DESCRIPTION AND ANALYSIS OF REVENUE-RELATED PROVISIONS OF S. 1415 RELATING TO NATIONAL TOBACCO POLICY AS MODIFIED BY THE MANAGER'S AMENDMENT

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of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation ("the Joint Committee staff") provides a description and analysis of revenue-related provisions of S. 1415 (relating to national tobacco policy) as modified by the manager's amendment to the bill as reported by the Senate Committee on Commerce, Science, and Transportation ("the Commerce Committee").[2]

Part I of the document provides a brief description of present-law tobacco excise tax provisions and general trust fund provisions of the Internal Revenue Code (the "Code"). Part II is a description of revenue-related provisions of S. 1415. Part III is a discussion of issues related to estimates of the revenue effects and distributional analysis of the "payments" required under S. 1415.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description and Analysis of Revenue-Related Provisions of S. 1415 Relating to National Tobacco Policy as Modified by the Manager's Amendment* (JCX-45-98), June 3, 1998.

[2] S. 1415 ("National Tobacco Policy and Youth Smoking Reduction Act") was reported by the Senate Committee on Commerce, Science, and Transportation on May 1, 1998 (S. Rept. 105-180). The bill was modified on May 18, 1998 (*Congressional Record*, S5001) by a manager's amendment offered by the Majority Leader (Senate Amendment No. 2420), which is the subject of this document. (See *Congressional Record*, May 19, 1998, S5034-5084, for the text of the manager's amendment.) Unless otherwise noted, references in the text of this document to S. 1415 are to S. 1415 as modified by the manager's amendment.

I. PRESENT-LAW TAX AND TRUST FUND PROVISIONS

Excise taxes on tobacco products

Excise taxes are imposed on cigarettes, cigars, chewing tobacco and snuff, pipe tobacco, and cigarette papers and tubes (Code sec. 5701). In addition, tax will be extended to "roll-your-own tobacco" at the same rates as pipe tobacco, effective on January 1, 2000. These taxes are imposed upon removal of the taxable tobacco products by the manufacturer, or on importation into the United States.[3] The current tax rates are shown in the table below.

Tobacco product	*Tax rate*
Cigarettes:	
Small cigarettes[4]	\$ 12.00 per thousand (24 cents per pack of 20 cigarettes)
Large cigarettes	\$ 25.20 per thousand
Cigars:	
Small cigars	\$ 1.125 per thousand
Large cigars	12.75% of manufacturer's price, up to \$30 per thousand
Chewing tobacco	\$ 0.12 per pound (3/4 of one cent per one ounce container)
Snuff	\$ 0.36 per pound
Pipe tobacco	\$ 0.675 per pound
Cigarette papers	\$ 0.0075 per 50 papers
Cigarette tubes	\$ 0.15 per 50 tubes

Effective on January 1, 2000, the tax rate on small cigarettes is scheduled to increase by \$5 per thousand (to 34 cents per pack of 20 small cigarettes), and the tax rates on other taxable tobacco products are scheduled to increase by proportionate amounts. For example, this will increase the tax on chewing tobacco to 17 cents per pound (1.06 cents per one ounce container). Effective on January 1, 2002, a further increase of \$2.50 per thousand (to 39 cents per pack of 20 small cigarettes) is scheduled to become effective. Tax rates on other taxable tobacco products will increase proportionately on that date as well.

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[3] The term United States includes the 50 States and the District of Columbia.

[4] A significant majority of taxable cigarettes, and of taxable tobacco products, is small cigarettes.

Generally, excise taxes on tobacco products that are sold or distributed for sale during any semimonthly period must be paid by the 14th day after the last day of such semimonthly period. Late payment of tobacco excise taxes is subject to interest charges and penalties in the same manner as the late payment of other types of taxes. In addition, a failure to pay penalty equal to 5 percent of the tax due but unpaid is assessed under section 5761(b).

Revenues from the current tobacco products excise taxes are deposited in the General Fund of the Treasury.

Tobacco occupational excise tax

An annual excise tax of $1,000 per premise generally is imposed on manufacturers of tobacco products, manufacturers of cigarette papers and tubes, and export warehouse proprietors (Code sec. 5731). The occupational tax is $500 per premise for taxpayers with gross receipts less than $500,000. Revenues from the occupational tax are deposited in the General Fund of the Treasury.

Penalty excise taxes

In addition to excise taxes imposed primarily to raise revenue, the Code includes several excise taxes imposed as penalties for taking (or failing to take) certain required actions. Examples of these excise taxes include taxes on excess lobbying expenditures by charitable organizations, certain "self-dealing" activities by officers and others involved with private foundations, failures by private foundations to distribute required percentages of income, and numerous regulatory excise taxes imposed with respect to specified activities of qualified pension plans. Present law does not establish any underage smoking reduction goals or impose any penalty excise tax with respect to such goals.

Overview of Internal Revenue Code Trust Funds

Most Trust Funds that are financed with dedicated excise tax revenues are established in the Code (secs. 9501 et. seq.). Examples of these Trust Funds are the Airport and Airway Trust Fund, the Highway Trust Fund, the Black Lung Trust Fund, the Aquatic Resources Trust Fund, the Inland Waterways Trust Fund, the Hazardous Substance Superfund, the Leaking Underground Storage Tank Trust Fund, the Oil Spill Liability Trust Fund, and the Vaccine Injury Compensation Trust Fund. Each of these Trust Funds includes provisions dedicating specified revenues to the Trust Fund and provisions approving expenditure purposes of the Trust Fund (generally as those purposes are in effect on the date of enactment of specific authorizing legislation). The Code also contains general provisions relating to the management of these Trust Funds. Under present law, there is no Federal Tobacco Trust Fund.

II. DESCRIPTION OF REVENUE-RELATED PROVISIONS OF S. 1415 AS MODIFIED BY THE MANAGER'S AMENDMENT

Payments required of cigarette and smokeless tobacco manufacturers

In general

S. 1415 would provide for several types of payments to be made by cigarette and smokeless tobacco manufacturers. These include an initial payment of $10 billion, annual general tobacco industry payments estimated to total $161.3 billion through 2007, and "look-back assessments" that could result in an industry-wide surcharge of as much as $4.4 billion per year (before adjustment for inflation) and manufacturer-specific surcharges of $1,000 per underage smoker (before adjustment for inflation) to the extent targets in the reduction of underage smoking are not achieved.

