Taxing Sin: A Win-Win for Everyone?

By Bruce Bartlett

Bruce Bartlett is a former Treasury deputy assistant secretary for economic policy. His latest book is *The New American Economy: The Failure of Reaganomics and a New Way Forward*, published by Palgrave Macmillan in 2009.

In this article, Bartlett reviews the history of taxing sin in the United States, showing that revenue needs usually triumph over sumptuary considerations. He suggests that this may lead to legalization of at least some illegal drugs so that they can be taxed, as recently proposed in California in the case of marijuana.

Economists have long known that there is a tension between the dual goals of taxing sin (alcohol, tobacco, gambling, etc.) because the more successful the tax is at discouraging the sinful activity, the less revenue the government raises. This problem was highlighted recently by Russian Finance Minister Alexei Kudrin. After announcing plans to raise taxes on cigarettes and liquor, he nevertheless urged Russians to keep smoking and drinking, saying the activities are good for the state by helping finance social services and programs to raise the birth rate.[1]

Taxing sin is nothing new, of course. Among the earliest federal taxes were those on alcohol, tobacco, and playing cards, and they remained mainstays of the federal revenue system until the creation of the corporate and individual income taxes in 1909 and 1913, respectively. In 1900, 50 percent of all federal revenue came from taxing alcohol, tobacco, and playing cards; the rest mostly came from customs duties. Today, taxes on alcohol and tobacco constitute just 1 percent of federal receipts.

Related to taxes on sin are taxes on luxuries — things people could easily do without or are consumed almost exclusively by the rich. Over the years, the federal government has had special taxes on carriages, refined sugar, watches, yachts, billiard tables, gold and silver plate, furs, jewelry, electrical appliances, luggage, phonographs and recordings, cameras and film, and many other items.[2]

Sin taxes represent a somewhat more important revenue source at the state and local level. According to the Census Bureau, taxes on alcohol and tobacco constitute 1.8 percent of total state and local government revenue, a percentage that has been about the same for at least 20 years, despite significant increases in tax rates on both products. The higher rates have been offset by lower consumption.

In recent years, there have been many efforts to expand sin taxes to include other activities that are thought to be socially harmful — or perhaps just not socially favored. These include taxing sugary drinks, strip clubs, fast food, firearms, pornography, escort services, cosmetic surgery, plastic shopping bags, tanning salons, and many others.[3]

Of course, it's not just a puritanical desire to encourage people to live better lives that underlies the expansion of sin taxes. Clearly, the pressing budgetary needs of governments at all levels are driving a desperate search for revenue. And given voters' strong opposition to increases in broad-based taxes, sin taxes are one of the few areas potentially available for additional revenue.[4] That's partly because those not engaging in the allegedly sinful activities targeted for taxation usually don't care, and because those who do often feel guilty about their indulgences and view sin taxes as a sort of penance.

The drive to raise revenue isn't limited to imposing new taxes and raising rates on sinful activities. It also has led to the legalization of previously illegal activities such as gambling and the relaxation of so-called blue laws. Sunday closing laws have been abolished or liberalized in many states partially because legislatures hoped that additional opportunities for shopping would raise sales tax revenue.

Historically, efforts to abolish smoking and drinking ended in large part because they prevented governments from taxing those activities and imposed additional costs in the form of law enforcement and incarceration.

[1]Bess Levin, "'People Should Smoke and Drink More,' Says Russian Finance Minister," *London Telegraph*, Sept. 1, 2010.

[2]Louis Alan Talley and Dennis Zimmerman, "Excise Taxation of Luxury Goods: A History and Economic Assessment," Congressional Research Service Report for Congress RL30049 (Feb. 4, 1999), at pp. 6-8, *Doc 1999-5866*, *1999 TNT 30-136*.

[3]Catherine Rampell, "For Cash-Strapped States, Sin Is Sure Lucrative," *The New York Times*, Apr. 18, 2010, at WK5; Janet Novack, "Pole Dancing and Other Sins," *Forbes*, May 10, 2010, at 28 and 30; Cari Tuna and Justin Scheck, "Strapped States Find New Virtues in 'Vice,'" *The Wall Street Journal*, May 11, 2010.

[4]Phineas Baxandall, "Taxing Habits: When It Comes to State Taxes, Sin Is In," *Federal Reserve Bank of Boston Regional Review*, 1st Quarter 2003, at 19-26.

The classic example, of course, is Prohibition. It could come into existence in the first place only because the income tax had given the federal government a way to replace revenue from the alcohol tax. The vast increase in income taxes during World War I significantly reduced alcohol taxes as a share of federal revenues — by 1918 they were down to just 12 percent of federal receipts.

