

THE BOTTOM LINE

Taxes on cigarettes, liquor, beer, wine, soda, candy, gum and gambling are not a sustainable solution to the state's structural budget gap.

Modeling with the WRC/REMI model of the Washington economy indicates that a package of sin taxes generating \$783 million in the upcoming biennium would cost the state on the order of 3,000 jobs by 2010.

Wallowing in Sin Taxes

Although the St. Patrick's Day revenue forecast brought enough green to slice the state's budget shortfall by nearly a third, lawmakers still have a substantial gap to fill. Governor Christine Gregoire and legislative leaders have generally avoided discussion of increases in the state's major taxes – business, sales, business and occupation – there has been a palpable eagerness to increase so-called “sin taxes.” In her budget released today, Governor Gregoire combines cutbacks in proposed spending with new revenues – reinstating some of the estate tax and hiking cigarette taxes.

In his last budget proposal as governor, Gary Locke opened the bidding with a package that included new taxes on beer, liquor, wine, and soda pop. Since then, others have called for new taxes on cosmetic surgery and gambling, as well as substantial hikes in the cigarette tax.

With the probable exception of the Botox tax, these taxes are regressive, falling most heavily on lower income taxpayers. And they increase the state's fiscal instability. If lawmakers choose to rely on such narrow-based taxes to support the general fund, they will face a continuation of the recent pattern of shortfalls, program cuts, and budget legerdemain.

In this report, WashACE examines the problems associated with sin taxes, fund dedications and tax earmarking. With Gov. Gregoire's budget now before the Legislature and the public, lawmakers move into the final stages of budget development. As they go about their work, they should concentrate on long-term fiscal stability.

Again and again state policymakers have used one-time revenue fixes—securitization of tobacco revenues, pension funding assumptions, fund transfers, and reserves—to perpetuate the structural imbalance by extending spending trends that current revenues cannot sustain. This year, the legislature must confront the imbalances that create this pattern. A pattern of steadily increasing tax rates on declining tax bases will fail. Spending must be controlled.

EARMARKING: POLITICALLY POPULAR, FISCALLY DANGEROUS

In a political climate increasingly intolerant of tax hikes, the tendency has been for lawmakers to turn to earmarked excise taxes, often dedicated to popular programs. The public often supports the tactic. Indeed, Washington's last major cigarette hike came about through Initiative 773, which dedicated a 60-cent a pack increase to the state's Basic Health Plan, a program already heavily reliant on dedicated taxes.

The 1996 Washington Research Council report, “Too Much Earmarking, Dedicating Funds,” documented the folly of relying on tobacco

and alcohol taxes to support health care programs: “The increased reliance on ‘sin’ taxes ... assures future shortages. ... The major human services dedicated funds are failing to keep pace with program requirements, primarily as a result of their narrow funding bases.”

Similarly, the 1998 Washington Roundtable report, "Looking at the Whole Budget: Recommendations for the Use and Oversight of Dedicated Funds," advised the Legislature to restore the integrity of the budget process by reducing reliance on fund dedication and tax earmarking.

The same dangers can be foreseen if lawmakers resort to sin taxes to prop up the state general fund, which experiences severe cost pressures as a result of escalating health care costs. (WashACE 2005) Health care costs are increasing at the rate of about 10 percent a year. The long-term rate of general fund revenue growth is about 5 percent. And the tobacco and alcohol taxes supporting the Health Services Account increase at an annual rate of from one to two percent.

The mismatch results in a rolling fiscal crisis, which can only be averted by controlling spending: No mix of tax revenues can long keep pace with the trend in health care spending. A turn to sin taxes provides, at best, temporary relief. Worse, it allows spending growth to continue unabated, increasing the magnitude of the next shortfall and, therefore, the likelihood of larger general tax increases in the future.

SETTING THE SIN TAX TABLE

The most likely scenario for a substantial revenue hike this year involves combining an assortment of taxes, along the lines of the Locke proposal. In constructing our hypothetical package, we drew on the state revenue department’s list of revenue alternatives – a report routinely produced by the department in response to legislators’ requests for estimates of the general fund budget impact of various tax proposals. We supplemented this information with fiscal notes associated with proposed revenue legislation.