Initial payment

S. 1415 would require a lump sum payment in the amount of $10 billion to be made to the National Tobacco Trust Fund ("Tobacco Trust Fund"), established by the bill, within 30 days of the date of compliance.[5] Liability for this amount is allocated between the five major cigarette and smokeless tobacco manufacturers who participated in the development of the Proposed Resolution to the National Tobacco Litigation, dated June 20, 1997. The allocation generally follows the relative capitalization of these manufacturers.[6] Interest on late payments would be assessed at an annual rate of prime plus 10 percent.[7]

Annual general tobacco industry payments

S. 1415 would require cigarette and smokeless tobacco manufacturers and importers to make annual payments to the Tobacco Trust Fund for each calendar year that begins after the due date of the initial payment in the following base amounts:

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[5] For revenue estimation purposes, the Joint Committee staff assumed that the initial payment will be due and paid within 30 days of the date of enactment. A technical correction is necessary to clarify this assumption.

[6] The specified payments are Phillip Morris Incorporated, $6.58 billion; Brown and Williamson Tobacco Corporation, $1.73 billion; Lorillard Tobacco Company, $710 million; R.J. Reynolds Tobacco Company, $660 million; and United States Tobacco Company, $320 million.

[7] The prime rate on June 2, 1998 was 8.5 percent, as reported by the *Wall Street Journal*. Assuming the prime rate does not change, late payment of any portion of the initial payment would be charged interest at an annual rate of 18.5 percent for the period it is delinquent.

Year	*Base amount* (billions of dollars)
1	14.4
2	15.4
3	17.7
4	21.4
5 and thereafter[8]	23.6

The base amount of each annual payment would be increased annually for inflation at a rate equal to the greater of 3 percent or the increase in the CPI, beginning with the sixth year after enactment. Beginning with calendar year 2002, the amount of each annual payment would be further adjusted, either up or down, to reflect changes in sales volume compared to 80 percent of sales volume in 1997.[9]

Liability for the annual general tobacco industry payment would be allocated among all manufacturers and importers in proportion to their share of tobacco products sold in the domestic market for the calendar year, as determined by the Secretary of the Health and Human Services ("HHS"). A manufacturer or importer's share of tobacco products sold in the domestic market is determined in terms of "adjusted units." In general, one pack of 20 cigarettes equals one adjusted unit, 1.2 ounces of moist snuff equals 0.75 adjusted units, and 3 ounces of any other smokeless tobacco product equals 0.35 adjusted units. In the case of a smokeless tobacco manufacturer that does not produce more than 200 million units, the first 150 million units would be counted at a 70-percent rate. No equivalent small cigarette manufacturer allowance is provided.

Under S. 1415, deposits toward the estimated amount of the annual general tobacco industry payment would be required to be made in three equal installments on March 1, June 1, and August 1 of the year to which the payment relates. Liability in excess of the amount so deposited would be due on March 1 of the following calendar year. Any excess deposits would be applied against deposits required in the following calendar year.[10] If, for example, S. 1415 were to be enacted in September of 1998, the first annual general tobacco industry payment

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[8] A technical correction may be necessary to clarify that the base amount for the sixth and subsequent calendar years beginning after the date of enactment is $23.6 billion.

[9] A technical correction may be necessary to clarify the operation of these adjustments.

[10] S. 1415 does not include a mechanism for the refund of overpaid deposits where no future liability for the general tobacco industry payment is anticipated. Such a situation could arise where a manufacturer or importer ceases all domestic sales or distribution activities. A technical correction may be necessary to clarify the availability of a refund in such a situation.

would be made with respect to 1999. Deposits toward the 1999 general tobacco industry payment would be due on March 1, 1999, June 1, 1999 and August 1, 1999, with reconciliation to take place on March 1, 2000. The manner in which each deposit would be made is not specified.

Deposits of estimated payments made after the due date would accrue interest at an annual rate of prime plus 10 percent.[11] In addition, a penalty could be assessed under section 406 of the bill if the manufacturer or importer failed to make a payment within 60 days of the due date of the payment. The penalty would be calculated in the same manner as the interest on late deposits. However, no penalty would be due if the failure to make the payment were due to reasonable cause and not to willful neglect and such failure were corrected during the 30-day period beginning on the first day that persons responsible for the payment knew, or should have known, that a deficiency existed.[12]

Any manufacturer that manufactures and distributes to consumers less than 3 percent of cigarettes in any calendar year, that had resolved tobacco-related civil actions with more than 25 States before 1998, and that provided to all other States the opportunity to enter into similar agreements would be exempt from making any annual payment. Only one manufacturer (The Liggett Group) would be able to meet these standards.

The annual general industry tobacco payments would be currently deductible as ordinary and necessary business expenses for Federal income tax purposes.

Look-back assessment

S. 1415 would provide that a look-back assessment in the form of an industry-wide nonattainment surcharge would be imposed on cigarette and smokeless tobacco manufacturers and importers if certain targets for the reduction of underage tobacco use are not met. The targets would be as follows:

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[11] It is assumed that appropriate safe harbor standards will be provided to allow cigarette and smokeless tobacco manufacturers and importers to determine the amount that is required to be deposited to avoid exposure to this interest charge.

[12] It is not clear whether the interest charge and the penalty are intended to be assessed separately. A technical correction may be necessary to clarify the application of these rules.

Year after enactment	*Reduction in underage use of cigarettes*	*Reduction in underage use of smokeless tobacco*
3 and 4	15%	12.5%
5 and 6	30%	25%
7, 8 and 9	50%	35%
10 and thereafter	60%	45%

In each case, the underage usage of the tobacco product would be measured by the results of a survey to be designed and conducted by the Secretary of HHS. The rate of reduction would be measured compared to the rate of usage in 1999.

The industry-wide nonattainment surcharge would be based on the number of percentage points by which the targeted reduction in underage use is not achieved. In the case of cigarettes, the assessment would be $80 million for each of the first 5 percentage points, $160 million for each of the next 5 percentage points, and $240 million for each percentage point in excess of 10, subject to an annual maximum surcharge of $4 billion. These amounts would be indexed for inflation occurring after 1998, beginning in the fourth year after enactment. The assessment would be allocated by HHS among the manufacturers and importers by market share. Any manufacturer or importer with less than 1 percent of market share would be exempt from payment unless HHS determined that such manufacturer's brands were used by underage individuals at a rate equal to or greater than the manufacturer's total market share. In the case of smokeless tobacco, the surcharge would be determined through a comparable procedure, with a annual maximum surcharge of $400 million.

S. 1415 also would establish a manufacturer-specific surcharge on individual manufacturers and importers whose brands account for more than one percent of the underage use of cigarettes or smokeless tobacco. If the reduction in sales of such a manufacturer or importer's brands did not separately meet the industry-wide underage use reduction targets, a manufacturer-specific surcharge of $1,000 per underage smoker in excess of the target also is assessed. The $1,000 amount would be adjusted for inflation occurring after 1998, beginning in the fourth year after enactment.[13]

The industry-wide nonattainment surcharge and any manufacturer-specific surcharges would be assessed by May 1 of the subsequent calendar year and would have to be paid by July 1 of the year in which it is assessed. HHS would be authorized to establish an annual interest rate

[13] Any increase resulting from this adjustment is rounded to the nearest $1,000.

of up to three times the prime rate for late payments.[14] Additional charges in an amount up to three times the surcharge could also be assessed for late payment of the surcharge.

