"Premium Tobacco Seeking Tax"

Rent Seeker (2006)

Premium Tobacco Seeking Tax to Hurt Generic Brand

U.S. Tobacco, which produces premium tobacco like Copenhagen, has for years lobbied states to impose an excise tax *per unit* of smokeless tobacco, rather than the usual *ad valorem* tax which is based on the final selling price.

Their latest attempt included some coaxing by public officials, specifically the governor of New Mexico. From The Albuquerque Journal article in mid-May:

Gov. Bill Richardson has taken tens of thousands of dollars worth of free corporate jet flights from the world's largest smokeless-tobacco company in his role as head of the Democratic Governors Association.

That company - UST, the parent corporation of the firm that makes Skoal, Copenhagen and other brands - lobbied hard at the New Mexico Legislature earlier this year for a tobacco-tax change that critics said would have exclusively benefited UST.

The bill, sponsored by Richardson's chief legislative ally, House Speaker Ben Lujan, passed the House after a state financial impact report to lawmakers was drastically changed using UST's numbers. The measure ran out of steam in the Senate, where it died.

Further down in the article:

Chewing tobacco in New Mexico is taxed at 25 percent of the manufacturer's price, meaning higher-priced products such as Skoal and Copenhagen are taxed more than budget brands.

Lujan's bill would have linked the tax to weight, meaning a budget brand of the same weight would have carried the same tax as a can of Skoal. Cigarettes in New Mexico are taxed at 91 cents a pack, regardless of price.

Why would UST be interested in supporting a tax on its own product?

Simple. Because a per unit tax makes its price cheaper compared to the generic brand competitor.

For example, say Skoal costs $10 per can, while Generic Brand costs $2 per can. The relative price is 5 to 1. If there's a $5 tax imposed on all smokeless tobacco, Skoal's price will rise to $15, while Generic Brand's price rises to $7 -- pushing the price ratio down to just 2 to 1.

The end result? Skoal gets cheaper compared to Generic Brand after the tax hike. And so they lobby for it. Clear rent seeking.

On the other hand, if we just taxed them both at, say, 10 percent each, the price ratio between them stays the same. So the end result is that Skoal -- that is, UST, the producer of Copenhagen -- lobbies for a higher tax, up to the point where the gain from moving from Generic Brand to Skoal is just offset by people quitting smokeless tobacco altogether.

So what's the right policy? That depends on the reason for the tax.

If the goal in taxing smokeless tobacco is to correct for some negative externality, then a quantity-based excise tax should be in place. In contrast, if the goal of the tax is just to raise revenue like any other tax, then it should be an ad valorem tax.

But whatever the case, it shouldn't be designed by rent-seekers aiming to transfer profits from a competitor to itself -- at the expense of economic efficiency and the right of companies to compete on an even playing field.