely to continue, with significant revenue ramifications for the state.

West Virginia's tobacco products tax is projected to raise $100.4 million in FY 2016, accounting for 2.33 percent of anticipated general fund revenue. In FY 2010, the tobacco products tax accounted for 2.86 percent of revenue. In FY 2005, the cigarette tax and the smokeless tobacco tax combined to account for 3.28 percent of general fund revenue.[3] There can be little doubt as to the overall trend.

West Virginia's 55 cents a pack excise tax dates to 2003. Before that, it stood at 17 cents a pack. The rate increased 324 percent; collections increased 270 percent year over year. In other words, West Virginia did not receive a one-to-one revenue increase on the tax

---

[1] *Trends in Current Cigarette Smoking Among High School Students and Adults, 1965-2011*, CENTERS FOR DISEASE CONTROL AND PREVENTION, http://www.cdc.gov/tobacco/data_statistics/tables/trends/cig_smoking/.
[2] *Behavioral Risk Factor Data: Tobacco Use (2011 and Later)*, Centers for Disease Control and Prevention, 2011-2013, https://chronicdata.cdc.gov/Survey-Data/Graph-of-Cigarette-Use-Among-Adults-Behavior-Risk-/syfb-fzcd.
[3] *Monthly Revenue and Cash Flow Reports* (multiple years), West Virginia State Budget Office, http://www.budget.wv.gov/reportsandcharts/revenuereports/Pages/default.aspx.

hike, though it did capture most of the value of that increase in the first year. It is not, however, a growing revenue source. In FY 2016, the state is projected to raise just a hair *below* what it raised the first full fiscal year the new rates were in effect—and that's in nominal terms. In real terms, of course, revenue declined further, and over that period, tobacco taxes have slid substantially in terms of their share of state revenues.

Policymakers impose excise taxes on tobacco for a variety of reasons, some of them potentially in conflict with each other. Some policymakers seek to induce behavioral effects, using taxes as a means to increase the costs, and thereby decrease the incidence, of smoking. Others see cigarette taxes as a means of paying for the state's share of the health costs of tobacco use. And still others regard it as a source of revenue more generally.

The problem, of course, is that to the extent that cigarette taxes reduce consumption, state revenue falls. Even absent those effects, tobacco consumption is clearly declining, and if you're seeking long-term revenue stability, raising taxes on a shrinking tax base probably isn't the best way to bring that about.

Estimates of price elasticity of vary greatly. A number of studies have pegged elasticity between -0.2 and -0.6, meaning that for each percent increase in the price of cigarettes, there will be a reduction in consumption between two- and six-tenths of a percent.[4] Others, however, have questioned this assumption; a Cato Institute analysis in 2014 estimated an elasticity of -0.065, which would suggest that factors exogenous of cost are overwhelmingly driving reduced demand for cigarettes.[5] But whether or not higher taxes meaningfully reduce consumption overall, they can certainly shift the point of sale.

Each year, the Tax Foundation partners with the Mackinac Center for Public Policy, a Michigan think tank, to conduct a statistical analysis of available data to estimate cigarette smuggling rates for each state. Smuggled cigarettes make up substantial portions of cigarette consumption in many states, with criminals taking advantage of the tax arbitrage opportunities afforded by differing tax rates in the several states. The median state tax rate is $1.53 per pack; the highest rate is New York's $4.35 a pack, and that doesn't even take New York City's $1.50 levy into account. Unsurprisingly, New York leads the nation in smuggled cigarette sales. Incredibly, smuggled cigarettes actually

---

[4] *See generally, Effectiveness of Tax and Price Policies for Tobacco Control,* IARC HANDBOOKS OF CANCER PREVENTION, VOL. 14, 2011, http://www.iarc.fr/en/publications/pdfs-online/prev/handbook14/index.php.

[5] Kevin Callison and Robert Kaestner, *Cigarette Taxes and Smoking*, REGULATION, Winter 2014-2015, http://object.cato.org/sites/cato.org/files/serials/files/regulation/2014/12/regulation-v37n4-7.pdf.

account for nearly 57 percent of all cigarettes sold in New York, according to the most recent estimates.[6]

West Virginia doesn't have that problem. In fact, West Virginia sees a substantial outflow. Over twenty percent of cigarettes purchased in West Virginia are resold elsewhere. Neighboring Virginia, with its 30 cent per pack tax, is an even more popular source of cigarettes for the black market trade.