The package we analyze includes the following (the dollar amounts represent the estimated impact in 2005-2007):

- Extension of the sales tax to candy and gum - \$34 million
- A \$1.075 increase in the cigarette tax – \$189.3 million
- A 5 percent increase in the liquor sales tax - \$38.2 million
- A \$1 increase in the liquor liter tax - \$68.2 million
- Doubling of the beer excise tax (to \$16.16 per barrel) - \$64.8 million
- Doubling the wine excise tax - \$37.2 million
- A five-cent a can soft drink tax - \$300.6 million
- A 10 percent gambling tax - \$50.7 million

Together, the taxes generate \$783.0 million in the coming biennium. (Of this \$413.6 million comes in the second year of the biennium, FY 2007.) For our purposes, it makes no difference whether the money collected is deposited into the state general fund or placed into one or more dedicated accounts. Experience has shown that funds are frequently transferred between dedicated accounts and the general fund. As well, funds such as the Health Services Account have become “near general fund” accounts, funding services and programs that are closely allied with the general fund; shortfalls in these accounts add to the overall state budget obligation.

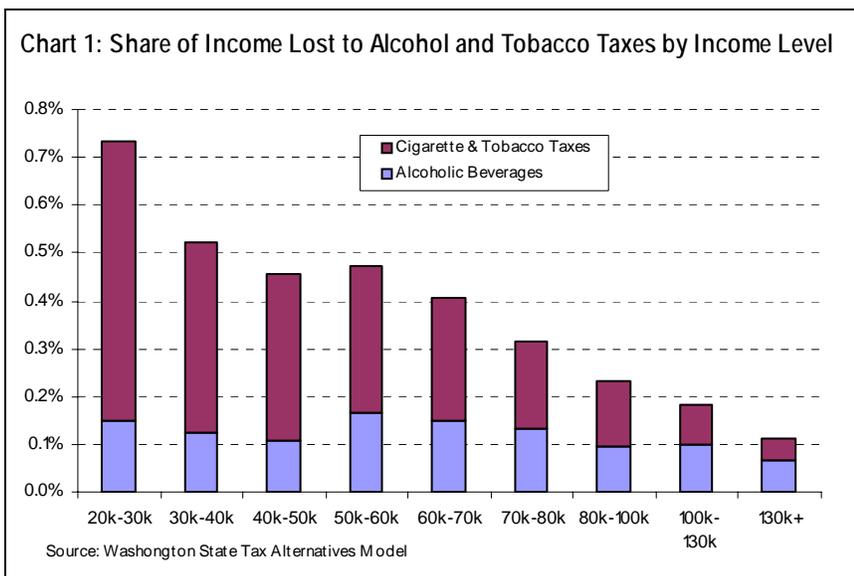
Candy and Gum. The sweet tooth tax has occasionally been mentioned by legislators, as it represents the low-hanging fruit of untaxed retail pur-

chases. It fits the bill of having some tenuous connection to health problems—primarily obesity—and taxing discretionary spending. Currently, candy, as a food item, is exempt from the sales tax. A bill to tax candy passed the state’s House of Representatives in 2003 and went no further. This year, a similar bill was introduced in the Senate.

Cigarettes. Washington’s tax of \$1.452 per pack ranks as the nation’s ninth highest (Federation of Tax Administrators). Oregon imposes a tax of \$1.18; Idaho, \$0.57. Various increases have been proposed, including HB 2075, which would lift the tax by \$1.075, taking it to \$2.50 per pack, the highest in the nation, four cents ahead of Rhode Island’s currently nation-leading \$2.46 and ten cents higher than New Jersey’s \$2.40. The money, as usual, would be earmarked for the health service account and youth tobacco prevention. Because of the peculiar interplay of existing cigarette tax dedications, the general fund loses some revenue as a result of the tax hike.

