NORTH CAROLINA CENTER FOR
PUBLIC POLICY RESEARCH INC.

NEWS RELEASE

For Immediate Release: December 13, 1982

CIGARETTE TAX EFFECTS EXAMINED BY CENTER FOR PUBLIC POLICY RESEARCH

The television commercial line goes, "When E.F. Hutton talks, people listen." If that is true, then North Carolina political leaders might have to re-examine their statements about the effects of the recent federal increase in the cigarette tax, says the North Carolina Center for Public Policy Research. This is because E.F. Hutton -- along with economists from Smith Barney, Forbes magazine, the U.S. Departments of Agriculture and Treasury, the National Bureau of Economic Research, and even the Tobacco Institute -- predict little, if any, effect on cigarette consumption from the federal tax increase. And, says author Bill Finger, what effects there are will likely be felt by North Carolina tobacco farmers rather than N.C. cigarette manufacturers.

In an article in N.C. Insight (Vol. V, #3) entitled "Cigarette Tax Increases -- Do they Hurt North Carolina's Economy?," Finger, who is also editor of the Center's quarterly N.C. Insight, asks two questions. First, when cigarette costs go up due to tax increases, does cigarette consumption decline? Second, if consumption does decline, will that have a negative impact on either North Carolina manufacturers tobacco farmers?

Effect of Tax Increase on Cigarette Consumption

Finger answers the first question by reviewing economic studies on what is called the "price elasticity" of cigarettes. In such studies, economists measure the ratio of the change in the number of cigarettes bought to changes in price. This calculation, called price elasticity, varies among products --such as salt, calculators, or cigarettes -- and also may vary among different types of smokers -- for example, young males and older females.

Finger reviewed research by the U.S. Treasury Department, the Smith Barney investment firm, the U.S. Department of Agriculture, the Tobacco Institute, economists Lewit and Coate at the National Bureau of Economic Research, and others. He found that economists think cigarettes are more like salt than calculators; that is, even significant increases in price may not cause significant declines in consumption. By contrast, a sharp price increase on calculators would be likely to significantly reduce consumption.

The federal tax increase of 8¢ per pack enacted by Congress in 1982 amounted to about a 10 percent price increase. On the low end of the research, U.S. Treasury Department and Smith Barney economists found that this 10 percent increase might lead to only a 4 percent drop in cigarettes bought. On the high end, even the Tobacco Institute, the cigarette manufacturer's trade association, estimated only a 7 percent decline in 1983 consumption. Lewit and Coate found that the main group of smokers likely to be affected by this price increase would be teenage males.

After finding that drops in cigarette consumption as a result of the federal tax increase are likely to be minimal, Finger goes on to ask whether North Carolina manufacturers or farmers will suffer under even these minimal declines. Here his research produces surprising findings. Cigarette manufacturers are unlikely to suffer in 1983, while farmers may suffer, but not solely because of the federal tax increase.

Effect on Manufacturers

The cigarette manufacturers appear to be able to absorb any ill effects from the tax increase through two means -- diversification into other product lines and an ability to substitute foreign tobacco for U.S. tobacco in cigarettes.

The Center for Public Policy Research reported last year that the six major tobacco companies have all diversified into other fields. The two North Carolina-based manufacturers have branched out -- R.J. Reynolds by acquiring Hawaiian Punch and Chun King Foods, and Philip Morris by acquiring Miller Beer and 7-Up. The companies have also begun using less domestic tobacco in their cigarettes. The Center's 1981 book-length study, entitled The Tobacco Industry in Transition, also found that U.S. flue-cured tobacco had dropped until it was 39 percent of the content of U.S. cigarettes in 1979.

These factors led both Forbes business magazine and E.F. Hutton to take the view that the federal tax increase will not hurt cigarette companies' profits at all. E.F. Hutton concludes, "Although excise tax increases on cigarettes have tended to affect unit volume in international markets, domestic price increases averaging 8.5 percent annually over the last three years appear to have had little or no effect on cigarette demand."

E.F. Hutton then predicts the future in these words: "Because of the pricing flexibility that exists in the cigarette industry, we believe that cigarette companies will be able to pass along to the consumers the excise tax increase without materially affecting unit volume; therefore we are not changing any of our earnings estimates."

Effect on Farmers

N.C. farmers are likely to feel some negative effects from the federal tax increase. But those effects are just as likely to come from factors other than the cigarette tax increase, says Finger. On November 30, 1982, U.S. Agriculture Secretary John R. Block announced a 10 percent reduction in the flue-cured tobacco quota, which will probably cut into farm profits. Block has also said that tobacco growers may have to pay more in contributions to cover the cost of the tobacco program. Under a law passed in 1982, tobacco producers are required to pay a 3-cents-a-pound assessment to help pay for the program.

While the increased use of foreign tobacco in domestic cigarettes helps the cigarette manufacturer, it hurts N.C. farmers. Finally, prices on the market were unexpectedly low this year. As a result, the Flue-Cured Tobacco Cooperative Stabilization Corporation had to purchase one-fourth of the 1982 tobacco crop with federal loans, and these costs will ultimately have to be borne by the farmers. All these factors will hurt North Carolina tobacco farmers.

The Center's research not only questioned conventional wisdom about the effects of the federal cigarette tax increase, it also highlighted a recent poll on North Carolinians' willingness to have the state cigarette tax increased. In June of 1982, the N.C. Office of State Budget and Management released the results of its N.C. Citizen Survey, a telephone poll of 800 adults across the state. Seventy-eight percent of those questioned had no objection to an increased cigarette tax. North Carolina now has the lowest state cigarette tax in the country, 2 cents per pack. Wisconsin has the highest, at 25 cents per pack, while the national average for state taxes is 14.23 cents. The average among the Southern states, where a majority of the U.S. tobacco is grown, is 11.77 cents per pack. (Comparative Southern and national tax and revenue figures appear with the magazine article.)

Copies of the magazine may be obtained for $1.75 and copies of the book, The Tobacco Industry in Transition for $23.95. Write the N.C. Center for Public Policy Research at P. O. Box 430, Raleigh, North Carolina 27602.

For more information, call Bill Finger at (919) 832-2839.