S. 1415 specifically provides that both the industry-wide and manufacturer-specific surcharges are not deductible, as an ordinary and necessary business expense or otherwise, for Federal income tax purposes.

Establishment of National Tobacco Trust Fund

S. 1415 would establish the National Tobacco Trust Fund (the "Tobacco Trust Fund") in the Treasury. Amounts equal to the net revenues[15] from the initial payment, the annual general tobacco industry payments, and the look-back assessments (including any interest or penalties on such payments or assessments) would be deposited in the Tobacco Trust Fund. Amounts in the Tobacco Trust Fund could be spent for the purposes established in S. 1415, pursuant to appropriations Acts and the direct spending provisions of the bill.

The Tobacco Trust Fund would not be included in the Code. However, general administrative provisions applicable to Code Trust Funds would apply to the Tobacco Trust Fund, except that no interest would accrue on unspent balances in the Tobacco Trust Fund. As with Code Trust Funds, the Tobacco Trust Fund would not be permitted to borrow from the General Fund.

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[14] The prime rate is currently 8.5 percent. Assuming the prime rate does not change, the bill would authorize an annual rate of up to three times the 8.5 percent prime rate (that is, an annual rate of up to 25.5 percent) on the late payment of surcharge amounts.

[15] As used in S. 1415, the term "net revenues" means the excess of the amount of these payments received in the Treasury over the decrease in income and tobacco excise tax collections, and other offsets, resulting from such payments.

III. DISCUSSION OF ISSUES RELATED TO ESTIMATES OF THE REVENUE EFFECTS AND THE DISTRIBUTIONAL ANALYSIS OF THE "PAYMENTS" REQUIRED UNDER S. 1415 AS MODIFIED BY THE MANAGER'S AMENDMENT

A. Payments Are Taxes

S. 1415 would require the following payments to be made to the Federal Government:

(1) An initial payment from the five major manufacturers that participated in the development of the Proposed Resolution as specified in section 402(a) of S. 1415;

(2) Annual general tobacco industry payments assessed on cigarette and smokeless tobacco manufacturers and importers as specified in section 402(b) of S. 1415; and

(3) Industry-wide and manufacturer-specific look-back assessments for failure to reduce underage smoking as specified in section 204 of S. 1415.

The Joint Committee staff view is that the above tobacco industry payments in S. 1415 represent revenues to the Federal Government that are in the nature of taxes. The Joint Committee staff believes this is the proper classification because the payments are mandated by Federal law, are to be deposited into a new Trust Fund within the Treasury of the United States, and are to be expended for purposes established by Federal law. These mandatory payments can not properly be classified as "user fees" because they would not be commensurate with, or intended to compensate for, the cost of providing services to the payors.

The annual general tobacco industry payments are equivalent to excise taxes on cigarettes and smokeless tobacco products. The amount of present-law excise taxes that a manufacturer or importer pays is determined by the volume of cigarettes or smokeless tobacco sold. The proposed payments likewise are mandatory amounts determined by the volume of cigarettes or smokeless tobacco sold by each manufacturer or importer.

The look-back assessments are equivalent to a nondeductible penalty excise tax on cigarette and smokeless tobacco manufacturers. The look-back assessments represent a mandatory charge for industry failures to meet prescribed goals. In addition, as with the present-law tobacco excise taxes, the amount of the look-back assessments are determined by reference to the sales volume of the tobacco manufacturer. The look-back assessments closely resemble penalty and regulatory excise taxes currently in the Code. Examples of such taxes include penalty excise taxes on excess lobbying expenditures by charitable organizations and specified activities of qualified pension plans, and regulatory excise taxes on certain wagering transactions and the manufacture of "explosive devices."

B. Issues Related to the Estimated Revenue Effects of S. 1415

1. Estimated revenue and price effects of S. 1415

Table 1 presents the Joint Committee staff revenue estimates of the initial and annual industry payments and look-back provisions of S. 1415. Table 1 also presents estimates of the price of cigarettes under the CBO baseline and under S. 1415. Table 1 also presents an estimate of the general industry payments on a "payment per pack" basis for the period 1999 through 2007. These payments per pack are the equivalent of an excise tax equal to these amounts.

The Joint Committee staff estimates embody a number of assumptions regarding changes in producer pricing decisions, consumer behavior, the possibility of a black market in tobacco products, and other changes in the market for tobacco products. The estimates, made in consultation with the Congressional Budget Office ("CBO"), also account for restrictions on marketing and sales of tobacco products that would be imposed by S. 1415. The subsequent two sections discuss the assumptions and analysis upon which these estimates are based.

TABLE 1.
SUMMARY OF ESTIMATED NET REVENUE EFFECTS AND PRICE EFFECTS UNDER S. 1415, AS MODIFIED BY THE MANGER'S AMENDMENT

Fiscal Years 1998 - 2007

[Billions of Dollars]

Provision	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-07
Estimated Net Revenue Effects											
1. Net Federal revenues from S. 1415 general tobacco industry payments (JCT May 19, 1998 estimate)	---	15.4	11.0	12.5	12.8	13.2	13.8	14.3	14.8	15.4	123.2
2. Net look-back assessment [1]	---	---	---	---	---	---	1.0	0.6	4.0	3.1	8.7
Total	---	**15.4**	**11.0**	**12.5**	**12.8**	**13.2**	**14.8**	**14.9**	**18.8**	**18.5**	**131.8**
Estimated Price and Industry Payments Per Pack [2]											
1. Price per pack under:											
a. Present-law Congressional Budget Office baseline	---	$2.14	$2.40	$2.43	$2.69	$2.75	$2.89	$2.99	$3.09	$3.19	
b. S. 1415, after manager's amendment, with look-back provisions	---	$2.88	$3.24	$3.41	$3.68	$3.83	$4.06	$4.12	$4.78	$4.84	
2. General tobacco industry payments per pack, without regard to look-back provision	---	$0.76	$0.89	$1.06	$1.13	$1.24	$1.28	$1.32	$1.36	$1.40	

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NOTE: Details may not add to totals due to rounding.

[1] This net revenue reflects the effect of reduced excise tax receipts because of the assumption that the look-back assessments are passed through in the price of tobacco products.

[2] Price difference between the baseline and S. 1415, after manager's amendment, differs from the general industry payments per pack for several reasons: (1) effect of superseding future State-by-State settlements; and (2) other factors such as present law increases in excise tax rates, youth look-back penalties, and induced changes in retail price markups and in State excise taxes. Prices are presented on a calendar year basis.

