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Sin Taxes: What Are They & What Are the Benefits and Harms From Imposing Them?

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What *are* sin taxes?

A *sin tax* is a tax levied on an often culturally disfavored but nonetheless legal and widely used product. The term "sin tax," however, is not as broad as it sounds and refers almost exclusively to taxes on tobacco, alcohol, and gambling. Although there have been a number of recent efforts to impose sin taxes on a greater variety of products, such as unhealthy food or firearms, almost all of these efforts have failed.

What is the purpose of sin taxes?

Generally, the purpose of a sin tax is two-fold. First, like all taxes, a sin tax is levied to raise revenue for government expenditures. Unlike other taxes, however, a sin tax is often enacted with the additional aim of reducing or eliminating the public's consumption of a particular product.

How can sin taxes generate a steady stream of revenue while simultaneously reducing the public's consumption of the product?

Simply stated, they cannot. If a sin tax succeeds in decreasing the public's consumption of the product upon which the tax has been imposed, then revenue generated by that tax will necessarily decline over time.

- **EX:** Most studies find that a 25% increase in the price of cigarettes due to a tax will almost immediately reduce consumption of cigarettes by slightly over 11%. In other words, if a state imposes a tax that raises the average price of cigarettes from $4 to $5 per pack, the demand for cigarettes will fall by about 11%.[1] Furthermore, consumption continues to fall for a number of years after the initial tax increase. As a result, taxes generated by the sale of cigarettes are likely to be lower than initial calculations might suggest.
- **Reliance on sin tax revenues to fund state services and programs can cause or exacerbate state fiscal problems.** Even if no new services or programs are created, expenditures on state services generally increase each year because of population growth, inflation, and increased state employee wages. Consequently, state revenues also must increase each year to maintain existing state services and programs. Revenue generated from sin taxes that succeed at reducing consumption cannot generally support existing state services and programs for very long; a gap between declining sin tax revenue and rising government expenditures will develop and grow over time. This gap is particularly problematic when states include in their budgets the amount of revenue initially expected from a sin tax increase without taking into account the reduction in consumption that is likely to follow.
- **Even if a sin tax fails to decrease consumption, it cannot keep pace with the rising costs of state services and programs.** Sin taxes are most often imposed on a per unit basis; that is, the rate is based not upon the *price* of the product purchased, but upon the *quantity* of the product purchased. As

[1] Iris J. Lav, *Cigarette Tax Increases: Cautions and Considerations,* (2002) http://www.cbpp.org/7-3-02sfp.pdf.

New Haven Office: 33 Whitney Ave. • New Haven CT 06510 • Phone: 203.498.4240 • Fax: 203.498.4242 | **Web Site:** www.ctkidslink.org
Hartford Office: 60 Gillett St. Suite 204 • Hartford CT 06105 • Phone: 860.548.1661 • Fax: 860.548.1783 | **E-mail:** voices@ctkidslink.org

a result, unlike a general sales tax, a sin tax does not vary in response to economic changes such as inflation. Thus, even if consumption of a product upon which a sin tax has been levied remains unaltered, revenue from that tax cannot keep up with a government's spending needs.

Who pays sin taxes?

Sin taxes are regressive; they represent a greater proportion of the income of poor and middle income households than of higher-income households. In other words, they disproportionately burden those less able to afford them.

- **EX:** Low-income people do not drink more than higher-income people, but a sin tax on alcohol represents a larger portion of their incomes.[2] In part, this is because a sin tax on alcohol is constant regardless of the type or price of the alcohol itself; the tax on a $5 bottle of wine is the same as the tax on a $50 bottle. Thus, those individuals who can afford expensive alcohol spend a smaller proportion of the price in taxes.
- **Sin taxes are regressive regardless of whether or not they induce lower-income people to reduce consumption.** Some studies have shown that lower-income people are more price-sensitive than higher income people, and therefore more likely to reduce consumption in response to sin tax increases. These studies have led some proponents of sin taxes to argue that sin taxes are less regressive than they first appear to be. Even if this is true, the only issue is *how* regressive these taxes are, not whether or not they are regressive.

Are there ways to reduce the harmful aspects of sin taxes?

Yes. There are several ways to implement a successful sin tax. Because sin taxes are a declining source of revenues:

- **Revenues from sin taxes could be budgeted as a one-time or short-term revenue gain.** States facing weak economies could use sin taxes as a one-time or short-term measure to fill in a gap in the state budget. This would avoid the problem of declining or stagnant revenues generated by sin taxes.
- **Revenues from sin taxes could be used to support cessation programs.** The revenues gained from cigarettes, alcohol and gambling could be funneled into anti-smoking, anti-drinking, and anti-gambling programs. Need for these programs would likely decline at the same time that the sin tax reduced consumption. Thus, declining revenues from reduced consumption would not be a problem.
- **Revenues from sin taxes could be coupled with an increase in another tax that generally grows faster than the economy and then both taxes could be put towards the same purpose.** This would result in a tax package that would grow, on average, at a rate sufficient to meet the normal increases in state expenditures. For example, an increased cigarette tax could be coupled with an increased income tax and applied to a single purpose.
- **To counteract the regressive nature of sin taxes, a portion of the revenues raised by sin taxes could be used to provide tax relief to low-income households.** These funds could be used to implement or increase such programs as a state Earned Income Tax Credit or a property tax/rent credit for low-income households.

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[2] Phineas Baxandall,"Taxing Habits," 13 *Federal Reserve Bank of Boston Regional Review* 19, 26 (2003).