Of course, organized smuggling isn't the only tax arbitrage that takes place when tobacco taxes diverge across state lines. Cigarette taxes are 25 cents a pack lower across the border in Virginia, and five cents higher in Kentucky. There's already an incentive for regular smokers to stock up on cigarettes in Virginia, and should West Virginia ever raise cigarette taxes substantially, Kentucky may become a viable option for such transactions as well. In short, whether or not tobacco users would maintain current consumption patterns in the face of a tobacco tax increase, they may very well prove responsive to higher taxes in terms of where they (or their suppliers) *procure* those tobacco products.

Even as fewer Americans smoke or consume smokeless tobacco products, however, more Americans are turning to electronic cigarettes—8.5 percent of all American adults have used an e-cigarette at least once, and over a third of current cigarette smokers have done so.[7] Studies indicate that nationwide, about two-thirds of electronic cigarette users are current smokers.[8] Many of those the other third are former smokers, some of whom may have given up traditional tobacco products for vapor products, while others may have returned to smoking via e-cigarettes rather than traditional cigarettes. This suggests, as one would expect, that the e-cigarette market share poaches significantly from the traditional tobacco market, which may accelerate the decline in tobacco use.

Electronic cigarettes generally do not fall under taxes that capture tobacco products other than cigarettes, since, outside of Minnesota, the use of nicotine has not been deemed sufficient to term e-cigarettes a tobacco product. Given recent trends, however, many other states have looked at imposing new taxes on vapor products. In 2015 alone, legislation to tax vapor was introduced in twenty-three states. Beyond Minnesota, three other states and the District of Columbia have adopted such taxes to date. The three

---

[6] Joseph Henchman and Scott Drenkard, *Cigarette Taxes and Cigarette Smuggling by State*, TAX FOUNDATION FISCAL FACT NO. 421, Mar. 19, 2014, http://taxfoundation.org/article/cigarette-taxes-and-cigarette-smuggling-state.

[7] *Key Findings: Trends in Awareness and Use of Electronic Cigarettes Among U.S. Adults, 2010-2013*, CENTERS FOR DISEASE CONTROL AND PREVENTION, http://www.cdc.gov/tobacco/basic_information/e-cigarettes/adult-trends/.

[8] Robert McMillen *et al, Trends in Electronic Cigarette Use Among U.S. Adults: Use is Increasing in Both Smokers and Nonsmokers,* NICOTINE AND TOBACCO RESEARCH, 2014, http://ntr.oxfordjournals.org/content/early/2014/11/28/ntr.ntu213.

states—Kansas, Louisiana, and North Carolina—impose an excise tax on milliliters of e-cigarette fluid, while the District of Columbia imposes an *ad valorem* tax on wholesale price, as does Minnesota under its administrative ruling.

There has been much debate as to the rationale for vapor taxes. Sometimes it's a straightforward revenue argument: if consumption is moving away from traditional tobacco products and toward electronic cigarettes, the tax structure should move with it. But tobacco excise taxes have also long been defended on public health grounds as well, promoting smoking cessation or providing funding for tobacco-related health expenditures, either or both. If e-cigarettes are thought of as a comparatively less health-adverse substitute for traditional tobacco products, or potentially even as a smoking cessation tool, then extending "sin taxes" to these products may prove counterproductive.

It can also prove extraordinarily complicated. Whether the goal is to tax vapor on an equalized basis with cigarettes or at a reduced rate, the conversion factors involved make it hard to know what the target rates should be. There is no simple way to compare milliliters of "e-juice," as it is often called, to cigarettes. Some say that a milliliter roughly corresponds to a pack of cigarettes; others insist it's more like two milliliters. Of course, one can compare nicotine content, but for users, the more accurate comparison is arguably how many cigarettes it replaces, which can vary widely from user to user, based on voltage, usage patterns, nicotine concentration, and more.

A midrange e-juice dosage would be about 12 milligrams per milliliter, though I understand that a pack a day smoker would be more likely to choose something in the 18 milligram range. A traditional cigarette contains between 8 and 20 milligrams of nicotine, but typically about 1 milligram per cigarette is actually absorbed. More of the nicotine in e-cigarettes is actually inhaled, typically about half the concentration. Therefore, at a high concentration, a little over a milligram of e-cigarette liquid would provide the same amount of nicotine absorption as a pack of cigarettes, though it might be as much as two milligrams for a low concentration. And if we're looking at total nicotine in the product, rather than absorption by the user, a single cigarette can contain more nicotine than a milligram of liquid—bearing in mind that one or two milligrams would suffice as a substitute for that pack of 20 cigarettes.