2. Changes in producer and consumer behavior

Consumer response to higher tobacco prices

The Joint Committee staff estimates assume that the general tobacco industry payments are passed through to the consumer in higher prices for tobacco products. Higher prices for tobacco products would have the effect of discouraging some individuals who currently are not users of tobacco products from choosing to use tobacco products and encouraging some individuals who currently use tobacco products to reduce their use of tobacco products or to quit using such products altogether. In addition, S. 1415 would establish limitations on the advertising and sale of tobacco products and provide for certain smoking cessation programs. These provisions of the bill also would be expected to limit the consumption of tobacco in addition to the effects of increased prices. For example, Table 2 below shows the Joint Committee staff estimates of the reduction in the percentage of the adult population that smokes cigarettes that would result from the enactment of S. 1415. Currently, approximately 22 percent, or 43 million, of the 196 million residents of the United States age 18 or over smokes on a regular basis. The incidence of adult smoking has declined over the past three decades, and is estimated to decline further in the absence of the enactment of S. 1415. As Table 2 shows, the Joint Committee staff estimates that S. 1415 would cause this percentage to decline further by nearly four percentage points by 2006-2007. This represents approximately a 20-percent decline in the incidence of adult smoking.

Table 2. Estimated Incidence of the Adult Population that Smokes Cigarettes Under Present Law and Under S. 1415, 1999-2007

(percent)

	1999	2000	2001	2002	2003	2004	2005	2006	2007
Present law incidence	21.8	21.1	20.9	20.4	20.1	19.7	19.3	18.9	18.4
Incidence under S.1415	20.2	19.1	18.4	17.5	16.8	16.3	16.0	15.0	14.7

Source: Joint Committee on Taxation

As noted above, total consumption of cigarettes falls in response to higher prices as fewer individuals smoke and as those who continue to smoke reduce their consumption. Table 3 below combines these two effects. Table 3 shows the Joint Committee staff estimates of the reduction in "legal" cigarette consumption (in billions of packs of cigarettes) that would result from the enactment of S. 1415.[16] This table overstates the extent to which actual consumption decreases because, as discussed below, some consumers will be able to purchase cigarettes and other tobacco products on the black market. Table 3 presents estimates of the consumption of legally acquired tobacco products.

Table 3. Estimated Total Packs of Cigarettes Consumed (Excluding Illegally Acquired Packs) Under Present Law and Under S. 1415, 1999-2007

(billions of packs)

	1999	2000	2001	2002	2003	2004	2005	2006	2007
Present law consumption	23.0	22.0	22.1	21.3	21.3	20.8	20.6	20.3	19.9
Consumption under S. 1415	19.0	17.4	16.7	15.6	15.0	14.4	14.3	12.4	12.3
Change (percent)	-17.3%	-21.0%	-24.4%	-26.8%	-29.8%	-31.0%	-30.6%	-39.1%	-38.2%

Source: Joint Committee on Taxation

[16] In addition to the effects of increased prices, these estimates of total consumption, as discussed below, include non-price effects on the incidence of tobacco use that are expected to result from the enactment of S. 1415. For example, S. 1415 would fund smoking cessation programs and provide for restrictions on the advertising and sale of tobacco products.

The Joint Committee staff estimates are based on empirical analysis of consumer demand in response to past tax changes, other price changes, changes in the regulation of tobacco products, and demographic trends that may affect the market for tobacco products. While all estimates involve uncertainty, it is important to note that there is additional uncertainty to these estimates because the pricing changes contemplated by S. 1415 are substantially greater than any price changes previously observed in the domestic market for tobacco products.[17] Generally, there is more uncertainty to estimates of consumer demand that are based on prices far outside the range of those previously observed.

Effects on the demand for tobacco products by underage consumers

S. 1415 would establish goals for reductions in the number of underage consumers reporting having used tobacco products within the past 30 days. Beginning after 2000, tobacco use by underage consumers would be compared to tobacco use by underage consumers in 1999 and penalties would be assessed if certain goals are not met. The look-back assessments relating to underage tobacco use require estimates of the reduction in tobacco use by underage consumers. The CBO projects that the combination of price increases and other restrictions in S. 1415 will lead to a reduction in underage smoking by the year 2001 greater than the 15-percent reduction standard required by S. 1415 to avoid penalty. However, the CBO estimates that reductions in underage smoking will fall short of the 30-percent reduction target for 2003 and also will fall short of the subsequent target of reductions in underage smoking of 50 percent in 2005 through 2007. The Joint Committee staff estimates therefore assume that cigarette manufacturers will be subject to the look-back assessments beginning in 2004 and thereafter for the failure to meet the target reductions in the incidence of underage smoking in 2003 and subsequent years. These payments would further increase the price of cigarettes leading to a further reduction in the demand for cigarettes. The Joint Committee staff also estimates that look-back assessments would apply to manufacturers of other tobacco products beginning in 2004.

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[17] Analysis of demand in foreign markets may be of limited usefulness in assessing the response of domestic demand to changes in domestic prices. For example, the in the late 1980s, cigarette excise taxes as a percentage of the price of cigarettes in the United Kingdom were twice that of the United States, yet the incidence of smoking in the United Kingdom exceeded that of the United States. See, Joint Committee on Taxation, *Description and Analysis of Title VII of H.R. 3600, S. 1757, and S. 1775 ("Health Security Act")* (JCS-20-93), December 20, 1993, pp. 16-17.

The possibility of black market activity

The Joint Committee staff estimates assume that the increased retail price of tobacco products relative to their wholesale cost and relative to retail and wholesale prices available outside the United States would create an incentive for some individuals to engage in illegal trade in tobacco products. While S. 1415 contemplates a rigorous registration system for manufacturers, importers, wholesalers, and retailers of tobacco products, no such system can be immune to illegal trafficking. The Joint Committee staff estimates that illegal sales of tobacco products would account for nearly 5 percent of domestic consumption in the years following enactment and that as the look-back assessments further increase the price of tobacco products, illegal sales would represent approximately 7.5 percent of domestic consumption. The Joint Committee staff accounts for this illegal activity in its estimates of net revenues to be received by the Federal Government under S. 1415.

The wholesale market for tobacco products

There is evidence that, in the past, increases in taxes or manufacturers' costs have resulted in greater than one-to-one increases in retail prices. This may be the result of various factors including non-competitive market behavior, rule of thumb mark-up pricing, increased inventory carrying costs from increases in taxes or manufacturers' prices, and increased State excise taxes on tobacco products. As a part of its estimates, the Joint Committee staff assumed that retail prices would increase by an amount in excess of the per-product share of the various payments imposed under S. 1415. This additional increase in the price of tobacco products would further reduce demand for tobacco products which would reduce subsequent tobacco excise tax receipts and annual payments required under the bill when they are adjusted for future sales volumes.

