



LIFT Perspective

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Cigarette Taxes: Phase-In the Dollar per Pack Tax Increase

House Bill 5 (Hamric, 79S3) calls for increasing cigarette taxes by a dollar to \$1.41 per pack effective September 1, 2006. While consumption taxes are preferable over other forms of taxation (largely due to their transparency), the proposed increase in cigarette taxes tests the limits of an otherwise agreeable form of taxation by too rapidly increasing the rate. While a dollar per pack increase in cigarette taxes may be justifiable, an immediate increase of that magnitude will have negative effects on the market. Instead, the steep rate increase (243% above current taxes) should be phased-in over the course of three years.

An immediate 243% increase in cigarette taxes potentially opens Texas as a market for smugglers who could stand to make millions by illegally importing cigarettes. For example, New York state taxes cigarettes at a \$1.50 per pack and allows cities to levy their own taxes. New York City levies an additional \$1.50 per pack for a combined state and local rate of \$3 per pack cigarette tax in the City. In the four months following the city's steep tax hike in 2002 (from \$.08 to \$1.50), sales of cigarettes dropped by 50%. While legal and taxable sales slumped, New York City's black market for cigarettes thrived, as did organized crime (Source: CATO Institute 2003).

Legislators should read two lessons into New York City's cigarette tax experience: first, a steep increase in cigarette taxes can lead to a drop in taxable sales, impacting revenues to the state; second, a dollar per pack tax increase on cigarettes could drive Texans across state borders to purchase cheaper cigarettes, again impacting state revenue. Given the excessive nature of the proposed increase (243%), coupled with the per pack tax rates of our neighboring states, a black market for cigarettes could develop in Texas as it did in New York City.

While New York City's large scale smuggling may be an extreme example, a steep and immediate increase in cigarette taxes, as HB 5 proposes, will readily lead to increased cross-border purchases. Of the four bordering states, Texas currently has the second lowest per pack tax rate on cigarettes:

<u>State</u>	<u>Per Pack Rate</u>
Oklahoma	\$1.03
New Mexico	\$.91
Arkansas	\$.59
Texas	\$.41 (proposed: \$1.41)
Louisiana	\$.34

Under House Bill 5, however, Texas will not only tax more per pack than all of our neighboring states, but by \$.38. To put the proposed, immediate cigarette tax increase into context, if HB 5 is enacted as filed, the difference between the Texas per pack tax rate and the next highest neighboring per pack tax rate (Oklahoma at \$1.03) will be greater than the rate of our lowest taxing neighbor (Louisiana at \$.34). Without a phase-in, Texas jumps from nearly the lowest taxing state in our area to the highest by far.

Under a phase-in plan, the Legislature could enact a \$.50 rate increase, effective September 1, 2006 so that total taxes per pack are \$.91. In 2007 and 2008, the Legislature can again increase cigarette taxes by \$.25. While taxes still reach \$1.41 per pack by 2008 under that plan, the shift is more gradual, giving consumers and retailer stores time to adjust. Additionally, once the tax increases to \$.91 per pack, subsequent increases are smaller.

Since consumption taxes are the most fair and transparent form of taxation, and since Texas currently taxes cigarettes at well below the national average rate of \$.80 per pack, raising cigarette taxes is a legitimate policy option to help resolve the school finance challenge. A drastic increase that takes effect all at once, however, should be avoided.