The difficulty in equalizing the tax, then, becomes clear. Notably, cigarette excise taxes don't try to distinguish between types of cigarettes, and excises on vapor haven't done so either, but clearly, any effort at equalizing the tax across traditional tobacco and vapor products would prove highly subjective. Essentially, states opting to impose an excise tax on vapor products have to make that determination somewhat independently of the rate on cigarettes, though in these considerations, it is important to ask (1) whether the theories behind the taxation of cigarettes suggest that taxes on e-cigarettes should be lighter, and (2) whether traditional justifications of a specific excise tax on a product hold up for e-cigarettes.

Generally, excise taxes conform in some way to the benefits test, or to matters of negative externalities. This is why they tend not to be *ad valorem* taxes: the costs to society are not pegged to price. Most gas taxes, for instance, are excise taxes, because the costs imposed by driving—both in terms of wear-and-tear to infrastructure and creating congestion—are largely independent of the cost of a gallon of gasoline. The same holds true for tobacco products: if we conclude that smoking a cigarette imposes societal costs or is otherwise something government ought to discourage, then the sale price really doesn't matter. The societal costs are the same whether a pack of cigarettes sells for $2 or $5.

This logic has been fairly consistently applied across the states in imposing excise taxes on cigarettes, but the consistency vanishes with taxes on other tobacco products. Smokeless tobacco is often subject to *ad valorem* taxes rather than a per-unit tax. That's what West Virginia does, imposing a tax of 7 percent of the wholesale price of these products, and among neighboring states, Virginia, Maryland, and Ohio do likewise, at rates of 10, 15, and 17 percent respectively. Kentucky, by contrast, imposes a 9.5 cent per unit excise, and Pennsylvania does not impose a special tax on smokeless tobacco products at all.

Overall, 41 states impose *ad valorem* taxes on chewing tobacco, while only six impose an excise tax. Similar margins hold for snuff and cigar taxes, with many states adopting a single regime for all three product categories. States imposing excise taxes typically do so per ounce of tobacco product and per ten cigars, though some impose an excise per unit, with a unit defined as, for instance, a can of no more than 1.5 ounces.[9]

If the rationale for unique taxes on tobacco and related products is to discourage consumption by making it more expensive, or to pay for the public health costs tobacco use imposes, excise taxes—for cigarettes as well as smokeless tobacco products—would seem the obvious choice, since the societal costs are not correlated with sales prices. If these policy rationales are not the basis of the state's tobacco taxes, then it is important to ask what that goal is. If these taxes are merely seen as a revenue source, without regard to any unique tobacco-related policy considerations, then the selection of one product over another would appears arbitrary, and it may be worth noting the regressive nature of such taxes. Presumably these taxes *were* intended, at least in part, to internalize

[9] This paragraph was not included in remarks as delivered, but was added subsequently, responsive to questions posed by the committee.

the societal costs of tobacco use—in which case, ideally, the tax on smokeless tobacco would be an excise tax, just like the tax on cigarettes.[10]

Minnesota and Washington, D.C. impose an *ad valorem* tax on e-cigarettes, and similar legislation has been introduced in other states. With vapor products, *ad valorem* taxes are particularly problematic, because the product varies so greatly. Some vapor products are single-use, while others are rechargeable and refillable. An *ad valorem* tax hits disposable e-cigarettes harder than a specific tax, since disposables typically contain less fluid, and also because the tax is assessed on both the fluid and the delivery mechanism. It is difficult to imagine a compelling policy rationale for this disparate treatment. Neutrality is an important principle of taxation, one we talk about a lot at the Tax Foundation, and for all tobacco and tobacco-related products, neutrality is best achieved through excises, not *ad valorem* taxation.

There is a strong case to be made against the idea of imposing a new, specific tax on vapor products at all, since, from a public health standpoint, these products—often utilized as a substitute for traditional cigarettes—are widely held to produce less adverse health outcomes, and therefore impose lower societal costs, than cigarettes. Whatever policy the state adopts, however, it is important to ensure that the theory and incidence of taxation align.

---

[10] *See, e.g.,* Gerald Prante, *What Is Proper Tax Policy for Smokeless Tobacco Products?* TAX FOUNDATION FISCAL FACT NO. 120, Mar. 26, 2008, http://taxfoundation.org/article/what-proper-tax-policy-smokeless-tobacco-products-0.