3. Technical differences between the gross payments prescribed in S. 1415 and net receipts received by the Treasury

Gross payments provided under S. 1415

The amounts of the general tobacco industry payments stated in section 402 of S. 1415 are *gross* payments due annually from the tobacco industry. In contrast, the amounts shown in the Joint Committee staff revenue estimates (in Table 1) represent the *net* revenue effects of the general tobacco industry payments. Table 4, on page 19 below, and the following discussion present a reconciliation of the difference between the gross payment amounts provided under S. 1415 and the net revenue amounts estimated by the Joint Committee staff.

First, beginning in 2004, the adjusted base payment would be indexed by the greater of 3 percent or the annual increase in the CPI. Throughout the period 1998 through 2007, the CBO baseline projects an annual inflation rate of less than 3.0 percent. Therefore, the Joint Committee staff assumed an annual "inflation adjustment" of 3.0 percent. The stated initial and base payments in section 402 of S. 1415, incorporating the inflation adjustments, total $204.2 billion for calendar years 1998 through 2007 (assuming the legislation is signed into law on October 1, 1998). (Line I.1. of Table 4)

Beginning in 2002, the base payment would be adjusted for changes in the volume of domestic sales by multiplying the base payment amount by the ratio of the actual volume for the calendar year to 80 percent of the volume in calendar year 1997. Because of the increased prices of tobacco products, the other restrictions on tobacco sales, and the programs designed to reduce tobacco use provided by S. 1415, the Joint Committee staff estimates that total volume in 2002 and beyond would be less than 80 percent of 1997 volumes. Under the bill, this reduces the annual payment for years 2002 and beyond. The Joint Committee staff estimates that the volume adjustments applied to these payments would reduce required payments by $32.8 billion for calendar years 1998 through 2007. (Line I.2. of Table 4)

The resulting gross calendar year payments are $171.3 billion for calendar years 1998 through 2007. (Line I.3. of Table 4)

The remaining differences between the gross payment amounts provided under S. 1415 and the net revenue amounts estimated by the Joint Committee staff stem from the following adjustments, which are described more fully below:

(1) Timing of the general tobacco industry payments (calendar year v. fiscal year);
(2) Estimated change in net revenues from Federal income and payroll taxes;
(3) Estimated change in net revenues from Federal tobacco excise taxes; and
(4) Estimated change in net revenues relating to State-by-State tobacco settlements.

Timing of the general tobacco industry payments

Joint Committee staff revenue estimates are prepared for Federal fiscal years (instead of calendar years), and assume that actual receipts to the Treasury are delayed somewhat relative to their stated due dates. As a result, the Joint Committee staff estimates assume approximately $5.1 billion of the payments due in calendar year 2007 would be paid in fiscal year 2008. The effect of this adjustment is to reduce the general tobacco industry payments to $166.3 billion for fiscal years 1999 through 2007. (Line II.1.a. of Table 4)

Estimated change in net revenues from Federal income and payroll taxes

The Joint Committee staff estimates assume that the general tobacco industry payments would be deductible for Federal income tax purposes and would be passed through to the consumer in higher prices for tobacco products. The effect is the same as an excise tax increase--resulting in a general reduction in Federal taxable income in the economy which in turn lowers income and payroll tax receipts. The composite tax rate used to assess the tax effect of this reduction in Federal taxable income is 25 percent. The effect of this adjustment is to reduce net Federal revenues by 25 percent of the general tobacco industry payments, or by $41.7 billion over fiscal years 1999 through 2007. (Line II.1.b. of Table 4)

Estimated change in net revenues from Federal tobacco excise taxes

As noted above, the Joint Committee staff estimates assume that the general tobacco industry payments would increase the price of tobacco products. This in turn would lead to reduced consumption of tobacco products. The regulatory regime of S. 1415 would be expected to further reduce tobacco consumption. As a result, net Federal revenues from the present-law tobacco excise taxes would be reduced compared with those in the January 1998 CBO baseline. The effect of this adjustment would be to reduce net Federal revenues by $16.3 billion over fiscal years 1999 through 2007. (Line II.1.c. of Table 4)

Estimated change in net revenues relating to State-by-State tobacco settlements

By the close of 1997, three States had entered into settlements to resolve litigation with a number of large tobacco manufacturers. The effect of these three settlements along with anticipated future State settlements reduced Federal tax receipts in the January 1998 CBO baseline.[18] S. 1415 gives States the option of continuing to receive payments from their individual State settlements or to receive payments under S. 1415 (but not both). The Joint Committee staff estimates assume many, but not all, States would elect to receive payments under S. 1415. As a result, net Federal revenues must be adjusted to back out the effect on Federal receipts attributable to State settlements that would be superceded by S. 1415. This adjustment would add back $14.7 billion over fiscal years 1999 through 2007. (Line II.1.d. of Table 4)

Net fiscal year Federal revenue effects of the annual payments

The net Federal revenue effects of the general tobacco industry payments is the total of the gross payments adjusted for the effects described above. The Joint Committee staff estimates an increase in net Federal revenues of $123.0 billion for fiscal years 1999 through 2007. (Line II.2. of Table 4 and also reported in Table 1)

Net revenues from look-back assessments

In addition, as explained above, the CBO estimates that some of the goals for reductions in underage smoking will not be met. The Joint Committee staff analyzes the look-back assessments in the same manner as penalty excise taxes. To arrive at a net revenue effect, the

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[18] A fourth State has entered into such a settlement in 1998, subsequent to the CBO's January 1998 baseline forecast.

Joint Committee staff adjusts the gross payments for changes in Federal income and payroll taxes and for reductions in present-law Federal tobacco excise tax receipts as explained above. (Line II.3. of Table 4 and also reported in Table 1)

Net fiscal year Federal revenue effects of S. 1415

The net revenue effect of S. 1415 is the sum of the net revenue effects of the annual payments and the net revenues from the look-back assessments. The Joint Committee staff estimates the enactment of S. 1415 would increase net Federal revenues by $131.8 billion in fiscal years 1999 through 2007. ("Total" line of Table 4 and also reported in Table 1)

TABLE 4.
RECONCILIATION OF GENERAL TOBACCO INDUSTRY PAYMENTS UNDER S. 1415, AS MODIFIED BY THE MANAGER'S AMENDMENT, AND NET FEDERAL REVENUE EFFECT OF SUCH PAYMENTS

Fiscal Years 1998 - 2007

[Billions of Dollars]