Liquor, Beer, and Wine. The Locke package has yet to be ruled out. The combination of increased alcohol taxes is expected to generate just over \$204 million for the 2005-2007 budget. Washington has always taxed alcoholic beverages heavily. The revenue department, noting that Washington is one of eighteen states that do not allow privately-owned wholesale and retail outlets, reports that liquor taxes have typically been among the highest in the nation – third highest, according to a 2002 study produced by a national trade group. Wine taxes similarly are among the nation’s highest and the beer tax is well above the median. And, of course, the sales tax also applies to these purchases.

Soft Drinks. A tax of a nickel a can, estimated to raise about \$300 million for the biennium, provided about half of the new revenue in the Locke budget proposal.



Gambling. Currently, only local government may tax card rooms, up to a maximum of 20 percent of gross revenues. Legislation introduced this session would subject these businesses to a 10 percent state tax.

ALCOHOL AND TOBACCO TAXES HIT LOW INCOME HARDEST

Taxes on alcohol (beer, wine, liquor) and tobacco fall most heavily on low income taxpayers. The 2004 version of the Washington State Tax Alternatives Model, used by policymakers to determine the effects of various changes to the state tax structure, makes the case. The model uses a consumer expenditure survey to determine how taxpayers at different income levels spend their money, then calculates the tax burden associated with such spending.

As Chart 1 shows, lower income taxpayers pay a higher proportion of their income in taxes on alcohol and tobacco products than do high income taxpayers. The difference is not trivial. For taxpayers earning between \$20,000 and \$30,000 these sin taxes amount to 0.7 percent of their income and 7.8 percent of their total tax burden. (Note: WashACE disre-

gards the results for taxpayers earning less than \$20,000 because of concerns with the quality and interpretation of the data for that complex mix of taxpayers. Were we to include that group, the degree of regressivity would appear to be much greater.) At the higher end of the income spectrum, taxpayers earning more than \$130,000 pay just 0.2 percent of their income in alcohol and tobacco taxes, which amount to 3.5 percent of their total tax obligation. The share of the sin tax burden represented by tobacco products, including cigarettes, declines as income increases.

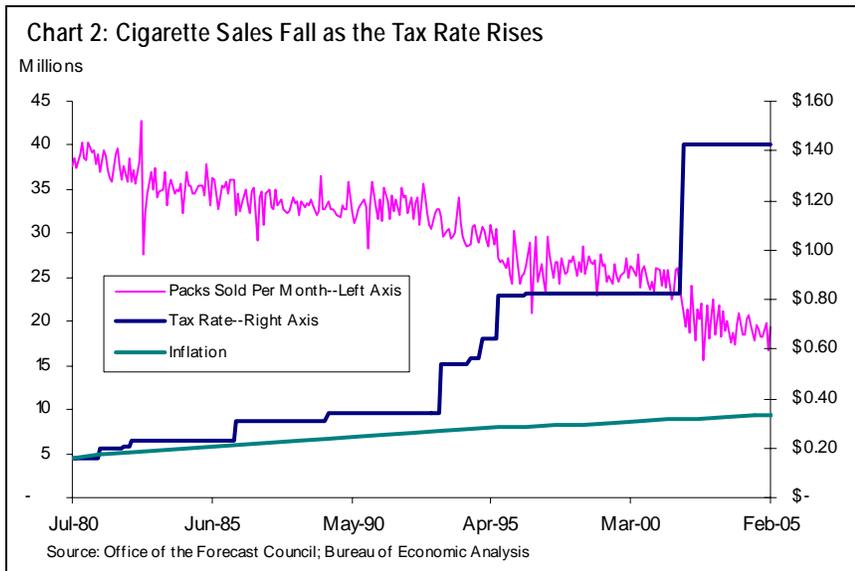
MAJOR SIN TAX BASES GROW SLOWLY

Over time, as society becomes wealthier, the share of income spent on food, alcohol and tobacco falls. This pattern is visible in the data on national consumption expenditures collected by the U.S. Department of Commerce's Bureau of Economic Analysis (BEA). Foods other than alcoholic beverages (the consumption category that includes soda pop, candy and chewing gum) were 21.6 percent of consumption expenditures in 1960 and 12.3 percent in 2004. Alcoholic beverages were 3.2 percent of expenditures in 1960 and 1.6 percent in 2004. Expenditures on cigarettes and other tobacco products were 2.1 percent of expenditures in 1960 and 1.1 percent in 2004.

