

- SUBJECT:** Increasing tax rates on cigarettes and other tobacco products
- COMMITTEE:** Ways and Means — favorable, without amendment
- VOTE:** 8 ayes — J. Keffer, Villarreal, Grusendorf, Luna, Paxton, Ritter, Smithee, Woolley
- 0 nays
- 1 absent — Edwards
- WITNESSES:** No public hearing.
- (Initial hearing on HB 5 as introduced:)*  
For — Larriann Curtis, Texas PTA; Jon R. Hornaday, American Cancer Society; Amit Khera, American Heart Association-Texas; Dick Lavine, Center for Public Policy Priorities; Ron Tully, Council of Independent Tobacco Manufacturers of America (CITMA)
- Against — Jason Moore, Permian Basin Citizen Watchdogs; William Orzecliowski, R.J. Reynolds Tobacco Co.; Peggy Venable, Americans for Prosperity; Shon Ross
- On — Kimberley Edwards, Judith M. Porras, Texas Public Finance Authority; Joe Ratcliff, Texas Grocery and Convenience Association
- BACKGROUND:** Texas levies three separate tobacco taxes — one on cigarettes, another on cigars, and a third on other tobacco products (OTP), including chewing/smoking tobacco and snuff. The cigarette tax rate is 41 cents per 20-count pack — \$20.50 per thousand for cigarettes weighing three pounds or less per thousand, plus an extra \$2.10 per thousand for those weighing three pounds or more per thousand. Cigars that weigh three pounds or less per thousand are taxed at 1 cent per 10, while cigars that weigh three pounds or more per thousand are taxed at \$7.50, \$11, or \$15 per thousand, depending on retail price and tobacco content. The OTP tax is 35.21 percent of factory price.
- Major exemptions include importation of small quantities (up to 200 cigarettes for personal use and small numbers of inexpensive cigars) as

well as Indian tribal and federal sales. Wholesale distributors must remit all three taxes. Cigars, cigarettes, and OTP also are subject to sales taxes — a 6.25 percent state tax and up to 2 percent local tax — and to federal excise taxes of 39 cents per pack on cigarettes and various rates, mostly by weight or quantity, for cigars and other tobacco products.

In fiscal 2006, the comptroller estimates that the state will collect \$492 million in revenue from total tobacco taxes. Of this amount, the cigarette tax is expected to generate \$426.1 million. After a 12 percent decrease in tobacco tax revenue from \$558.8 million in fiscal 2005 to \$492 million in fiscal 2006, tobacco taxes are expected to increase almost 12 percent to \$552.4 million in fiscal 2007, according to the Comptroller's Office. These taxes are expected to generate a total of slightly more than \$1 billion in fiscal 2006-07. After allocation of any administrative cost appropriations, 18.75 percent of the first 10 cents' worth of cigarette tax revenues on 20-count packs (and the first 20.5 cents' worth on larger packs) is allocated to the foundation school fund, with the remainder going into the general revenue fund.

Texas increased its cigarette tax rate for the ninth time in 1990 and also has raised cigar and OTP rates several times. As of January 1, 2006, Texas' cigarette tax rate ranked 40th among the 50 states and the District of Columbia. Rhode Island had the highest rate per pack at \$2.46, while South Carolina's 7-cent rate was the lowest. Rates per pack in states bordering Texas were 91 cents in New Mexico, \$1.03 in Oklahoma, 59 cents in Arkansas (plus a dealer enforcement/administration fee), and 36 cents in Louisiana. The U.S. median rate was 80 cents.

DIGEST: HB 5 would increase tax rates for cigarettes and other tobacco products, excluding cigars.

The cigarette tax rate would increase by \$1 to \$1.41 per pack. The OTP tax rate would rise from 35.21 percent to 40 percent of the manufacturer's list price.

The bill would take effect September 1, 2006.

SUPPORTERS SAY: By increasing taxes on cigarettes and other tobacco products, HB 5 would provide a reliable revenue stream while helping to reduce tobacco use, thereby saving lives and lowering health care costs. In tandem with HB 2

by Pitts, the bill would raise additional funds that would be dedicated to school property tax relief.

Tobacco taxes provide a reliable source of revenue that remains relatively unaffected by rate increases. Cigarette tax revenue in Texas has been declining on average only by about 0.7 percent per year since 1993, despite price hikes and base erosion at more than double that rate. Since 2002, more than 40 states have increased their tobacco tax rates, generating significant new revenue in each instance. When Alaska raised its cigarette tax by 71 cents per pack in 1997, revenue initially doubled and has remained steady at a much higher level over a five-year period. Revenue declines due to higher rates are gradual, predictable, and easily compensated for with small incremental rate hikes. The tax increase in HB 5 would raise about \$700 million in additional annual revenue, an estimate that accounts for existing declining usage trends, reduced consumption attributable to the rate increase, and tax avoidance behavior.

While tobacco is an addictive product that many customers will continue buying regardless of price hikes, tobacco taxes still are a self-assessing user fee on discretionary consumption. No one is forced to start smoking, and ample resources are available to smokers who wish to quit for health or economic reasons. Avoiding the tax is a matter of individual choice.

Taxing an activity does not mean condoning it. To the contrary, it often discourages inappropriate behavior or harmful activities. The state does not tax sales to penalize commerce, nor does it fine bad drivers to promote traffic violations. Because a certain segment of the population will use tobacco regardless of cost, the state is perfectly justified in taxing that activity and funding other state requirements with the proceeds.