Provision	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	1998-07
I. Calendar Years											
1. Federal revenues from S. 1415 general tobacco industry payments as adjusted for inflation beginning in 2004	10.0	14.4	15.4	17.7	21.4	23.6	24.3	25.0	25.8	26.6	204.2
2. Volume adjustment beginning in 2002	---	---	---	---	-3.8	-5.0	-5.4	-5.8	-6.2	-6.6	-32.9
3. Gross payments	10.0	14.4	15.4	17.7	17.6	18.6	18.9	19.2	19.6	20.0	171.3
II. Fiscal Years											
1. Adjustments:											
a. Convert Federal revenues from S. 1415 general tobacco industry payments to Federal fiscal years	---	20.8	15.2	17.1	17.6	18.3	18.8	19.1	19.5	19.9	166.3
b. Change in net revenues from Federal income and payroll taxes (because of the impact of S. 1415 general tobacco industry payments on aggregate taxable income)	---	-5.2	-3.8	-4.3	-4.4	-4.6	-4.7	-4.8	-4.9	-5.0	-41.6
c. Change in net revenues from present-law Federal tobacco excise taxes (because of price increases from S. 1415 general tobacco industry payments)	---	-0.8	-1.2	-1.5	-1.9	-2.1	-2.2	-2.2	-2.2	-2.2	-16.4
d. Net revenue effect of replacing State-by-State tobacco settlements with S. 1415 payments	---	0.5	0.9	1.1	1.4	1.6	1.9	2.2	2.4	2.7	14.9
2. Net Federal revenues from S. 1415 general tobacco industry payments (JCT May 19, 1998 estimate)	---	15.4	11.0	12.5	12.8	13.2	13.8	14.3	14.8	15.4	123.2
3. Net look-back assessment [1]	---	---	---	---	---	---	1.0	0.6	4.0	3.1	8.7
Total	**---**	**15.4**	**11.0**	**12.5**	**12.8**	**13.2**	**14.8**	**14.9**	**18.8**	**18.5**	**131.8**

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

[1] This net revenue reflects the effect of reduced excise tax receipts because of the assumption that the look-back assessments are passed through in the price of tobacco products.

C. Analysis of the Distribution of Tobacco Payments

Table 5 below presents the Joint Committee staff analysis of the distribution by income class of the gross revenue raised by the initial, annual, and penalty payments under S. 1415 for each year between 1999 and 2003. The Joint Committee staff estimates the aggregate tax liability of the Federal individual income tax, payroll taxes, and excise taxes both under present law and under S. 1415, with the payments required under the bill treated like present-law excise taxes as explained above. From these data, the Joint Committee staff estimates an effective tax rate under present law and under S. 1415. Table 5 shows that, assuming consumers bear these payments in the form of higher prices for tobacco products, approximately 73 percent of the gross revenue raised by S. 1415 will be paid by persons with annual incomes of $50,000 or less.

Because consumption of taxed goods does not always rise proportionately with income, often excise taxes are perceived as imposing a larger burden on lower-income families (relative to income) than on middle- and higher-income families. The estimates in Table 5 of the incidence of the tobacco-related payments under S. 1415 are consistent with this view.[19] Some economists argue that family expenditures may be a better measure of ability to pay than is annual family income. Measured against expenditures, tobacco taxes appear less regressive than when measured against annual income.[20] Tobacco excise taxes also have a varying impact on families with similar incomes because the incidence of tobacco use varies by family.

While the estimates in Table 5 are consistent with estimates made by other analysts, it is important to recognize the limitations of the data that underlie these estimates. The primary data for an analysis of the distribution of the payments of cigarette excise taxes are from the Consumer Expenditure Survey. There is a tendency of people interviewed for the survey to under report their consumption of certain products, among them tobacco products. As a result, the national consumption of tobacco products as derived from the Consumer Expenditure Survey substantially understates total domestic tobacco product consumption as measured by the shipments from manufacturers. An adjustment must be made to the survey data to reflect more closely "true" total consumption. In addition, many analysts believe that income is under

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[19] Table 5 presents a distribution of the gross revenues received by the Federal Government from the imposition of the various payments under S. 1415. Table 5 assumes these receipts are paid by consumers in the form of higher prices for tobacco products. Table 5 reports only Federal receipts and not a measure of the economic burden of these payments. A measure of the economic burden would include estimates of the loss in consumer value from reduced use of a product that, prior to imposition of the payments, was enjoyed by consumers and also would include estimates of the gain in value from eliminating external harms created by the use of these products.

[20] United States Congress, Congressional Budget Office, *Federal Taxation of Tobacco, Alcoholic Beverages, and Motor Fuels*, June 1990.

reported in the Consumer Expenditure Survey. This is believed to be a particularly acute problem among low-income consumers. As a result, many low-income consumers report total consumption that far exceeds reported income. There are a number of reasons for these outcomes in the survey. Governmental transfer benefits may be under reported by survey respondents. Similarly, some low-income individuals may receive financial support from relatives and such support is not reported as income by the individual. For example, a college student may spend his or her parents' income, but report a low personal income. An individual who is temporarily out of work may draw down past savings to finance consumption but have a low current-year income. Both the college student and the temporarily unemployed individual may be measured as "low income" only temporarily. These problems in the survey data may make low-income tobacco product consumption look larger relative to income than it actually is.

TABLE 5
DISTRIBUTIONAL EFFECTS OF THE TOBACCO PAYMENT PROVISIONS OF S. 1415 AS MODIFIED BY THE MANAGER'S AMENDMENT

Calendar Year 1999

INCOME CATEGORY (2)	CHANGE IN FEDERAL TAXES (3)		FEDERAL TAXES (3) UNDER PRESENT LAW		FEDERAL TAXES (3) UNDER PROPOSAL		Effective Tax Rate (4)	
							Present Law	Proposal
	Millions	Percent	Billions	Percent	Billions	Percent	Percent	Percent
Less than $10,000........	$1,710	34.5%	$5	0.4%	$7	0.5%	5.7%	7.7%
10,000 to 20,000........	2,463	8.2%	30	2.2%	32	2.4%	7.9%	8.5%
20,000 to 30,000........	2,556	3.6%	70	5.2%	73	5.3%	13.5%	14.0%
30,000 to 40,000........	2,292	2.4%	95	7.0%	97	7.1%	16.1%	16.5%
40,000 to 50,000........	1,563	1.5%	101	7.5%	103	7.5%	17.5%	17.7%
50,000 to 75,000........	2,602	1.1%	242	17.9%	244	17.9%	19.7%	19.9%
75,000 to 100,000........	1,003	0.5%	203	15.1%	204	15.0%	22.5%	22.6%
100,000 to 200,000.......	190	(5)	283	21.0%	283	20.8%	24.8%	24.8%
200,000 and over..........	21	(5)	319	23.7%	319	23.4%	29.0%	29.0%
Total, All Taxpayers....	**$14,400**	**1.1%**	**$1,348**	**100.0%**	**$1,363**	**100.0%**	**20.6%**	**20.9%**

Source: Joint Committee on Taxation

Detail may not add to total due to rounding.