Experience with the state's existing taxes on tobacco and alcoholic beverages conforms to this pattern.

The sin tax paradox – seeking to raise money from behaviors the tax discourages – eventually catches up with revenue-hungry policymakers.

Cigarette taxes. Extraordinarily high cigarette taxes, coupled with tobacco cessation messages and a health-conscious population, have led to steady declines in smoking. Furthermore, tax evasion is common. Consumers dodge the tax by purchasing at tribal smoke shops, crossing the border to neighboring states, or through Internet or mail order shopping. The higher the tax, the greater the incentive to evade it.



In 1980, the Washington State tax on a pack of cigarettes was 16 cents and monthly sales averaged nearly 40 million packs, 800 million cigarettes, 10 packs per month for each of the state's 4.1 million residents. By 2005, the tax had risen to \$1.425 and monthly consumption had fallen below 20 million packs. Population had increased to 6.2 million, so sales are now only three packs a month for each state resident.

Chart 2 shows seasonally adjusted monthly sales for the period July 1980 through February 2005, as well as the cigarette tax rate and the 16 cent 1980 rate indexed to inflation. Over this 26-year period, the legislature increased

the cigarette tax 10 times, while an 11th increase came through a citizen initiative (Initiative 773, approved in November 2001). Over the period, sales trended downward, with the rapid drops occurring at times of large tax rate increases (1993-1995 and 2002). Had the 1980 rate of 16 cents per pack been indexed to the rate of inflation (measured by the implicit price deflator for personal consumption expenditures) the rate would be 34 cents

today, rather than \$1.425. The real cigarette tax rate has quadrupled since 1980.

Chart 3: Cigarette Tax Revenue and State Personal Income

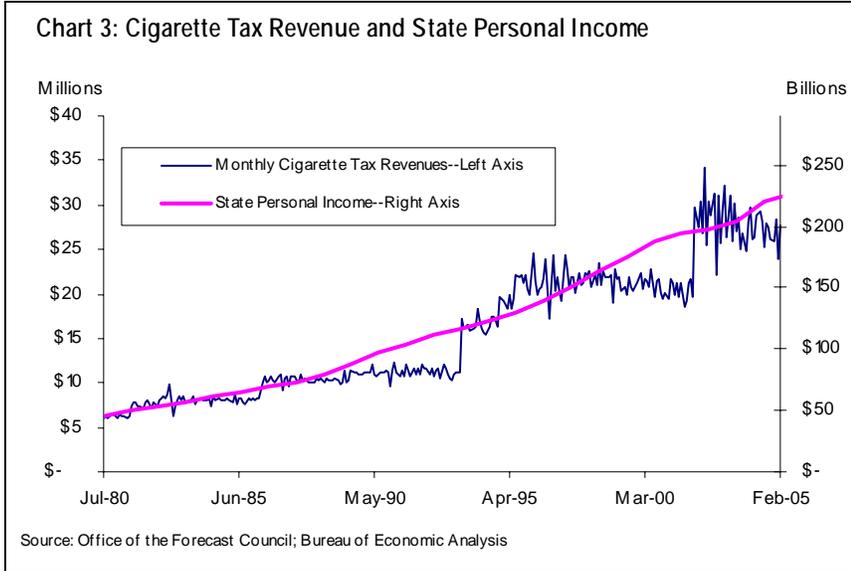


Chart 3 shows monthly revenues from the cigarette tax. With the underlying downward trend in cigarette sales, revenue from the tax tends to fall over time. (DOR estimates that cigarette consumption in the state is falling by 2.6 percent per year.) It is only the periodic large hikes in the tax rate that has allowed revenue from the tax to keep up with personal income. Such growth rates in cigarette tax revenue are not sustainable, however.