Needless to say, Prohibition caused alcohol tax revenues to collapse, although they never completely disappeared because of some permissible alcohol production. The onset of the Great Depression, however, led to a sharp decline in all federal revenues. The potential revenue gain to the government became a key argument for those in favor of repealing Prohibition.[5] Thus, revenue considerations were crucial both to the rise of Prohibition and to its abolition in 1933.[6]

A parallel story is told about cigarettes. During the 1890s and the early part of the 20th century, there was a powerful national campaign to abolish smoking that was no less intense than the drive for Prohibition.[7] A key reason the campaign ultimately fizzled out in the 1920s was the government's need for tobacco tax revenues, especially after alcohol tax revenues dried up. The Republicans' cuts in income taxes in the 1920s also increased the federal government's dependence on tobacco tax revenues, which rose from 4 percent of federal receipts in 1920 to 11.2 percent in 1929. The onset of the Great Depression, the concomitant fall in income tax revenues, and the inelasticity of demand for cigarettes caused tobacco revenues to rise to 20.7 percent of all federal receipts by 1932.

In the end, revenue needs trumped sumptuary considerations in the cases of both alcohol and tobacco.[8] This raises the interesting question of whether revenue considerations will drive reform of the laws against illegal drugs.

In November California voters will turn thumbs up or down on Proposition 19, a ballot measure that would permit cities and counties to allow the legal sale of marijuana, which would be taxed and regulated similarly to alcohol. The revenue potential of taxing marijuana is a major argument for the proposition in cash-strapped California.[9]

Last year, California's State Board of Equalization estimated the revenue potential of Prop. 19 at $1.4 billion at both the state and local government level.[10] A study from RAND Corp. estimated that the state is spending about $300 million per year enforcing current marijuana laws — an amount that presumably would be saved in the event of legalization.[11] An important uncertainty about the fiscal effect of Prop. 19 is how the federal government will react in the event of passage, given that marijuana would continue to be an illegal substance under federal law.[12]

Harvard economist Jeffrey Miron has looked at the fiscal impact of legalizing all drugs at the national level. His latest analysis estimates that if all illegal drugs were taxed similarly to alcohol and tobacco, aggregate governmental tax revenue would increase by $46.7 billion annually. It also would save $41.3 billion per year in government enforcement costs — $25.7 billion for state and local governments and $15.6 billion for the federal government.[13]

There are lots of reasons beyond the pecuniary why one might argue that the war on drugs has been a failure and that reform of the drug laws is long overdue. But it's also a fact of life that pressure to change failed policies that may still enjoy significant political support has often been motivated by fiscal considerations. In Virginia, for example, the prospect of obtaining almost $500 million for needed transportation projects while still raising the same annual revenue from alcohol taxation is driving the state to sell its liquor monopoly — something most economists think should have been done long ago.[14]

Perhaps the lesson to be drawn from the historical experience is that prohibiting nonviolent activities and substances that people are going to insist on doing or using anyway will never stamp them out. But if they are legalized, controlled, and taxed, society may be able to keep them within acceptable bounds while raising significant government revenue exclusively on the backs of those who insist on engaging in the behavior. That's about as close to a win-win situation as one is going to find in the public policy arena.

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[5]The Democratic Party's 1932 platform: "We favor immediate modification of the Volstead Act; to legalize the manufacture and sale of beer and other beverages of such alcoholic content as is permissible under the Constitution and to provide therefrom a proper and needed revenue."

[6]Donald J. Boudreaux and A.C. Pritchard, "The Price of Prohibition," *Arizona Law Review*, Spring 1994, at 1-10; Daniel Okrent, op-ed, "No Closing Time for Income Taxes," *The New York Times*, June 13, 2010, at WK11.

[7]Cassandra Tate, *Cigarette Wars: The Triumph of "The Little White Slaver"* (New York: Oxford University Press, 1999).

[8]Jendi B. Reiter, "Citizens or Sinners? — The Economic and Political Inequity of 'Sin Taxes' on Tobacco and Alcohol Products," *Columbia Journal of Law and Social Problems*, Spring 1996, at 443-468.

[9]Jesse McKinley, "Latest Legal-Marijuana Push Is All About the Tax Revenue," *The New York Times*, Mar. 26, 2010, at A1.

[10]Prepared Testimony of Robert Ingenito before the California State Assembly Committee on Public Safety, Oct. 28, 2009, *available at* http://www.boe.ca.gov.

[11]Beau Kilmer et al., *Altered State? Assessing How Marijuana Legalization in California Could Influence Marijuana Consumption and Public Budgets*, RAND Corp. 2010.

[12]California Legislative Analyst's Office analysis, Sept. 9, 2009, *available at* http://www.lao.ca.gov/ballot/2009/090512.aspx.

[13]Jeffrey A. Miron and Katherine Waldock, "The Budgetary Impact of Legalizing Drugs," Cato Institute, study forthcoming. *See also* Miron, "The Budgetary Implications of Drug Prohibition," paper prepared for the Criminal Justice Policy Foundation, Feb. 2010, *available at* http://www.economics.harvard.edu/faculty/miron/files/budget%202010%20Final.pdf.

[14]Anita Kumar and Rosalind S. Helderman, "McDonnell Unveils Plan to Privatize Va. Liquor Sales, But Skeptics Question Taxes," *The Washington Post*, Sept. 9, 2010.