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(1) Includes gross payments by tobacco companies distributed equivalent to an excise tax.

(2) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable social security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, and [8] excluded income of U.S. citizens living abroad. Categories are measured at 1998 levels.

(3) Federal taxes are equal to individual income tax (including the outlay portion of the EIC), employment tax (attributed to employees), and excise taxes (attributed to consumers). Corporate income tax is not included due to uncertainty concerning the incidence of the tax. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis. Does not include indirect effects.

(4) The effective tax rate is equal to Federal taxes described in footnote (3) divided by: income described in footnote (2) plus additional income attributable to the proposal.

(5) Less than 0.005%.

TABLE 5
DISTRIBUTIONAL EFFECTS OF THE TOBACCO PAYMENT PROVISIONS OF S. 1415 AS MODIFIED BY THE MANAGER'S AMENDMENT

Calendar Year 2000

INCOME CATEGORY (2)	CHANGE IN FEDERAL TAXES (3)		FEDERAL TAXES (3) UNDER PRESENT LAW		FEDERAL TAXES (3) UNDER PROPOSAL		Effective Tax Rate (4)	
							Present Law	Proposal
	Millions	Percent	Billions	Percent	Billions	Percent	Percent	Percent
Less than $10,000........	$1,785	34.7%	$5	0.4%	$7	0.5%	6.0%	8.1%
10,000 to 20,000........	2,615	8.6%	30	2.2%	33	2.3%	7.7%	8.4%
20,000 to 30,000........	2,731	3.8%	72	5.1%	75	5.3%	13.4%	14.0%
30,000 to 40,000........	2,458	2.5%	98	7.0%	101	7.1%	16.1%	16.5%
40,000 to 50,000........	1,690	1.6%	106	7.6%	108	7.6%	17.5%	17.8%
50,000 to 75,000........	2,756	1.1%	250	17.8%	253	17.8%	19.6%	19.8%
75,000 to 100,000........	1,114	0.5%	213	15.2%	214	15.1%	22.5%	22.6%
100,000 to 200,000.......	225	0.1%	298	21.2%	299	21.0%	24.8%	24.8%
200,000 and over..........	27	(5)	332	23.6%	332	23.4%	29.1%	29.1%
Total, All Taxpayers....	**$15,400**	**1.1%**	**$1,406**	**100.0%**	**$1,421**	**100.0%**	**20.7%**	**20.9%**

Source: Joint Committee on Taxation

Detail may not add to total due to rounding.

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(1) Includes gross payments by tobacco companies distributed equivalent to an excise tax.

(2) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable social security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, and [8] excluded income of U.S. citizens living abroad. Categories are measured at 1998 levels.

(3) Federal taxes are equal to individual income tax (including the outlay portion of the EIC), employment tax (attributed to employees), and excise taxes (attributed to consumers). Corporate income tax is not included due to uncertainty concerning the incidence of the tax. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis. Does not include indirect effects.

(4) The effective tax rate is equal to Federal taxes described in footnote (3) divided by: income described in footnote (2) plus additional income attributable to the proposal.

(5) Less than 0.005%.

TABLE 5
DISTRIBUTIONAL EFFECTS OF THE TOBACCO PAYMENT PROVISIONS OF S. 1415 AS MODIFIED BY THE MANAGER'S AMENDMENT

Calendar Year 2001

INCOME CATEGORY (2)	CHANGE IN FEDERAL TAXES (3)		FEDERAL TAXES (3) UNDER PRESENT LAW		FEDERAL TAXES (3) UNDER PROPOSAL		Effective Tax Rate (4)	
							Present Law	Proposal
	Millions	Percent	Billions	Percent	Billions	Percent	Percent	Percent
Less than $10,000........	$2,003	37.5%	$5	0.4%	$7	0.5%	6.3%	8.7%
10,000 to 20,000........	2,982	9.7%	31	2.1%	34	2.3%	7.6%	8.3%
20,000 to 30,000........	3,135	4.2%	74	5.0%	77	5.2%	13.4%	13.9%
30,000 to 40,000........	2,833	2.8%	103	7.0%	106	7.1%	16.1%	16.6%
40,000 to 50,000........	1,964	1.8%	111	7.6%	113	7.6%	17.5%	17.8%
50,000 to 75,000........	3,138	1.2%	259	17.6%	262	17.6%	19.6%	19.8%
75,000 to 100,000........	1,327	0.6%	224	15.2%	225	15.2%	22.5%	22.7%
100,000 to 200,000........	283	0.1%	315	21.5%	316	21.2%	24.9%	24.9%
200,000 and over..........	36	(5)	347	23.6%	347	23.3%	29.2%	29.2%
Total, All Taxpayers....	**$17,700**	**1.2%**	**$1,468**	**100.0%**	**$1,486**	**100.0%**	**20.7%**	**21.0%**

Source: Joint Committee on Taxation
Detail may not add to total due to rounding.

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(1) Includes gross payments by tobacco companies distributed equivalent to an excise tax.

(2) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable social security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, and [8] excluded income of U.S. citizens living abroad. Categories are measured at 1998 levels.

(3) Federal taxes are equal to individual income tax (including the outlay portion of the EIC), employment tax (attributed to employees), and excise taxes (attributed to consumers). Corporate income tax is not included due to uncertainty concerning the incidence of the tax. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis. Does not include indirect effects.

(4) The effective tax rate is equal to Federal taxes described in footnote (3) divided by: income described in footnote (2) plus additional income attributable to the proposal.

(5) Less than 0.005%.

TABLE 5
DISTRIBUTIONAL EFFECTS OF THE TOBACCO PAYMENT PROVISIONS OF S. 1415 AS MODIFIED BY THE MANAGER'S AMENDMENT

Calendar Year 2002

INCOME CATEGORY (2)	CHANGE IN FEDERAL TAXES (3)		FEDERAL TAXES (3) UNDER PRESENT LAW		FEDERAL TAXES (3) UNDER PROPOSAL		Effective Tax Rate (4)	
							Present Law	Proposal
	Millions	Percent	Billions	Percent	Billions	Percent	Percent	Percent
Less than $10,000........	$1,945	35.4%	$5	0.4%	$7	0.5%	6.6%	8.9%
10,000 to 20,000........	2,943	9.4%	31	2.0%	34	2.2%	7.5%	8.2%
20,000 to 30,000........	3,116	4.1%	76	4.9%	79	5.1%	13.3%	13.8%
30,000 to 40,000........	2,826	2.6%	108	7.0%	111	7.1%	16.1%	16.6%
40,000 to 50,000........	1,975	1.7%	116	7.5%	118	7.6%	17.6%	17.9%
50,000 to 75,000........	3,093	1.2%	267	17.4%	270	17.4%	19.5%	19.7%
75,000 to 100,000........	1,364	0.6%	238	15.5%	240	15.4%	22.5%	22.6%
100,000 to 200,000.......	307	0.1%	332	21.6%	332	21.4%	24.9%	24.9%
200,000 and over..........	42	(5)	363	23.6%	363	23.4%	29.3%	29.3%
Total, All Taxpayers....	**$17,611**	**1.1%**	**$1,536**	**100.0%**	**$1,554**	**100.0%**	**20.8%**	**21.0%**

Source: Joint Committee on Taxation

Detail may not add to total due to rounding.