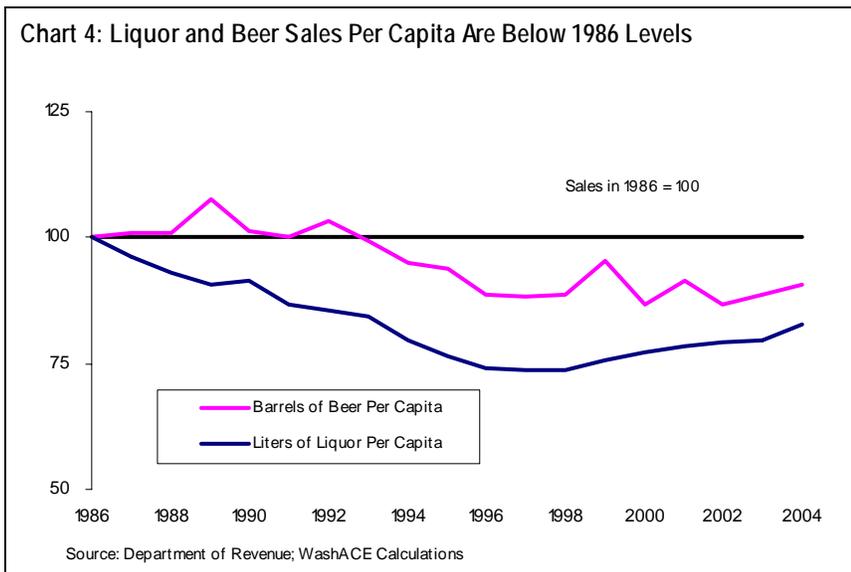
Sales of cigarettes fall as the tax rate rises both because smokers smoke less as the price of cigarettes goes up and because the higher tax rates increase the number of smokers who travel to

tribal smoke shops or to stores in Oregon or Idaho, or purchase over the Internet in order to evade the tax. Economists measure the influence of changes in price on sales with the concept of elasticity, defined as the percent decrease in sales that results from a one percent increase in price. Analysts with the department of revenue believe that the elasticity varies according to the size of the tax increase--with large increases having much greater proportional impacts on sales than small increases--because large tax increases encourage tax avoidance.

Currently DOR estimates that around 30 percent of cigarette consumption escapes taxation. The revenue loss from this in the 2003 fiscal year was roughly \$220 million. At a tax rate of \$2.50, the share of consumption evading taxation could approach 50 percent.

Alcoholic beverages. The consumption of alcoholic beverages has grown slowly in Washington in recent years.

Chart 4: Liquor and Beer Sales Per Capita Are Below 1986 Levels



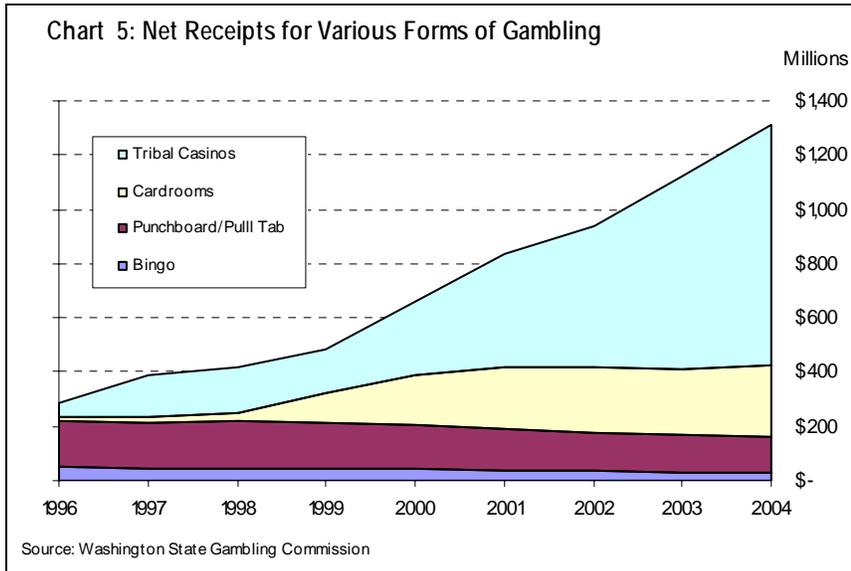
From the receipts of the liquor and the beer taxes we can calculate measures of the quantities sold for each class of beverage. Since 1986, sales of each have lagged the growth in state population (See Chart 4). For liquor, per capita sales fell 25 percent from 1986 to 1996; from 1996 to 2004 it recouped about one third of this loss. Annual per capita consumption was 5.9 liters in fiscal year 1986 and 4.9 liters in FY 2004. For beer, per capita annual consumption fell from 169 pints to 154 pints over the 18-year period.

