Economic Policy Institute

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POLICY MEMORANDUM

DATE: July 24, 1990

SUBJECT: EXCISE TAXES: NOT REGRESSIVE?
Comments on the CBO Study, Federal Taxation *of Tobacco, Alcoholic Beverages, and Motor Fuels*

Many people now agree that the principle of progressive taxation -- the criterion that taxes should be levied according to the ability to pay -- is essential to any deficit reduction plan with a claim to fairness. Otherwise, the burden of deficit reduction will fall on middle- and low-income taxpayers who work for a living. These are people who have already suffered under the upward redistribution of income and wealth and the downward shift in the tax burden over the past ten years. As the title of a 1987 Economic Policy Institute report urged, we should send *the bill for* the *budget* deficit *to those who went to the party.*

Making a tax system more progressive, in turn. has generally been understood to mean relying more on the revenue obtained from taxing personal incomes, particularly among upper income taxpayers, and relying less on sales, excise and other consumption taxes that are regressive -- the smaller the income the larger is the share of it that is taxed. Recently, however, some have begun to argue that raising taxes on consumption would not violate principles of fairness. For example. a Washington *Post* editorial (Monday, July 16, 1990) cited a recent study by the Congressional Budget Office entitled *Federal* Taxation *of Tobacco,* Alcoholic Beverages, and Motor *Fuels* (June 1990).

According to the editorialist, the study purports to show that excise tax increases "would be less regressive than commonly thought."

This memorandum examines the extent to which the CBO study supports a reconsideration of the fairness of taxes on consumption.

CBO's keystone argument is that because consumer expenditures on some items subject to excise taxes -- motor fuels, alcoholic beverages, and tobacco -- rise as expenditures increase, tax increases on these items are not regressive. This analysis is a radical departure from the normal measure of tax burden -- that is, its incidence relative to <u>income</u>.

The difference can be illustrated with a simple example. Suppose Mr. A earns $11,000 per year and spends $10,000 out of his income. Mr. B earns $150,000 and spends $100,000. Mr. A spends $250 per annum on beer, including $25 on beer taxes; Mr. B spends $2.500 on Scotch whiskey, including $250 on whiskey taxes. CBO notes, in effect, that if both gentlemen pay 10% of their alcoholic beverage expenditure in excise taxes, their excise tax liabilities are the same percentage of their total expenditure -- 0.25% -- since their alcoholic beverage expenditures are each 2.5% of their total consumption.

It will be noticed immediately, however, that Mr. A's excise tax liability is greater relative to his income -- 0.23% -- than Mr. B's tax relative to his income -- 0.17%. This satisfies the traditional criterion for a regressive tax: the share the tax takes of one's income diminishes as income rises. (It should be noted, by the way, that in the same study discussed here, CBO presents data which strongly confirm the regressivity of excises by the traditional criterion.)

CBO's new concept is that *over* his lifetime, Mr. B will only benefit from his income insofar as he spends it and therefore we should measure tax incidence against the income he spends, not the income he receives;

OBJECTIONS TO THE CBO APPROACH

1. Mr. A pays the same tax regardless of whether he has to take care of children or other dependents, whether or not he is disabled, whether he has extraordinary medical costs, or whether he labors under any other expenses which the tax code permits him to deduct from his taxable income. Although the same is true for Mr. B, such costs for Mr. A, and the costs of basic necessities in general, are likely to claim a larger share of his income and expenditure than for Mr. B. That's why Mr. B can save 3396 of his income and Mr. A only 10%. It is well known that savings rates generally increase with income.

2. Choosing total expenditure as an index of ability to pay presumes that Mr. B's financial assets are of no consequence to his well-being, nor is the bequest he is able to leave to his heirs, nor is the surplus of wealth such a fortunate family is able to accumulate over the years.

3. The argument neglects Ms. C, who earns and spends the same in total as Mr. A, but is able to escape taxation entirely by virtue of ignoring the temptations of drink. There is also their country cousin Mr. D, who is in the worst shape of all. He has the same income as Mr. A and Ms. C and the drinking habits of Mr. A, but he drives more, so he also pays more gasoline taxes. Thus, it can be clearly seen that all excises violate the principle of horizontal equity -- people in the same economic circumstances *should* pay the same tax.