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(1) Includes gross payments by tobacco companies distributed equivalent to an excise tax.

(2) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable social security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, and [8] excluded income of U.S. citizens living abroad. Categories are measured at 1998 levels.

(3) Federal taxes are equal to individual income tax (including the outlay portion of the EIC), employment tax (attributed to employees), and excise taxes (attributed to consumers). Corporate income tax is not included due to uncertainty concerning the incidence of the tax. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis. Does not include indirect effects.

(4) The effective tax rate is equal to Federal taxes described in footnote (3) divided by: income described in footnote (2) plus additional income attributable to the proposal.

(5) Less than 0.005%.

TABLE 5
DISTRIBUTIONAL EFFECTS OF THE TOBACCO PAYMENT PROVISIONS OF S. 1415 AS MODIFIED BY THE MANAGER'S AMENDMENT

Calendar Year 2003

INCOME CATEGORY (2)	CHANGE IN FEDERAL TAXES (3)		FEDERAL TAXES (3) UNDER PRESENT LAW		FEDERAL TAXES (3) UNDER PROPOSAL		Effective Tax Rate (4)	
							Present Law	Proposal
	Millions	Percent	Billions	Percent	Billions	Percent	Percent	Percent
Less than $10,000........	$2,000	35.1%	$6	0.4%	$8	0.5%	6.9%	9.4%
10,000 to 20,000........	3,075	9.7%	32	2.0%	35	2.1%	7.5%	8.2%
20,000 to 30,000........	3,278	4.2%	78	4.8%	81	4.9%	13.2%	13.7%
30,000 to 40,000........	2,984	2.6%	114	7.1%	117	7.2%	16.2%	16.6%
40,000 to 50,000........	2,103	1.8%	120	7.4%	122	7.5%	17.6%	17.9%
50,000 to 75,000........	3,230	1.2%	280	17.3%	283	17.3%	19.5%	19.7%
75,000 to 100,000........	1,481	0.6%	252	15.6%	253	15.5%	22.6%	22.7%
100,000 to 200,000.......	350	0.1%	351	21.7%	351	21.5%	24.9%	25.0%
200,000 and over..........	51	(5)	383	23.7%	383	23.5%	29.3%	29.3%
Total, All Taxpayers....	**$18,553**	**1.1%**	**$1,614**	**100.0%**	**$1,633**	**100.0%**	**20.8%**	**21.1%**

Source: Joint Committee on Taxation

Detail may not add to total due to rounding.

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(1) Includes gross payments by tobacco companies distributed equivalent to an excise tax.

(2) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable social security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, and [8] excluded income of U.S. citizens living abroad. Categories are measured at 1998 levels.

(3) Federal taxes are equal to individual income tax (including the outlay portion of the EIC), employment tax (attributed to employees), and excise taxes (attributed to consumers). Corporate income tax is not included due to uncertainty concerning the incidence of the tax. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis. Does not include indirect effects.

(4) The effective tax rate is equal to Federal taxes described in footnote (3) divided by: income described in footnote (2) plus additional income attributable to the proposal.

(5) Less than 0.005%.

D. Other Economic Considerations

If increases in tobacco prices succeed in reducing consumption of tobacco products, the domestic tobacco industry can be expected to contract. To the extent that the farming of tobacco and production of tobacco products is geographically specialized, reduction in demand may lead to at least short-term economic dislocations in these geographic areas. For example, unemployment may rise among those currently employed in tobacco farming and tobacco product manufacturing. The severity of this economic dislocation would depend in part on the ability of the affected individuals to gain employment in different industries. Finding new employment may require some individuals to relocate to another region and/or undergo substantial retraining. The major tobacco-growing States are North Carolina, Kentucky, and South Carolina, followed by Virginia, Georgia, and Tennessee.

In addition to possible economic dislocations in tobacco-growing States, substantial reductions in tobacco consumption may be expected to reduce the revenues of all State governments, as all States impose tobacco taxes at the State level. Currently, tobacco taxes are a relatively more important revenue source for States than for the Federal Government. In 1994, States collected $6.7 billion in tobacco tax revenues, representing 1.8 percent of all State tax receipts.[21] By contrast, the Federal Government collected $5.9 billion in tobacco tax revenues in 1997, representing less than four tenths of one percent of Federal tax receipts.

Higher tobacco prices should induce fewer people to begin to use tobacco products. Thus, even if no existing tobacco users altered their behavior through time, a smaller percentage of the population would use tobacco products. Therefore, an increase in tobacco taxes could be expected to reduce the incidence of tobacco use in the long run, by a greater amount than any reduction achieved in the short run.[22] In the past, in the United States, population growth generally has made up for a reduced incidence of smoking such that the revenue yield of tobacco

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[21] Tax Foundation, Scott Moody, Editor, *Facts and Figures on Government Finance*, (Washington, D.C.: The Tax Foundation), 1998, pp. 260 and 284. Some local governments assess additional tobacco taxes which produced approximately $186 million in local governmental revenues in 1994 (*Facts and Figures*, p. 336). These revenues also would be expected to be reduced by reductions in tobacco consumption.

[22] A Canadian study finds that the price elasticity, that is, the behavioral response to price changes, is greater in the short run than in the long run. The study attributes this to the habitual nature of tobacco and argues that at first smokers quit, but that they eventually start smoking again. (See, Department of Finance, Canada, *Tobacco Taxes and Consumption*, June 1993.) This analysis does not appear to account for long-run aggregate behavior, such as fewer new-starting tobacco users.

taxes has increased through time.[23] However, if higher prices induce substantial declines in the incidence of smoking, the short-run revenue yield may overstate the long-run revenue yield. If the tobacco tax revenues are earmarked to fund certain programs, the potential for lower revenue in the long run than in the short run may be an important consideration for Government policymakers.

[23] There also have been increases in the tobacco excise tax rates that have further increased the revenue yield of tobacco excise taxes. However, if the downward trend in the incidence of smoking continues, lower rates of population growth in the future could cause tobacco revenues to fall in the absence of changes in tobacco tax rates.