It is not possible to extract a similar quantity measure for wine sales from published tax revenues because stan-

dard wines, fortified wines, and apple and pear wines (cider) are subject to different tax rates. However, wine tax revenues per capita have fallen from

\$3.07 in FY 1986 to \$2.88 in FY 2004, which strongly suggests that per capita consumption of this alcoholic beverage has also fallen.

Gambling. Up until the early 1990s punchboards, pull tabs and bingo were the primary forms of gaming in the state (other than the state lottery). This changed with the introduction of tribal casinos, and subsequent changes to state law that allowed social card rooms to offer “house-banked” games. The non-tribal house-banked card rooms, sometimes called mini-casinos, are limited to 15 tables and prohibited from offering slot machines.



The tribal sector has grown explosively (see Chart 5) and continues to grow. The non-tribal card room sector grew sharply from 1996 to 2001 but has since plateaued. Punchboards, pull tabs and bingo are declining.

Card rooms have faced stiff competition from tribal casinos, which have a competitive edge because of their larger size, ability to offer slot machines and tax advantages.

The fiscal note accompanying the proposed tax reports that the tax would affect 125 establishments, including 95 house-banked card rooms and 30 traditional poker rooms. Of the house-banked card rooms, 33 operated at a

net loss in 2003; the gambling commission projects an additional 24 would operate at a net loss when the tax is applied and that 20 would cease operations. In addition, eight poker rooms would close.

With continuing strong competition from the tribal casinos and the added burden of the state tax, growth in card room revenues, and growth in receipts to the state from the tax on those revenues will be weak to negative.

ECONOMIC IMPACT OF THE PACKAGE

We have used the Washington Research Council/Regional Economic Modeling, Inc. (WRC/REMI) model of the Washington economy to simulate the impact of this package of taxes on the state economy. The model is constructed on a calendar year basis. We model the tax package raising \$413.6 million in 2006 and every year thereafter.

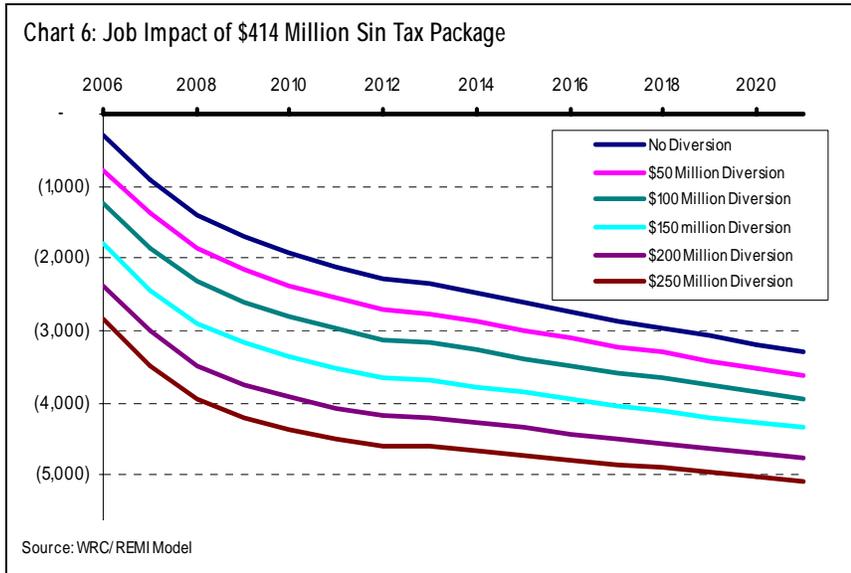
The taxes influence the economy through four main channels. First, the taxes effectively reduce household income by the amount of revenue raised. In response, households reduce consumption purchases. Second, households divert consumption purchases to out-of-state retailers. Third, the higher prices of the taxed commodities raise the cost of living in the state. Fourth, government uses the tax revenues to pay salaries, and buy goods and services. The first three impacts reduce employment, while the fourth increases it.