Higher tobacco taxes would help the state recoup some of its tobacco-related health care costs by discouraging smoking among Texans, particularly among price-sensitive young people. For example, the American Cancer Society estimates that Texas eventually could save up to \$1 billion a year in Medicaid expenses and up to \$10 billion overall by raising the rate \$1 per pack. Tobacco tax revenue need not be dedicated to health care programs because under the Texas tobacco settlement, the tobacco industry already provides funding for this purpose.

Tax avoidance caused by higher tobacco prices in Texas would be short-lived and too small to offset the economic benefits of the rate increases.

The opportunity for consumers to buy cheaper cigarettes elsewhere is limited to small segments of the population living across the border from neighboring states and Mexico. It is unlikely that this activity would have any meaningful impact on tobacco-tax revenue collected in Texas.

HB 5 would not increase the tax rate on cigars because raising the cigar tax would produce relatively little revenue for school property tax relief.

OPPONENTS  
SAY:

Increasing tobacco taxes to raise additional state revenue would not be sound fiscal policy. Tobacco use, particularly smoking, already is declining, which has led to an average annual revenue decrease of 2 percent (inclusive of population growth), according to the Comptroller's Office. The Legislative Budget Board (LBB) projects that between fiscal 2009 and fiscal 2010 revenue from the tax would drop by more than \$96 million (13 percent). This estimate is based on a phenomenon known as "steepening avoidance," taking into account bootlegging and black market sales, in which higher costs gradually reduce discretionary consumption. Funding for important state priorities should not be dependent on a shrinking revenue source.

Estimates of new revenue that would be generated by a \$1 rate hike are inflated because the ratio used to correlate price and sales does not account for some recent factors that affect taxable consumption of cigarettes, including price hikes and Internet sales. As a result, Texas likely would collect much less per year than has been projected.

Increasing tobacco taxes to help pay for property tax reduction or general state services would amount to "tax profiling." It would force a narrow class of taxpayers to subsidize a public good to a greater degree than other taxpayers. Smokers already are taxed at the state and federal levels and through the tobacco settlement. In addition, cigarette taxes are regressive because they charge all smokers the same rate, regardless of ability to pay. A tax increase would disadvantage lower-income smokers, particularly young smokers, to a greater degree than higher-income smokers.

The state should not use objectionable and self-destructive behavior to fund important state priorities. To do so would be hypocritical and could send a message to Texas children that smoking is somehow to be encouraged.

A \$1-per-pack rate hike on cigarettes would be a 244 percent increase that would put Texas at a competitive disadvantage with regard to its neighboring states, all four of which would have substantially lower rates. It would increase black-market trade and encourage out-of-state shopping, especially on Indian reservations, in duty-free shops in Mexico, and over the Internet. Tax officials in Washington state report difficulty dealing with avoidance tactics resulting from its latest cigarette tax hike, a problem that Texas would experience even more acutely.

OTHER  
OPPONENTS  
SAY:

The principle of tax fairness dictates that any additional tobacco tax revenue should be dedicated to health care or anti-smoking programs, not to school property tax reduction or general revenue. A tax increase of \$1 per pack of cigarettes, for example, could generate enough revenue to restore funding cut from the Children's Health Insurance Program and Medicaid during past legislative sessions.

Instead of an immediate \$1 increase in the cigarette tax, HB 5 should phase in the tax over time. Implementing the new tax over a three-year period, as proposed in the version of HB 5 originally voted out of committee, would allow the state to increase the cigarette tax substantially while maintaining the future stability of this revenue stream. An immediate \$1 increase in the tobacco tax, by contrast, would lead to dramatic fluctuations in cigarette tax revenue and a more pronounced decline over the long term, factors that are undesirable for a revenue source that would pay for ongoing state spending priorities.

If the Legislature is going to increase the tax rate on cigarettes and OTPs, it should increase the tax rate on cigars as well. While higher cigar taxes might raise only a fraction of the amount that a higher cigarette tax would yield, raising the cigar tax at least would mitigate some of the revenue decline projected from raising other tobacco taxes. Those who buy cigars should have to contribute to school property tax relief the same as other tobacco users.

NOTES:

As originally reported from committee, HB 5 would have increased the cigarette tax rate in three annual stages to \$1.05 per pack by January 1, 2009. The state would have issued up to \$400 million in bonds, supported by a fee of 5 cents per pack to be paid by cigarette distributors and wholesalers. During House consideration of HB 5 on April 24, the House by 106-39 adopted an amendment by Rep. Smithee to restore the entire cigarette tax rate increase of \$1.00 in the first year of the new rate and

eliminate the bond authorization, as in the bill as filed. Rep. Coleman then successfully raised a point of order that the substitute was not germane to the original bill, and HB 5 was recommitted to the Ways and Means Committee, which reported the original bill without amendment.

According to the LBB, HB 5 would result in an increase of approximately \$678 million in general revenue-related funds in fiscal 2007 and an increase of \$1.4 billion in the fiscal 2008-09 biennium.

On April 24, the House passed HB 2 by Pitts, which would dedicate to school property tax reduction the revenue generated by any increase enacted during the third called session in cigarette or tobacco products taxes over current rates. HB 2 has been referred to the Senate Finance Committee, which has scheduled public hearings on the bill for Friday, Saturday, and Sunday.