4. The argument ignores what else we have been doing to Mr. A, Ms. C, and Mr. D: increasing their payroll taxes (and using the surplus to finance general government expenditure), and increasing their state and local taxes (due to cuts in federal grants to state and local governments).

5. The CBO study claims that a tax on motor fuels is a benefit *tax*, or in words favored by the Office of Management and Budget, a "user fee." Such a tax is judged fair because you get back what you pay for in the form of public services, in this case public transportation. (This argument, it should be

noted, is irrelevant to the tobacco and alcohol excises.)

It is true that federal taxes on motor fuels are dedicated in principle to public transportation expenditures. In practice, however, surpluses in gas tax revenues, like the Social Security surplus, have been used to defray the general deficit. So if gasoline tax revenues are used for deficit reduction, the benefit character of the proposed tax increase evaporates.

6. CBO's data show that excises have a disparate effect on families headed by younger adults. On average such families include younger children. Thus, in the name of securing the nation's future through deficit reduction, raising excise taxes would force young families to continue to bear a disproportionate share of the cost of the defense spending binge, the Reagan tax cuts, and the S&L scandal, notwithstanding the fact that fewer workers in such families will be around in the future to support a growing number of Social Security retirees. And notwithstanding the increase in regressive payroll taxes they have been burdened with over the last decade.

7. CBO states that state and local excises are lower as a share of state-local revenue, relative to prior years. The implication is that they don't need these revenue sources.

In fact. any additional federal encroachment on these traditional state and local revenue sources makes it more difficult for state and local governments to collect or increase their own excises. The higher the federal rate on any such good, the more costly it is to the taxpayer to pay an additional tax to his state government, and the more reluctant he/she will be to do it. The encroachment is doubly egregious in light of the past decade's cutbacks in federal support for state and local public spending, due to cuts in grants-in-aid, limits in subsidies to state and local revenue through the federal income tax, and increases in unfunded federal mandates placed upon state and local governments.

8. CBO notes that excises in the U.S. are lower, relative to **GNP, than they** used to be, and lower relative to GNP than in other countries. The point

is irrelevant. Tax policy should seek to make the tax system more just and more efficient, not more like other countries or more like it used to be.

9. In terms of specific taxes, CBO's own data show:

— Motor fuel consumption increases from the bottom to the middle expenditure quintile (e.g., 20% of the population) but decreases thereafter. Thus the richest 20% of the population pay a lower percentage of their expenditures for the tax than the middle 60% of the population.

-- Tobacco tax liability decreases relative to total expenditure as total expenditure increases, so even by this new criterion tobacco taxes remain regressive.

-- CBO predicts that a tax increase on alcoholic beverages would be mildly progressive with respect to total expenditure. But CBO admits that its estimation method understates the regressivity of these taxes because it is based on the assumption that Mr. A's beer costs the same per ounce as Mr. B's Scotch whiskey.

SUMMARY

Those who use the CBO's new and eccentric definition of tax incidence to argue for more taxes on consumption are slipping into the posture that proportional taxes (which is the best face it is possible to put on these excise taxes) are acceptable -- that a new, lower standard of economic justice is appropriate. Moreover, no matter what criteria for the tax burden one uses -- income or expenditures -- increasing excise taxes will mean an increased tax burden on the poorest Americans.

Professor Richard A. Musgrave, often referred to as the dean of public finance, pointed out in a study for the Economic Policy Institute (Strengthening *the Progressive Income Tax: The* Responsible Answer *to America's Budget Problem),* that the only existing source of tax revenues sufficiently large to deal with the deficit problem, and deal with it fairly, is the federal personal income tax. Concerning taxes on consumption, he said:

> "Resort to the excise [tax] route would involve an ad hoc selection of inferior tax bases ... Dallying with the deficit problem by upping excise taxes might offer a politically attractive way of pretending that the deficit problem is being dealt with, but little would be accomplished and the quality of the tax system would be impaired."

The economic sins of the 1980s were not driving, drinking. or smoking by the average American family. They were ill-considered tax cuts for the wealthy, an unfunded defense spending binge, and the blind deregulation of the savings and loan industry. The bill for these sins should be paid by those who benefitted the most and who are most able to pay, and such a bill can best be collected through the personal income tax.

- Max Sawicky