The second of these impacts (diversion of sales to out of state) is the hardest estimate. We know that taxes drive purchases out of state. John Beck, Professor of Economics at Gonzaga University and member of the recent Washington State Tax Structure Study Committee (chaired by Bill Gates, Sr.), estimates that taxable retail sales would be 22 percent higher in the 14 Washington counties that border Oregon and Idaho if those states levied

sales taxes at the Washington state rate (Washington State Tax Structure study Committee 2003, page 147).

Very high tax rates on specific commodities present a special problem. Retailers worry not just about losing sales on the highly taxed goods. An individual driving to a grocery store in Idaho in order to save nearly \$40 on a couple of cartons of cigarettes might well do a full week's shopping once there.

When we simulate the tax package without allowing a diversion of sales to out-of-state retailers, we find that the package reduces employment in the state by only 300 in the first year. The job loss grows to 1,900 in 2010, and continues to grow thereafter. (See the curve labeled "no diversion" on Chart 6.)



In the initial year, the dominant effects are the changes in consumer spending and state government spending. Since the reduction in consumer spending is roughly equal to increase in government spending, these two impacts roughly cancel. (A simulation of the tax increases without the state spending increase shows a loss of 7,100 jobs in 2006. A simulation of the state spending increase without the tax increase shows a gain of 7,100 jobs in 2006.)

Over time, the job loss grows as the impact of the taxes on the cost of living is increasingly felt. The taxes initially raise the cost of living by 0.25 percent. Because of the higher cost of living, there is a reduction in the flow of jobs and workers to the state.

Chart 5 also shows employment affects under five alternate scenarios where sales are diverted to out-of-state retailers, at rates that vary from \$50 million per year to \$250 million per year. Each \$50 million in diverted sales costs the state economy 500 jobs, on average. In 2010, the simulation with \$50 million in diverted sales shows 2,370 jobs lost; the simulation with \$250 million in diverted sales shows 4,370 jobs lost.

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EARMARKING SIN TAXES

In the current budget environment, lawmakers may attempt to justify taxes on products they deem to have negative health effects in order to ease pressures on the state general fund. Beefing up dedicated health care accounts with these taxes reduces the need to provide a general fund subsidy to maintain health care services. Regardless, the costs of the programs to which the tax is being dedicated grow much faster than the revenues generated by the tax. The mismatch can be foreseen at the outset. Inevitably, the state will soon face yet another budget shortfall, and there will be renewed pressure to find a revenue solution to a spending problem.

As the Washington Research Council pointed out in its 1996 report, the National Conference of State Legislatures (NCSL) has long warned lawmakers

to be wary of fund dedications. In a 1995 report, the NCSL said flatly: "For most fiscal analysts and budget experts, there is little, if anything, to be said in favor of earmarking taxes."

More recently, NCSL analysts note that "a high quality revenue system minimizes the use of tax earmarking. ... State programs may be placed in jeopardy if they are funded solely by earmarked revenues because there is no guarantee of a consistent revenue stream (stability) nor of adequate on-going revenue (sufficiency)." (NCSL 2002) These are the precise problems experienced in the state's deficit-ridden Health Service Account.

RECAPITULATION

Taxes on cigarettes, liquor, beer, wine, soda, candy, gum and gambling are not a sustainable solution to the state's structural budget gap. They are also regressive.

Modeling with the WRC/REMI model of the Washington economy indicates that a package of sin taxes generating \$783 million in the upcoming biennium would cost the state on the order of 3,000 jobs by 2010. This reduction in employment is the result of the taxes' effect on the cost of living in the state and the diversion of purchases to out-of-state retailers.

As the legislature turns to constructing a budget for the 2005-2007 biennium, it must confront the structural imbalances within the system and avoid grabbing for another hodgepodge of one-time patches.

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